01-Nov-2023

The Estée Lauder Companies, Inc. (EL)

Q1 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to the Estée Lauder Companies fiscal 2024 first quarter conference call. Today's call is being recorded and webcast. For opening remarks and introductions, I'd like to turn the floor over to Senior Vice President of Investor Relations, Ms. Rainey Mancini.

Ma'am, you may begin.

Laraine A. Mancini

Senior Vice President-Investor Relations, The Estée Lauder Companies, Inc.

Hello. On today's call are Fabrizio Freda, President and Chief Executive Officer, and Tracey Travis, Executive Vice President and Chief Financial Officer. Since many of our remarks today contain forward-looking statements, let me refer you to our press release and our reports filed with the SEC where you'll find factors that could cause actual results to differ materially from these forward-looking statements.

To facilitate the discussion of our underlying business, the commentary on our financial results and expectations is before restructuring and other charges and adjustments disclosed in our press release. Unless otherwise stated, all organic net sales growth also excludes the non-comparable impacts of acquisitions, divestitures, brand closures, and the impact of foreign currency translation. You can find reconciliations between GAAP and non-GAAP measures in our press release and on the investor section of our website.

As a reminder, references to online sales include sales that we make directly to our consumers through our brand.com sites and through third-party platforms. It also includes estimated sales of our products through our retailers' websites. During the Q&A session, we ask that you please limit yourself to one question, so we can respond to all of you within the time scheduled for this call.

Now I'll turn the call over to Fabrizio.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

Thank you, Rainey and hello to everyone. We appreciate you joining us to discuss our first quarter results, revised outlook for fiscal year 2024, and accelerated profit recovery plan to benefit fiscal years 2025 and 2026.

Before we begin, I want to start by expressing the tremendous grief and sadness we have for the victims and their families of the horrific terrorist attacks against Israel, the tragic loss of Palestinian lives and the growing humanitarian crisis in Gaza. Our hearts break for the profound suffering across the Middle East during this terrible time. We are committed to continuing to support the safety and well-being of all our employees in the affected areas and around the world.

Let me now turn to our first quarter results. We delivered our outlook for organic sales and exceeded expectations for adjusted diluted EPS. Organic sales decreased 11%. Our global travel retail business drove the decline, as expected, with organic sales lower by 51% given the combination of trade inventory reduction and a structured market containment. The entire rest of our global business rose 4% organically led by mid- to high-single digit growth in the Americas and the markets of EMEA and double-digit growth in Asia-Pacific excluding Mainland China. The excellent performance in these regions enable us to deliver our sales outlook despite its lower-than-expected recovery of overall prestige beauty in Mainland China.

Adjusted diluted EPS of $0.11 was ahead of the outlook as we achieved a better-than-expected adjusted operating margin. There were several drivers for this more favorable profitability led by a greater contribution to sales from Skin Care than forecasted as well as disciplined expense management.

Notably, we continue brand-building investments in the areas with the greatest growth opportunities with AP spending rising as a percentage of sales. While we had a better-than-expected start of the fiscal year, we are lowering our fiscal year 2024 outlook given the further incremental external headwinds in two specific areas of our business.

First, the expected growth rate of overall prestige beauty has lowered in Asia travel retail and Mainland China, which is currently also evidenced in the pre-sale phase of the 11.11 Shopping Festival. To reflect this input as well as the ongoing policies and efforts to contain and structure market activity, we are moderating our expectation for fiscal year 2024 retail sales for Asia travel retail and Mainland China. As part of this, we continue to expect to reset retail inventory in Asia travel retail by the end of the third quarter.

Second, we are reflecting the risks of business disruption in Israel and other parts of the Middle East. For fiscal year 2024, our revised outlook continues to expect sequentially improving sales trend each quarter, with double-digit organic sales growth in the second half. We also still expect sequentially stronger adjusted operating margin each quarter with continued consumer-facing investment in our growth engines.

