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# EDITED TRANSCRIPT

EL - Q1 2014 The Estée Lauder Companies Inc. Earnings Conference Call

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## OVERVIEW:

Management discussed 1Q14 results, reporting net earnings of \$301.6m or \$0.76 per diluted share on net sales of \$2.68b. Guidance was for 2Q14 EPS of \$0.99-1.04 on sales up 3-5% in local currency vs. 2Q13, and for FY14 EPS of \$2.80-2.87 on sales up 6-8% vs. FY13 in constant currency.



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## PRESENTATION

### Operator

Good day everyone and welcome to The Estee Lauder Companies fiscal 2014 first-quarter conference call. Today's call is being recorded and webcast. For opening remarks and introductions, I would like to turn the call over to the Vice President of Investor Relations, Mr. Dennis D'Andrea. Please go ahead sir.

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**Dennis D'Andrea** - *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 Carl Haney, Executive Vice President, Global Research and Development, Corporate Product Innovation and Packaging Development. Carl will give a strategic overview of our innovation program.

Since many of our remarks today contain forward-looking statements, let me refer you to our press release and our reports filed with the SEC, where you'll find factors that could cause actual results to differ materially from these forward-looking statements. 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.

And I'll turn the call over to Fabrizio now.

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

Thank you, Dennis, and good morning everyone. I am pleased to say that this fiscal 2014 is off to a strong start, as our strategy continued to fuel progress in many areas.

During our first quarter we had good global success from innovations; gained meaningful market share in Asia, China and the UK; and continued to attract new consumers to our brands.

Our sales rose 6% in local currency, in line with our guidance. Importantly, our growth came from every major category and every region, illustrating once again broad-based success thanks to our diverse portfolio of brands and unparalleled high-touch service.

Diluted earnings per share were \$0.76 which was better than we had anticipated. Continuing a trend we have seen in recent quarters, our biggest winners were our luxury brands as well as MAC, which were all up double digits.

China and other emerging markets advanced sharply as did our online and travel retail channels.

Our fragrance business was also an important contributor to sales growth thanks to increased launch activity, excellent innovation and robust sales in the ultra-prestige tier. As we anticipated, the US prestige beauty was somewhat soft, driven by low traffic in stores in July and August, but it improved in September. Overall prestige growth in the quarter was just about half the pace of a year ago and the environment was more promotional.

Many consumers sought value about prestige beauty products that were either advertised innovations or promotions. In this environment, our brands focused on driving innovation and did not increase their promotions.

In the US, we started gaining share in fragrance for the first time in several years. Also five of our brands, mainly in luxury, increased their share of prestige beauty. Our products held nine of the top 10 SKUs in prestige skincare and eight of the top 10 in makeup.

Our performance in Europe, the Middle East and Africa was encouraging, led by continued strong results in the UK and healthy retail sales in emerging markets. Some Western European markets remained challenging for prestige beauty. But in several of them, we outperformed the general trend.

In France for instance, prestige beauty struggled. But many of our brands resonated well with consumers, which fueled good retail sales. The same was true in Germany, Italy, and the Benelux countries.

Asia Pacific was our strongest region led by sharp gains in greater China. Retail growth in China was also strong and like-door growth improved over the preceding quarter. Results in Japan again were positive, posting local currency growth for the seventh consecutive quarter. And Australia showed signs of a turnaround as we generated mid-single-digit retail sales growth.

Our business in Korea is stabilizing, but the difficult prestige beauty environment continued and our sales there declined moderately.

Driving our growth is a well-defined focus on product and service innovations, as Carl will soon elaborate. As a global company, we are innovating for a diverse world. And two of our biggest launches in the quarter came from our two biggest brands.

The cutting edge technologies used in Estée Lauder's new Advanced Night Repair Serum helped drive growth in the brands ANR franchise, and its skincare category. Retail sales of ANR products climbed sharply in Asia and North America during the quarter.

Clinique's new blockbuster Dramatically Different Moisturizing Lotion+, met our expectations, and had widespread acceptance globally, thanks to its enhanced technology and increased moisturizing benefits. For example in the UK, where Clinique is the number one prestige beauty brand, sales of DDML+ rose strong double digits at retail during the quarter.



While these two products are among our most publicized and visible launches, our innovation spans our complete portfolio. Even though we are focused on creating more impactful innovations, all brands launch innovations that are meaningful relative to their size.

Innovation is integral to reenergizing our fragrance category to drive profitable growth. So we recently introduced several important new scents.

Estee Lauder rolled out Modern Muse to select countries in September, marking its first new major fragrance in a decade. It quickly became a bestseller in Harrods in the UK and reached the top 10 in the US for women's prestige fragrances in September. , its first months at counter, and has continued to climb since then.

We have high expectations for this exciting fragrance during the holiday season.

Other successful fragrance launches include Michael Kors collection, which helped drive our strong fragrance retail sales in North America. Additionally, Tory Burch launched exclusively in Bloomingdale's in the last week of September and has held the number one spot in the retailer since then.

Another new newcomer, Zegna Uomo, was well-received and has been the top seller in Boots in the UK since its launch two months ago. In our ultra-prestige tier, Tom Ford fragrances have been significant growth around the world and Jo Malone's new scent, Peony and Blush Suede, has been the brand's best selling innovation ever.