Moreover, we are accelerating and expanding our profit recovery plan which is designed to benefit fiscal years 2025 and 2026 for us to realize our ambitions to rebuild profitability despite the external headwinds' increased pressure on the business in fiscal year 2024.

On our earnings call in August, I described our four strategic imperatives for fiscal year 2024 which are: drive momentum where our business is thriving, return to growth in the US, capture demand from the returning individual travelers in Asia travel retail, and begin to rebuild our profitability.

Let me share with you our progress across these pillars as well as the framework of our accelerated and expanded profit recovery plan. First, we are focused on extending the gains we achieved in fiscal year 2023 in the numerous developed and emerging markets around the world where we prospered. In the first quarter, we did just that. In the markets of EMEA, we achieved impressive results once more driven by the UK and Germany. Organic sales growth were balanced across brick-and-mortar and online as engaging activation in-store and on social media resonated strongly with consumers across our brand portfolio.

We extended our prestige beauty share gains in Western Europe driven by our high-quality hero products and innovation. In [ph] EMEA's (00:07:15) emerging market, India was a standout driven by stellar gains by The Ordinary and double-digit growth by M·A·C.

In Latin America, prestige beauty remains vibrant and we again achieved strong results. Mexico and Brazil excellent, each up double-digits organically. Our localized go-to-market initiatives in these two dynamic emerging markets has succeeded in attracting new consumers.

We continued our winning ways in many markets across Asia-Pacific. The evolution of Hong Kong's SAR is especially compelling, and we realized very strong prestige beauty share gains with our brands' strong desirability, high-touch services, and innovation engaging consumer as retail traffic increasingly returns. Our performance in Japan and Australia once again robust, driven by our diversified brand portfolio catering to local desires.

Around the world, our direct-to-consumer business performed especially well. Every region contributed, led by double-digit organic sales growth in freestanding stores in Asia-Pacific. On a global basis, we are thrilled that the Makeup renaissance is in full swing, and we have been ready to meet consumers as they again embrace their enthusiasm for the category. Makeup thrived in the quarter as the Americas, the markets in EMEA, and Asia-Pacific, each contributed high-single digit organic sales growth to offset the pressure in the category from global travel retail.

We are successfully tapping into and creating trends with on-point innovation like M A C Studio Radiance Foundation and Estée Lauder Futurist SkinTint Serum Foundation. During this exciting area for the category, our brands are leveraging their expert artists and social media know-how to engage with consumers and generate strong and expanding levels of earned media value.

Fragrance again prospered. We delivered our 11th consecutive quarter of organic sales growth led by outstanding performance in the Americas and Asia-Pacific and strong share gains in prestige fragrance in Western Europe. We continue to believe that we are still in the beginning of a promising long-term phase of growth for Fragrance in Asia-Pacific as consumer increasingly embrace the category and penetration levels are low relatively to the West.

Indeed, in Asia-Pacific, Fragrance represent 8% of the prestige beauty industry whereas in Western Europe, it is 40% of the industry. We are well positioned for this growth opportunity with our luxury and our artisanal brands' alignment with the trends in the region as consumer gravitate to Fragrance collections in addition to [ph] seeing as those (00:10:11) trends for multiple distinct scents of the highest quality.

Moving to our second pillar, we are focused on returning to growth in the US for the full year and made strides in the first quarter when encouragingly our organic sales growth improved strongly on a sequential basis and moved from a modest decline last quarter to mid-single digit growth this quarter.

Our multi-faceted strategic plan included launching a robust innovation pipeline with increased focus on breakthrough ideas and leading trends, increasing engagement by brands on social media to realize greater earned media value, accentuating our strength in luxury and artisanal fragrance and in high-performance ingredient-led in derma Skin Care and expanding brand reach in specialty multi to attract new consumers.

During the first quarter, innovation proved to be a powerful catalyst for growth in the US across every category. The contributions are many, from Clinique High Impact, High-Fi Full Volume Mascara and M A C Studio Radiance Serum-Powered Foundation and Makeup to Estée Lauder Advanced Night Repair Rescue Solution in Skin Care and more. Through these high-profile launches with sophisticated media strategies, our brands elevated their engagement on TikTok, Instagram, and other platforms.

Impressively, M A C's earned media value in the US beauty improved several ranks to number 2 in the month of September, further solidifying its number one rank globally. We also achieved strong progress in Fragrance in the US, driven by our luxury and artisanal brands. Le Labo, TOM FORD, and Jo Malone London each rose double-digit driven by multiple growth engines from innovation to online, brick-and-mortar and expanded consumer reach.

Encouragingly, we returned to growth in Skin Care in the US. The Ordinary was a standout. Consumers continue to gravitate to the brands for its scientific ingredient-led skin care driving strong prestige beauty share gains. The brand launch of Soothing & Barrier Support Serum drove exceptional new consumer acquisition trends on brand.com and strategically expanded The Ordinary portfolio to include more multi-active products. Moreover, Estée Lauder and La Mer further bolstered our improving performance in the category.

Let me now discuss the third pillar, to capture demand from the returning individual travel in Asia travel retail. For the first quarter, retail sales in global travel retail were substantially ahead of our organic sales decline which reflects the execution of our priority to reduce trade inventory in alignment with retailers.

Indeed, we are making solid progress through exciting activation of our heroes, capitalizing on innovation, and investing in beauty advisors. Across these three pillars, one of our greatest strengths to leverage is our diverse brand portfolio, which was a fundamental driver of our progress during the first quarter.

M A C's excellent performance showcased the strengths of our portfolio among large brands, while The Ordinary drove double-digit organic sales growth among our scaling brands and Le Labo excelled, rising over 40% among the developing brands.

Let me now turn to our fourth pillar, rebuilding our profitability. We are accelerating and expanding upon our profit recovery plan. We expect to realize $800 million to $1 billion of incremental operating profit across fiscal years 2025 and 2026. The plan consists of four building blocks to improve each of gross margin and operating margin.

First, we are focused on optimizing mix by elevating luxury across brands most especially in Skin Care and Fragrance, driven by consumer preferences by expanding our direct-to-consumer ecosystem across brick-and-mortar and online. Second, we have identified many opportunities to maximize value through better price realization and accretive innovation. Third, we intend to increasingly leverage the strategic investment we have made over the last few years, most notably, our new manufacturing facility in Japan, our new China Innovation Lab in Shanghai, and expanded online capabilities.

Lastly, we believe we can unlock meaningful cost efficiency from a combination of shorter supply chains, rationalization of our value chain, and improved forecasting accuracy enabled by our new integrated business plan in process across the global operation supported by advanced AI capabilities.

Before I close, I'm pleased to share that today we will release our fiscal year 2023 Social Impact and Sustainability Report, feature advancement made possible by the extraordinary efforts of our employees around the world across our ESG areas of focus and previously stated goals.

Importantly, we again achieved Scope 1 and Scope 2 carbon neutrality and maintained our status of 100% renewable electricity globally for our direct operations. The report also details that we obtained our global gender pay equity target for selected employees' populations and achieved our spending targets with women and black-owned suppliers and made strong progress towards our water withdrawal reduction and packaging targets.

Today, we will also publish our second Climate Transition Plan which describes the effort in our ongoing climate transition journey.

In closing, in fiscal year 2024, we will remain focused on driving momentum in our markets of strength, returning to growth in the US, normalizing our Asia travel retail trade inventory, and expanding prestige beauty share farther in Mainland China from our calendar to-year date gains while accelerating our profit recovery plan for a robust acceleration of profitability in fiscal years 2025 and 2026.

To our employees, these are difficult times for the world and all of us. I'm grateful for what you do each and every day in caring for each other and for our beautiful company. Thank you.

And I will now turn the call over to Tracey.

Tracey Thomas Travis

Executive Vice President & Chief Financial Officer, The Estée Lauder Companies, Inc.