Many of our fragrances have been backed by strong advertising campaigns to build awareness leading up to their peak selling period.

Our business model for fragrance launches seeks to improve the success rate by introducing them selectively in certain markets, and often after testing the waters. For instance, based on Michael Kors' strong results in the United States in the first quarter, we plan to expand the new collection to Europe.

Our sales growth also stems from high-growth channels, which continued to advance rapidly. In e-commerce for example, both brands and retailer sites had substantial gains, resulting in excellent double-digit sales growth.

In the US an increasing amount of our sales in prestige department stores are coming from their e-commerce sites. And that channel is also a key component of the retailers' growth.

Consumers in China are also migrating to shopping online much faster than we anticipated. Even though e-commerce is a small percentage of our business in China, our online sales more than doubled from a year ago.

Turning to our travel retail business, our retail sales growth was more than twice the rate of passenger traffic growth. We saw a significant spike in Asia, most notably in Thailand, Japan and China due in part to an increase in Chinese travelers. Our recent skincare innovations are selling well and our travel retail business should benefit from the addition of the new fragrances.

As part of the ongoing effort to expand our brand's presence in this profitable channel, we opened 27 doors in the recent period. We also invested in expanding our global network of freestanding stores, having opened approximately 20 new ones this quarter, nearly all in international markets.

Sales in our retail location climbed double digits, with the strongest growth coming from international stores. In particular, MAC flagships in New York and Paris generated higher average unit sales and items per transaction than other MAC freestanding store in the US or France.

In emerging markets, our expansion continued into smaller cities which are providing the fastest growth. For instance, in China we entered five new tier 3 and 4 cities, and this strategy also has been successful in other countries like Brazil.



To support our growth, we increased our advertising, merchandising and sampling in the first quarter, using a mix of in-store, print, TV and digital depending on what was appropriate for the product and the country. Importantly, we continue to invest in many capabilities to sustain our growth including innovation and retail store operations, and our SMI adoption continues to progress smoothly.

As we have said before, our main priority is to drive our topline and leverage that growth for continued margin expansion. Heading into the holidays, we are upbeat about our product offering and believe our retail sales growth will accelerate for several reasons.

First, our major innovations are succeeding globally. And the marketing investments that we made in the first quarter and will continue to make should propel their momentum. Moreover, we have many other innovations on the horizon across all our product categories that we expect to contribute to higher sales.

Additionally, we are much better positioned to have a stronger performance in fragrance this year, thanks to our new launches, and believe we will be able to gain share. Our brands' wide collection of desirable fragrances covers a broad range of tastes and price points that should generate higher sales during the second quarter and beyond.

Lastly, as the year goes on, the markets that have been challenging, including Korea, are facing easier comparisons. We continue to believe that global prestige beauty will grow 3% to 4% in fiscal year 2014. And our intent is to expand twice as fast.

We are forecasting topline growth of 6% to 8% in local currency even as we navigate several soft markets. We are confident we can achieve this ambitious goal because more than one-third of our business is growing by double digits. And the rest can keep pace with prestige beauty, confirming the resilience of our multibrand and multichannel strategy.

I want to thank everyone in our organization for their hard work and dedication, which has enabled us to start the year well. As we continue on our strategic journey, we carefully consider what paths to take. We are selective and pursue only the right opportunities, those we consider the most promising, that will enhance our leadership in global prestige beauty.

Our creativity and imagination will lead with strong innovation will be key to our success in fiscal year 2014. And now I'll hand over to Carl to give you more detail on our innovation process and plans. Carl?

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**Carl Haney** - *The Estée Lauder Companies Inc. - EVP of R&D, Product Innovation & Brand Product Development*

Thank you, Fabrizio, and good morning to everyone. I am pleased to join you today to share a few words on the research development, product and packaging innovation that is the backbone of The Estée Lauder Companies.

I joined the Company nearly two years ago following more than 25 years at Procter & Gamble with previous responsibilities including male grooming, cosmetics and beauty care.

Our R&D and innovation organization is composed of hundreds of industry-leading scientists, engineers and managers working in five major research centers around three continents. These talented innovators partner with our brand and product development leaders to fuel our innovation pipeline to deliver short and long-term results directly linked to our Company's strategy and 10-year compass.

We have a diverse and talented team with deep expertise focused solely on prestige beauty. Over the past few years, we've been reinforcing our upstream capabilities globally and have recently doubled our investment in Asia.

Our innovation centers have been designed to be close to the most demanding consumers we serve and are structured to drive local relevance for a diverse multiethnic world. Our goal is to foster innovation in these centers to develop products for the largest and fastest-growing categories and segments.



We research, design and test where our consumers live and shop, giving us insight into their behaviors and desires. For instance, our R&D center in Shanghai taps into the personal customs and skincare requirements of the fast-growing Chinese market and provides valuable local insights. Local relevance is something you can expect to see even more of going forward.

Creativity and innovation is part of our DNA and drives everything we do. We complement our internal capability with a long-standing and growing network of external innovation partners. These include world-class labs, universities, suppliers, and cutting edge technology research centers.

We also leverage creativity and innovation from every chair, tapping into the latest trends and consumer insights from thousands of professional makeup artists, hairstylists, and beauty advisors globally. We are collaborating deeply with film, fashion, and pop culture to develop innovative trends.

Our product development, creative and brand leaders directly collaborate with top designers, celebrities, artists and experts to co-create inspiring innovations such as MAC's Rihanna collections and Tory Burch's new fragrance. Together, we find ways to translate unique and creative points of view into beautiful products that our consumers love.

As a creativity-driven, consumer-inspired organization, one of our greatest strengths is our ability to give consumers around the world the products and services they crave, or will crave even before they want or need them.

We define innovation broadly at Estee Lauder. We seek to innovate across many dimensions, from idea-led product innovations and brand-led storytelling to service innovations. We design, plan and track innovation by brand, by product category, by year, by region, and by type of innovation to ensure near-term and long-term sufficiency.

Our strategy in recent years has been to focus on bigger and broader launches. In fiscal 2013, innovation and new products across all brands and regions grew to 16% of our sales. We have also made significant progress in developing bigger initiatives with increasing local relevance whilst maintaining productivity.

Let me take you through briefly through our five types of innovations. Hero products are the pillars of our brands and provide truly transformational results. They delight existing consumers as well as attract new users.

As Fabrizio mentioned before, these include products with new technologies, such as Estee Lauder's new Advanced Night Repair serum with patented Chronolux technology, and Clinique's new Dramatically Different Moisturizing Lotion+ with improved clinical efficacy.

They also include launching entirely new products, like Clinique's Even Better Clinical Dark Spot Corrector, which introduced a new breakthrough technology to the market, creating a new segment in skincare. These patented and proprietary skincare technologies and ingredients were developed with our basic science research and skincare labs in Melville, New York.

We also designed new hero products to be incremental to the brand, with new forms and textures or adding incremental categories. Additional examples of this are La Mer's Moisturizing Soft Cream that brought a new generation of consumers to the franchise and our new La Mer treatment lotion with a revitalizing ferment in a watery essence, which is a preferred form in Asia, and was developed in partnership with our skin labs in Melville and Shanghai.

Finally, we also create hero products inspired for regions, like Estee Lauder's successful Revitalizing Supreme Global Anti-Aging Creme. This patented multi-benefit product and texture was developed for and tested extensively on European women by our European team based in Paris. Having been broadly accepted in Europe, we are now launching it in North America this January.

Sustaining innovations are upgrades and extensions to our core franchises and segments. They are a way to reengage consumers and extend our franchises to new categories and new users.



A good illustration is how we're continuing to build out Clinique's groundbreaking Even Better franchise. Taking selective ingredients of the original dark spot correcting formula, we've extended the franchise to encompass a full collection consisting of an eye cream, hand cream, facial moisturizer and foundation.

Most recently we created Even Better Essence Lotion with a unique blend of ingredients and sensorial texture of a watery lotion geared towards Asian consumers.

Surprise and new trend innovations allow us to respond to emerging trends in ways that engage and delight consumers as well as drive in-store traffic. These innovations create news, excitement and interest like MAC's over 40 collections and collaborations a year that leverage our color innovation center in Toronto with expertise in optics, polymers, and pigments.

For example, the RiRi Hearts MAC campaign co-designed with global pop superstar Rihanna drew 18 million visitors in one day during the exclusive online launch of RiRi Woo lipstick, a key part of this collaboration.

Launch and leverage innovations allow us to make a major launches even bigger over time. These include developing idea-led storytelling, leveraging claims on existing products, creating new regimens and expanding to new geographies.

Launch and leverage also allows us to efficiently bring news to our hero products by exploiting our rich portfolio of existing and dormant assets, such as claims in clinical studies. We leverage these assets with consumer relevant stories, cutting edge insights and imagination to efficiently fuel our initiatives.

Service innovations are designed to create high touch services that enhance the shopping experience that are tailored for locally relevant needs. Bespoke gifting at Jo Malone, Bobbi Brown's Pretty Powerful Makeup Lessons and Origins Sampling Bar are all examples of service innovations.

We expect our innovation to be fully sufficient across our key metrics and I am personally very excited by the depth, breadth and balance of the pipeline of new technologies, formulations and products we plan to launch in fiscal 2014 and over the next few years.

I would like to close by thanking all the innovators across our brands, regions and functions worldwide as well as our partners who are creating these exciting product and service innovations that will continue to fuel our growth.

Thank you, and now I will turn the call over to Tracey.

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

Thank you, Carl, and good morning everyone. I will briefly review our fiscal 2014 first-quarter results and then cover our expectations for the remainder of the year. My commentary on the financial results excludes the impact of restructuring and other charges.

As Fabrizio mentioned earlier, our sales for the first quarter were in line with our expectations. Net sales rose 5% to \$2.68 billion. Excluding the impact of currency translations, sales grew 6%. Net earnings and earnings per share each decreased 3% to \$301.6 million and \$0.76, respectively.

EPS was above the top end of our expectations, reflecting more favorable exchange rates and more disciplined management of cost.