Thank you, Fabrizio, and hello, everyone. Let me begin with a brief review of our first quarter results in order to devote the majority of my discussion to our revised fiscal 2024 outlook and our profit recovery plan. Our first quarter organic net sales declined 11% and earnings per share was $0.11.

From a geographic standpoint, organic net sales in the Americas increased 6% led by mid-single-digit growth in North America and continued strength in specialty multi. In Latin America, net sales rose high single digits and was driven by continued strength in makeup as well as strong growth in both brick-and-mortar and online channels.

Organic net sales in our Asia-Pacific region fell 3% primarily due to incremental headwinds from the slower-than-expected recovery of overall prestige beauty in Mainland China. There were several bright spots in the rest of the region led by triple digit growth in Hong Kong SAR as well as double-digit growth in Japan and Australia.

Our strategic investments in brand activations and new product innovation continued to resonate well with consumers in these markets. Hong Kong SAR also benefited from increased traffic in brick-and-mortar due to fewer COVID-related restrictions compared to last year and the resumption of tourism.

Organic net sales fell 27% in Europe, the Middle East, and Africa due to the ongoing headwinds in our Asia travel retail business. The overall challenges in our travel retail business more than offset the performance in the rest of the region where we saw strong growth in Skin Care and Makeup as well as growth in most western and emerging markets. Organic net sales growth was driven by our developed markets led by the UK, Germany, and France.

From a category perspective, Fragrance continued to lead growth with organic net sales rising 5%. Strength from hero products as well as compelling innovation from Le Labo propelled double digit increases in the Americas and in Asia-Pacific. TOM FORD also contributed to growth rising double digits in the Americas.

Organic sales rose 1% in Makeup. We continue to enhance consumer engagement through strategic investments and brand campaigns including social media activations and new product innovation. Once again, M A C was the overall top performer and Too Faced, TOM FORD and Clinique, all contributed to growth as well.

Organic net sales declined 7% in Hair Care and 21% in Skin Care. The pressures in Asia travel retail and in Mainland China drove the decrease in Skin Care. The declines from Estée Lauder and La Mer were somewhat offset by strong growth from The Ordinary.

Consumer demand from the brand's hero products and new product innovation boosted its standout performance in the quarter. Our gross margin declined 440 basis points compared to last year. The benefits from the strategic pricing actions we took at the beginning of the fiscal year were more than offset by the underabsorption of overhead in our plants due primarily to the lower production of Skin Care products that accelerated in the second half of fiscal 2023, higher obsolescence charges and an increase in promotional items such as sets and samples to support consumer activation.

Operating expenses increased 950 basis points as a percent of sales, driven largely by the reduction in sales. We maintained key investment plans in areas such as advertising and promotional activities, innovation and selling, to accelerate growth where we had momentum which collectively accounted for 480 basis points of the increase compared to last year.

Operating income declined 84% to $108 million and our operating margin contracted to 3.1% from 17% last year. Diluted EPS of $0.11 decreased 92% compared to the prior year. The impact from the cybersecurity incident we disclosed this past July was $0.08 dilutive to EPS. The acquisition of the TOM FORD brand was neutral to EPS including interest expense related to our debt financing and reflecting savings from royalties we no longer pay as we now own the brand.

During the quarter, we utilized $408 million in net cash flows from operating activities compared to $650 million last year. The decrease from last year reflects lower levels of working capital including lower inventory levels, partially offset by lower net income. We invested $295 million in capital expenditures and we returned $236 million in cash to stockholders through dividends.

Turning now to our outlook for the second quarter and the full year. As Fabrizio mentioned, while we delivered on our Q1 expectations, we are lowering our fiscal 2024 outlook for the balance of the year to reflect this lower-than-expected pace of recovery due to incremental external headwinds that continue to evolve during the second quarter.

This includes the slower-than-expected growth in overall prestige beauty as well as the containment of the unstructured market activity in Asia travel retail and in Mainland China. This reduction also reflects the risks of potential business disruptions in Israel and other parts of the Middle East as well as currency headwinds.