Every region contributed to sales growth in the quarter. Sales in our Americas region increased 2% in local currency, with low single-digit growth in North America and strong double-digit growth in Latin America. The strongest performance in North America came from double-digit sales growth through online as well as high single-digit increases at specialty multibrand stores and our freestanding stores. Midtier department stores were challenged, but their online businesses grew strongly.



In the Europe, Middle East and Africa region, sales increased 7% in local currency. We achieved double-digit sales gains in the UK, Turkey and Switzerland, and our sales in the travel retail channel rose 9%. Among the more established markets in Western Europe, Germany and France rose mid to high single digits while Iberia and Italy were essentially flat.

Our sales in the Asia-Pacific region rose 11% in local currency. Our business in virtually all markets grew and we saw particularly strong double-digit growth from greater China. Distribution expansion continues in China where we added 30 new doors and five new cities during the quarter.

Retail sales growth remained strong at approximately 16% and like-door growth was mid-single digits.

Thailand, Japan and Australia were also contributors to growth while Korea remains challenging as sales there declined 5%.

Our gross margin increased 80 basis points to 79.7%, which largely reflected the impact of both positive mix and pricing.

Operating expenses as a percent of sales grew 280 basis points to 62.8%. Advertising and marketing investment primarily drove the increase, reflecting the planned support of major product launches.

Operating income fell 7% to \$450.7 million, and operating margin decreased 200 basis points to 16.9%. Net interest expense declined 15% to \$13.5 million, primarily due to lower rates, and our effective tax rate was 30.8%.

During the quarter, we generated a \$155 million improvement in cash flow from operating activities, primarily through improved working capital and receivables and payables.

Inventory days to sell rose to 195 compared with 177 days last year. The higher inventory was due in part to the size of our new product launches as well as an increase in safety stock to meet customer demand. We expect to reduce this inventory level throughout the second and third quarters, and we are working on finalizing a long-term plan to address further improvements in working capital.

We invested \$86 million in capital projects to support new counters, technology and retail stores. We repurchased approximately 0.9 million shares of our stock for \$59 million and used \$70 million for dividends to stockholders. And we ended the quarter with \$1.3 billion in cash and cash equivalents.

With the first quarter behind us, let's now turn to our outlook for the second quarter and for the full fiscal year. As we outlined last quarter, for the full fiscal year, we plan to grow at approximately double the rate of global prestige beauty, which is expected to rise between 3% and 4% this year.

Our main growth drivers continue to be enhanced global and local innovations, some of which you heard from Carl this morning; accelerating growth of our small and medium-sized brands; expansion and growth in developing markets; and continued focus on skincare and makeup, with a greater contribution from fragrance as we renew our commitment to the category.

Sales for fiscal 2014 are still expected to grow to 6% to 8% in constant currency. Currency translation is expected to negatively impact our full-year sales growth by approximately 1% to 2%. Our estimate assumes weighted average exchange rates for the full year of 1.33 for the euro, 1.58 for the pound and 100 for the yen.

The combined benefits of gross margin expansion and operating leverage are expected to drive operating margin expansion by 40 to 50 basis points for the full year. Continued cost discipline allows us to invest for sustained growth and efficiency.

This year we plan to further strengthen our capabilities in consumer and shopper insights, innovation, retail stores, supply chain, human resources and information systems. We expect advertising, merchandising and sampling to remain fairly consistent as a percent of sales for the year. But we have flexibility to invest incrementally behind activities that demonstrate good momentum.





We will invest more heavily in the first half, since supporting both major skincare franchise launches at the beginning of the year, as well as new fragrance launches which distort more at holiday.

Our fiscal 2014 tax rate is planned at 30% to 32%.

With a good start to the year, we are comfortable raising the low end of our guidance for full-year EPS to a range of \$2.80 to \$2.87, which effectively increases the midpoint of our expectations range. Depending on the magnitude of exchange rate movements, the approximately 1% to 2% negative currency impact on our topline equates to about \$0.07 of EPS.

As a reminder, the next wave of our SMI rollout is scheduled for July of 2014 and will include our North America order to cash process, our travel retail division, Japan and the Middle East markets, and represents approximately 18% of our sales. As has been the case in previous rollouts, we expect retailers will increase their orders in advance of the go live to mitigate any potential disruptions from the transition.

The impact of this potential shift in orders will be to increase sales in our fiscal 2014 fourth quarter and full year. We plan to provide an estimate of the shift as we get closer to the date and have a better indication of the needs of our retailers. The guidance we are giving today does not include any shift in these incremental sales and profits in fiscal 2014.

Regarding the second quarter, our sales are expected to grow 3% to 5% in local currency. Translation could contract growth by approximately 1 percentage point. The support of major product launches particularly in fragrance should drive higher sales growth as well as higher marketing investments. We anticipate that EPS will come in between \$0.99 and \$1.04.

There are a few items impacting comparability to the prior-year quarter that you should keep in mind. You will recall that we also had an SMI shift last year, and that some of our customers increased orders ahead of the SMI rollout last January. That resulted in a shift in sales from our third quarter to the second quarter of last year of \$94 million, or \$78 million in operating income, and \$0.13 and EPS. Adjusting for this shift, our sales growth is expected to be between 6% to 8% in local currency for the quarter.