Using September 30 spot rates of 1.055 for the euro, 1.219 for the pound, 7.302 for the Chinese yuan, and 13.49 for the Korean won, currency translation is anticipated to negatively impact reported sales and dilutive EPS for the second quarter and for the full year.

We expect organic sales for our second quarter to decline 8% to 10%. The incremental pressures from impacting sales in our Asia travel retail business and Mainland China are expected to continue to more than offset anticipated growth in other markets globally.

Currency translation and the potential risks of further business disruptions in the Middle East are each anticipated to dilute reported sales growth for the second quarter by 1 percentage point. We expect second quarter adjusted EPS of $0.48 to $0.58 for a decline of between 62% to 69%. This includes dilution of approximately $0.08 from assumed risks of potential business disruption in Israel and other parts of the Middle East and approximately $0.04 from currency translation.

The increases in our full-year effective tax rate and net interest expense are collectively expected to dilute EPS by $0.04. In constant currency, adjusted EPS is expected to decline between 60% and 66%. For the full year, we expect organic sales to range between a decline of 1% and an increase of 2%.

Currency translation and the potential risk of further business disruptions in the Middle East are each anticipated to dilute reported sales growth for the fiscal year by 1 percentage point. We expect full-year operating margin to be between 9% and 9.5%, a contraction from 11.4% last year due to the lower sales growth level. We now expect our full-year effective tax rate to be approximately 28% reflecting the full-year estimate of our geographical mix of earnings.

Diluted EPS is expected to range between $2.17 and $2.42 before restructuring and other charges and adjustments. This includes approximately $0.22 from the potential risks of business disruptions in the Middle East as well as approximately $0.16 from currency translation. The increases in our full-year effective tax rate and interest expense are collectively expected to dilute EPS by $0.16. In constant currency, we expect EPS to fall between 25% to 33%.

Given this more challenging backdrop for fiscal 2024, we have advanced the development of our multi-year profit recovery plan to support our priority to progressively rebuild margin in fiscal years, 2025 and 2026. This plan is designed to accelerate the pace at which we expect to rebuild our margins while also facilitating operational efficiencies to support go-to-market agility in our local markets.

The plan initiatives will target specific areas to deliver expanded gross margin and operating profitability improvements and is initially expected to drive $800 million to $1 billion of incremental operating profit over the next two fiscal years. We aim to accelerate many initiatives and substantially operationalize the plan in the second half of fiscal 2024 to enable the realization of a meaningful amount of the benefits beginning in fiscal 2025.

Our first priority is to accelerate the rebuild of our gross margin. We plan to optimize our category, product, and channel mix to support profitable growth as well as focus on accretive innovation. We aim to better capitalize on our strategic pricing initiatives by reducing discounts related to excess production and continuing to exercise our pricing power ahead of inflation in our markets. Furthermore, we plan to reduce excess and obsolete inventory by enhancing our operational efficiencies and begin to leverage the investments we've made to regionalize our supply network in Asia.

Our profit recovery plan will also target OpEx reductions while further investing in consumer-facing activities that are imperative to accelerating recovery and driving long-term profitable growth. Our main areas of focus include containing head count as well as reduction in costs related to indirect procurement, T&E, and transportation.

These are just a few examples of actions we expect to take under our profit recovery plan. We plan to share more during our second quarter earnings call in February.

In closing, while we are encouraged by the strength we are seeing across our brand portfolio in recovery markets, intensifying macroeconomic and geopolitical volatility as well as weakening consumer confidence in certain markets have unfortunately slowed the pace of our anticipated recovery in isolated markets.

Given these incremental challenges, we are taking actions through the advancement of our profit recovery plan to support our intention to progressively rebuild our profit margins over the next few years. We remain confident about the long-term prospects for global prestige beauty and in our corporate strategy to drive long-term sustainable profitable growth.