Last December, we recorded \$21.3 million in other income related to the August 2007 sale of Rodan and Fields. This added approximately \$0.04 to EPS in last year's second-quarter. And lastly, I want to remind you that the holiday selling period is shortened this year due to the late Thanksgiving.

That concludes our prepared remarks. We will be happy to take your questions at this time.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Bill Schmitz, Deutsche Bank.

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### Bill Schmitz - Deutsche Bank - Analyst

Could you just talk about -- it's not just an Estee thing, it seems like. But if you look at some of the NPD data, some of the mainstream brands which obviously includes Estee and Clinique, seems like they've slowed recently. And so why do you think that's happening? Is there anything you can do to sort of accelerate your relative growth in that respect?

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

Yes, in NPD -- so first of all, one clarification. NPD North America covers about 60% of our business. There is all the freestanding stores, the online, some specialty there outside of this.



Anyway, in NPD there are some specific reasons of what's happening. We say we call it heritage brands, and Lauder and Clinique where the initiatives that we supported have been very successful.

But the base business, especially in July and August was softer than we expected. And this was because the environment, first of all there was low traffic in-store, lower traffic in store than what we expected, as I said -- improved dramatically in September.

And second reason was that the environment was very promotional and our brands were in a moment where the focus was on the innovations. So there was clearly not competitive level of promotions during this period.

Now, we believe that our promotional competitiveness during the holiday season will be dramatically improved. Our programs are much stronger in this sense. However, we do not plan to increase promotions for the long-term.

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**Operator**

Neely Tamminga, Piper Jaffray.

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**Neely Tamminga - Piper Jaffray - Analyst**

Fabrizio, could we talk a little bit more about fragrances? It sounds like that seems to be a major initiative for you guys. Could you just help us contextualize kind of the size and scope of the family of fragrances that you have, and maybe who you expect to kind of be some of the newer ones that could become the bigger ones?

And just clarify related to that. Is it really kind of based on global points of distribution? Is that how you were thinking about it?

Because obviously Jo Malone is going to be more prestige and premium than maybe even a Michael Kors. But just help us understand kind of how big some of these fragrance families could be. Thank you.

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

Sure, I think we will grow our fragrances substantially in this year and the next few years. Our fragrance portfolio is first of all very strong and very high-end, meaning Jo Malone, Tom Ford.

These fragrances are, first of all, is profitable business and is growing very fast, more than double digit or more, and is growing globally for the moment very strong in Europe and North America, and with a lot of future potential also in Asia.

The second group of our fragrances are the fragrances which are part of our cosmetic brands, namely Clinique and Lauder fragrances. In this portfolio -- this year our most important launch -- in this part of the portfolio, sorry. Our more important launch is Modern Muse of Estee Lauder.

We believe this is a very strong fragrance. Our test and our early acceptance in the markets is outstanding. It has been going number one in Harrods and is rated number 10 in the US after a few weeks of launch and continued progress in climbing the ranking, as I said.

And we have also a pretty solid promotion level in fragrances I said during the holiday season, including the Clinique brand.

And then the third group of our portfolio in our portfolio is the designer fragrances like Michael Kors, Tory Burch, DKNY, etc. And this portfolio particularly includes two very strong and important new launches, three actually.

One is Michael Kors. That asset has been very successful in the launch in the United States, and this is why we will expand in Europe soon. Tory Burch, for the moment, is exclusive here to Bloomingdale's in the US and is the number one fragrance there.



And Zegna, which has been a global brand launch from the beginning where the super high aesthetician [rationale] in Asia, because of the high position of the Zegna brand particularly in China.

And we believe that these combinations of activity will drive our growth in fragrance. We will go back growing market share in fragrances. We will improve our travel retail business in fragrances, which was one of the key goals, which is very profitable.

And each one of these new fragrances that we launched will carry higher profitability versus our historical fragrance profit model.

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**Operator**

Alice Longley, Buckingham Research.

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**Alice Longley - Buckingham Research - Analyst**

I've got one follow-up question and one bigger question. I think you indicated that you think that your US performance in department stores will be better in the December quarter than the September quarter, because you're doing more, I guess, planned promotional activity. Could you just comment on whether that's the case?

And then the other question is you are guiding to margin expansion, operating margin expansion for the year. In which are the business segments that are going to lead that? In other words, will skincare be up in most and fragrance margins be down, or where are we going to see the margin expansion for the year by business segment? Thanks.

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

Okay, I'll take the first one which is, yes, you understood correctly. We believe that our trend in October, December in department stores in terms of market share will improve, and will improve first of all because of our innovation and the investment behind our innovation that we did in July/September will have an impact. And our innovative product will continue growing.

And second, we will invest behind the fragrance launches, which will hit the holiday season. And third, because our promotional competitiveness will be stronger.

I also want to remind that 60% of the fragrance sales in the United States happen during the holiday season. That's why we are focusing our fragrance investment and promotions in that period this year and we have expectations from it.

In terms of the -- what will drive profit margin, I'll let Tracey comment on that.

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

So, we typically obviously don't guide by product category. So we do expect, though, from a total portfolio standpoint to have the margin expansion.

I would comment, though, on fragrances and remind you that we have a number of new fragrance launches this year. So it is a heavy investment year for fragrance.

In light of those launches, which will continue to build not only in terms of the doors that we've launched them in, but we are also phasing the rollout of some of these fragrances. So they will continue to build distribution as well.



**Operator**

Jason English, Goldman Sachs.

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**Jason English - Goldman Sachs - Analyst**

I wanted to focus in on the organic sales growth in a couple of areas that seemed a little bit light to me versus my expectations. One is in travel retail. 9% looks like a decent headline number, but not really when you contemplate the easy comparison and the lapping of the destock. The two-year deceleration is pretty stark. So I was hoping you could help me understand maybe the drivers of that.

And similarly this was a rare quarter when your Americas like-for-like growth actually lags what was reportedly measured in NPD. Was there something anomalous about that as well?

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

Speaking about travel retail, our retail in travel retail was 13% growth. And our net sales were 9%. And this was also driven by time of launch of [mega] initiatives like Advanced Night Repair and DDML.

So our travel retail business actually grew in double digits. And in fact, we forecast -- we guide to continue driving at double digits in the next quarters and is very strong in this moment, as I said in my initial comments, particularly in Asia.

On North America, I didn't completely understand the question.

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

It was the difference between our net sales and then the NPD growth, which obviously NPD does not measure all of our sales channels. But the other thing that I would remind you of is a small amount.

But in order to support some of the skincare fragrance launches that we had at the beginning of the quarter, we did ship in product at the end of June in order to support the July launches.

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**Operator**

Caroline Levy, CLSA.

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**Caroline Levy - CLSA - Analyst**

My question is why you are so confident in the margin expansion in the back half? Because it's going to require a really major recovery across the board, or maybe it's not in fragrance. It sounds like fragrance may stay down for the year to support the launches.

But you know you're expecting tough comps in this coming quarter because of the lap. I understand that completely. But what gives you such confidence that you can continue to grow 6% to 8% topline, if you cut back [ANM] in the back half to be flat as a percent of sales for the year, which I think you had guided to last quarter? Thanks.

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

Yes, the first thing I would like all of you to notice that anyway we are delivering two-thirds of our profit in the first six months. So in the second six months, we have an equal amount of sales and, historically, one-third of our profit.

So clearly, as Tracey commented on, we have flexibility in the second quarter to invest and support our business and to deliver the profit growth that we want to deliver. And the way the quarter has been historically built have been very, very heavy in the first six months and lighter [in terms of] profit in the second six months.

This is also dependent by calendarization and by many other aspects. So we are calendarizing our initiatives and our investments, I believe, in a more appropriate way this fiscal year. But most importantly we are calendarized based on the consumer needs and the kind of innovation we have, rather than just working on last year or previous years' comparisons.

So all in all, we are confident in the overall fiscal year. We are confident that we can accelerate margin in the second six months of the year.

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

And the only thing that I would add to that is even though certainly we have some soft environments that we're managing in; EMEA and certainly North America. The fact that many of our very strong large innovation launches happened at the beginning of the year, we expect that those products will continue to build momentum throughout the year, which certainly should help the second half of the year.

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**Operator**

David Wu, Telsey Advisory.

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**David Wu** - *Telsey Advisory Group - Analyst*

I just have a question for Carl. Can you perhaps talk about how you envision skincare innovation to evolve really over the next five years, just given the demographic shifts with the aging baby boomers as well as the new millennials as a new customer base?

And also just given the changing consumer trends that you're seeing, whether it's increasing use of beauty tools or sort of fusion products into other categories such as with CC creams. Thank you.

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**Carl Haney** - *The Estee Lauder Companies Inc. - EVP of R&D, Product Innovation & Brand Product Development*

Sure, our innovation is balanced and competitive in product development across all of our categories, including skincare. And as I said, we use a number of types of innovation against that. And our future pipeline is even more robust; it's bigger and broader.

We leverage launch and leverage, we are locally relevant. We focus on the specific segments of growth and we're creativity-driven and consumer-inspired. So that's a long-winded way to say that we have developed capabilities to target consumer opportunities in fast-growing segments.

The aging consumer is a large and fast-growing opportunity and we've developed innovation pipelines against those targets. And I won't get into the specific details on them, but we have a very robust pipeline against those consumer targets.



**Operator**

Chris Ferrara, Wells Fargo.

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**Chris Ferrara** - *Wells Fargo Securities - Analyst*

Just I guess on fragrances, two things, Fabrizio. One is how do you think about the incremental margin on the growth of the business going forward with a greater focus on fragrance as opposed to skin and makeup? And I get that the fragrances you are launching are higher profitability fragrances, but I suspect still lower than the broader portfolio.

And secondly, obviously, mass has lost share to prestige in most categories more recently, probably less so in fragrance. Do you think going forward that prestige will source a big portion of its growth from mass over the next 6 to 12 months, especially with your initiatives in fragrance? Thank you.

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

So, on profitability of fragrances, as I said, fragrances improved profitability in the last five years within the organization and within our Company, and that was step one. Second, our new fragrance launches will have ongoing better profitability. Third, our portfolio is within fragrances is a mix which is toward higher profitability fragrances, like our high end, like Jo Malone, which I already mentioned.

And third, the growth on fragrances will allow us to leverage productivity and overrides across the organization, across the entire Estee Lauder companies. And this will be a positive factor. So, that's why we believe that the growth of fragrance will be anyway creating value for us in the future.

Said this, fragrance will remain in lower margin than skincare and makeup. In our portfolio, you need to have one category which is less margin than the others anyway, in any portfolio. And that's the reality of what we have.

On your second question, which is the question on sourcing from us, I would like to say that's been our strategy now for years. And this is probably the key idea behind our success in the last four years in terms of accelerating growth, has been that on top of competing for market share within prestige, we put ourselves as category builder. As the only company in cosmetic -- big company in cosmetic completely focused on prestige and without any other mass business, and so as great partners for our retailers that want to build the category in prestige around the world.

And with this strategy we have been working in sourcing from us in skincare and makeup. And as you have seen in the United States, we succeeded. And even in this last quarter, the prestige market in the United States, although softer than last year, because as you have seen below 3.2% versus 7% last year, has been growing faster, decisively faster than mass.

Now, we believe that this could happen also in fragrances in the future. And this could be a trend that will see also in the fragrance business, although for the moment in the fragrance business this trend has been less remarkable than it has been in skincare and makeup.

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**Operator**

Ali Dibadj, Bernstein.

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

I just had a quick housekeeping and then a little bit more on fragrances, actually. The housekeeping was about -- Tracey, if you could help us quantify the impact of currencies, because it seems like it's better than you'd anticipated. And how much of that was driving your increase in EPS over the course of the year? So if you could help us quantify that.



And I do want to -- just a little bit more in fragrances, because the pushback I'm getting from some investors is that -- is this the best ROI that Estee Lauder can find? So why don't we go into more tier 3 and tier 4 cities in China for the same money, or more e-commerce, or in fact buying back more stock than investing in fragrances?

So it feels like folks are thinking maybe they are stretching a little bit into margin dilutive areas to grow, and I want your response to that.

And also kind of in that context, talk a little bit more, if you could, about the dividend raise, which seems a little bit lower than it's been in the past, and how that should make us think about the priority we give to that versus M&A or other uses of cash. Thanks guys.

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

I'll take the fragrance part and Tracy will cover all the others, and then comment also in the fragrance part, the way she thinks.

On fragrances, I want just to remind you that the role of having a strong fragrance business is not only about the value creation and margin creation. It's also in certain parts of the world, the fragrance is such a big part of the business that in order to create the critical mass of the Company that then will absorb all the rest, being able to serve retailers and cover the market appropriately. In absence of a strong fragrance business this is going to be very costly. And skincare, makeup can be much less profitable because of this.

An example of this in many European markets, example of this is Latin America and there are many other examples in Asia.

Then second point is fragrances are attracting new consumers to counters in many cases. So, for example, on our Estee Lauder or Clinique brands, a strong fragrance business is also a source of customers for the counters, and then these people buy also skincare and makeup. So it's a driver.

So fragrance can be profitable, can be value creating and can be an enhancer of critical mass of the Company, and finally, of building -- of bringing new consumers to our brands and sell our entire portfolio. So they are an integral part of our strategy. Even if skincare in China in the long-term may create more value, still there is space for a strong fragrance business in our portfolio, but never detracting priority levels from skincare and makeup, however. Tracey?

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

Regarding currency, as we have taken up the midpoint of our range, a small portion of that certainly is related to the improved outlook in currency. As I had mentioned in my prepared remarks, we did initially expect that currency would impact us by about 2% from a topline standpoint. We now expect that it would impact us negatively 1% to 2%.

The euro is doing slightly better. Others are doing slightly worse, and we certainly saw that in the first quarter from a netting standpoint. So, from a full-year standpoint there could be a \$0.07 differential in EPS.

But our decision to take up our guidance is somewhat related to currency. But the other is the beat in the first quarter related to performance as well.

In terms of dividends, you asked about that and our increase the dividend. We look at, along with the board every year, distribution to shareholders and the mix of distribution to shareholders between dividends and share repurchases. And what we were comfortable with, given our plans this year, is very similar to prior years in that the free cash flow that we deliver this year is almost 100% delivered to shareholders in the mix of share repurchases and dividends.

So, through discussions and analysis and prudent planning with the board, this is the mix of distribution that we've decided is appropriate for us as a Company this year. But it is a heavy focus of us -- of ours in terms of distributing back to shareholders what -- excess cash.



We still obviously have a pretty -- very strong balance sheet, both from a debt capacity standpoint and from a cash standpoint. So we believe that any acquisitions that we might be considering we can certainly fund with our balance sheet.

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**Operator**

Wendy Nicholson, Citi.

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**Wendy Nicholson - Citigroup - Analyst**

I had a follow-up on the travel retail question. Is it your sense that you are gaining share in travel retail? And maybe if you could specify if you think it's travel retail globally, or are you gaining share in Asia travel retail but maybe not in Europe. So if you could clarify that.

And then the second question, Tracey, just to follow up on the inventory days, 195 seems really, really big to me. And I would have thought that -- I know you've got a big whatever holiday planned with fragrance. But at the same time I would have thought you would've already done a lot of that ship in.

So had you anticipated 195? Because it just seems like that number is getting higher and higher, and that maybe as you bring that down to work through that excess inventory, there's going to be a negative margin impact. Thanks so much.

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

So, on travel retail, we are definitely building market share and we are building strongly market share. The marketshare build is very strong in Asia, a little bit in Europe, and we are now building in this moment market share in the US part of travel retail. That is the split. And we are actually accelerating the marketshare buildup in the Asia part of the business.

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

And in terms of the inventory days, you may recall that we did carry higher levels of inventory post the group 3 go live for SMI, as we had some stock issues that we were working through. So we ended the year higher.

I would say that we were not expecting quite as high a level in the first quarter as we had. But the inventory is current. And so it is certainly salable throughout the second and the third quarters, as I mentioned.

We never were relaunching new products or launching new products in the case of our fragrances. We want to make sure, depending on what the sellthrough is, that we have enough inventory. So that will provide some level of variability to our inventory levels when we have big launches like what we had in the quarter.

But we have, to your point, shipped some holiday and are certainly shipping more as we speak.

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**Operator**

Mark Astrachan, Stifel Nicolaus.





**Mark Astrachan** - *Stifel Nicolaus - Analyst*

Curious about your thoughts of using gift with purchase for this holiday season and sort of just broadly how you're thinking about that. And then more specifically, is that amount going to be higher or lower this year versus, call it, year-ago levels?

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

So we have, as I said, we have good promotional activity in the holiday season, which is not only gift with purchase. It's also relative to all the fragrance activity that happens there. And we do believe we have a competitive gift with purchase program in the period of October-December.

However, in the quarter where we just closed, the July-September, as I said, we were actually declining gift with purchase versus the past. And we were continuing our program, and that's one of the reasons I was saying we were not competitively promotional in that quarter.

In terms of our program we plan to improve our gift with purchase quality and activities in the future to make sure that they work better and better with the consumers. And we are working with it. We have seen this. And already in September we have seen, for example, a very strong gift with purchase activity on the Estee Lauder brand was particularly successful.

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**Operator**

Olivia Tong, Bank of America Merrill Lynch.

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**Olivia Tong** - *Bank of America Merrill Lynch - Analyst*

Just first one point of clarification on advertising spend. You mentioned it would be up for the December quarter. Can you just say in terms of absolutely or as a percentage of sales that you expect it up?

Because, correct me if I'm wrong, but I think there's quite a bit already in the base. And then on the inventory levels, obviously higher from your standpoint. But how does your inventory levels -- how do your inventory levels at retail look? Thank you.

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

So, our advertising is -- for the second quarter is deleveraging about 40 basis points as a percent of sales. So that's the increase in the spend in the second quarter; the advertising, promotion and marketing.

And in terms of our stock and trade, it really varies around the world. But in general I don't think we have a situation where we have lots of -- an abnormal amount of stock in any area of trade.

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**Operator**

Lauren Lieberman, Barclays.

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**Lauren Lieberman** - *Barclays Capital - Analyst*

Quick two things. One was just if you could comment on Russia, just because there's been no mention of that and I thought last quarter perhaps it was starting to stabilize, so would be curious on trends there.



And the second thing was just longer-term on hair care. I know everyone keeps asking about fragrance and the strategic importance. I think within prestige beauty it should actually be pretty clear.

I think hair care, given both the margin structure and hair care's size in global prestige beauty is actually the more interesting long-term strategic question. So could you talk a little bit about how you think that evolves over time and sort of the near-term kind of returns and profitability goals for hair care?

Because I noticed a lot of advertising on TV this quarter for Aveda, and you mentioned specifically in the release that bumble had some new specialty distribution. Thanks.

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

So, on Russia is -- Russia, as I said, is stabilizing. And it's stabilizing because we had some part of the retail that was going well anyway.

We have stabilized the relationship with the retailers that was not going well. And because we have started an aggressive distribution change in Russia, with more freestanding stores of the brands that carry freestanding stores and good online business. So it's a mix of stabilization and diversification of our distribution that is giving to us more confidence about us being able to go back in the future years to grow our business in Russia.

In terms of hair care, we are having a very successful moment in hair care. Aveda has huge momentum. Aveda is growing momentum with salons, which remains the critical and key channel for Aveda in the United States and in other countries of the globe.

And in that is driving the success in the Aveda freestanding stores, and importantly in Aveda salons. And yes, you're right, you're seeing advertising on Aveda [on invited], which is basically our activity to drive and support the best innovation and build on strengths and drive initiatives, where we see there is an enormous consumer traction and consumer reaction. And also we continue Aveda expansion.

Around the world, the most important thing in the travel retail channel where, particularly in Asia, we are seeing great traction for the brands, which has a very positive impact also on profitability.

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**Operator**

That concludes today's question and answer session. If you were unable to join for the entire call, a playback will be available at 1 PM Eastern Time today through November 30. To hear a recording of the call please dial 855-859-2056 and passcode 78520821. Again dial 855-859-2056 and enter passcode 78520821.

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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