The desirability of our brands as well as the positive momentum we are seeing across categories and in certain markets give us optimism for the future recovery in all of our markets and demonstrates the resilience of our multiple engines of growth and our ability to drive share gains globally. Our return to sales growth combined with the profit recovery plan which we plan to finalize and begin implementing in the second half of this year, as I said before, support the achievement of margin rebuilding and profit recovery in the next few years.

I would like to extend our heartfelt appreciation to our employees around the globe for their continuing commitment and efforts to deliver our results during these challenging times.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question today comes from Dara Mohsenian from Morgan Stanley. Please go ahead with your question.

Dara Mohsenian
Analyst, Morgan Stanley & Co. LLC

Q

Good morning. So apologies for multi-part question, but just had a few things on the profit recovery program. Conceptually, it sounds like it's more of a recovery from a depressed fiscal 2024 base pushing even harder on some of the building blocks you outlined previously. Is that the case, or are there more significant organizational changes that are now new in this plan to generate incremental savings?

And also, that $800 million to $1 billion profit recovery, should we think of that as just savings and recovery from a depressed base and then base business top line growth on top of that could lead to greater recovery? How do we think about that?

And then just, B, taking a step back, why not get even more aggressive here in terms of posture with a larger restructuring? Obviously, the external environment has changed. There's been some internal issues with supply chain and forecasting. So just thoughts on taking more aggressive tack with a broader restructuring at some point. Thanks.

Operator: And ladies and gentlemen, at this point, we may be having some technical difficulties with the speaker line, so one moment while we attempt to reconnect the speaker line.

Dara, I'm just going to leave you in the queue. I'll have your line muted and we'll open you up as soon as we rejoin the speakers.

Dara Mohsenian
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Thanks.

[Technical Difficulty] (00:31:44-00:33:00)

Operator: And ladies and gentlemen, once again, we do thank you for your patience as we attempt to reconnect the speaker line. I'm going to place the hold music back on here momentarily. I'll let you know as soon as we join the speakers back into the conference.

[Technical Difficulty] (00:33:13-00:37:34)

Operator: And ladies and gentlemen, we do have the speaker line reconnected to the conference. I'd like to turn the floor back over to Rainey for a quick statement.

Laraine A. Mancini
Senior Vice President-Investor Relations, The Estée Lauder Companies, Inc.

Thank you, everyone, for your patience. We apologize for the difficulty. Fabrizio and Tracey are ready for our Q&A session now, so, Jamie, if you can take us to our first question, please.

QUESTION AND ANSWER SECTION

Operator: Absolutely. And our first question, once again, is Dara. Please go ahead and restate your question.

Dara Mohsenian
Analyst, Morgan Stanley & Co. LLC

Q

Hey, guys. So just wanted to start with a clarity question on the profit recovery program. It sounds like it's stemming more from a recovery versus a depressed fiscal 2024 base and pushing even harder on some of the building blocks you had previously outlined. Is that the case, or is it more the larger organizational changes here that are new in this plan versus three months ago?

And also, is that $800 million to $1 billion profit recovery, is that just the savings and recovery from a depressed base and should we expect base business growth on top of that in terms of a top line rebound and the flow-through to profit?

And then, B, and I apologize for the multi-part, but I wanted to get clarity there. Just taking a step back, why not get more aggressive here with a larger restructuring? Obviously, the external environment's changed. There's been internal issues the last few quarters with supply chain and forecasting. In theory, SG&A levels have looked high, ex-marketing relative to peers. So just any thoughts on taking a more aggressive tack with a broader restructuring and how you guys think about that. Thanks.

Tracey Thomas Travis
Executive Vice President & Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Thanks, Dara, for the question, and again, we do apologize for the technical difficulties. As it relates to the profit recovery plan, it is incremental to the growth that we expect from the base depressed level this year, as you indicate, Dara.

So – and we are looking at everything. Obviously, the first thing we're looking at is as we mentioned in our prepared remarks recovering our gross profit margin. And to your point, we've had issues with high levels of inventory. We've talked for years about and you all know that we typically because of our lead times and our historic footprint carry high levels of inventory which does affect our agility to be able to manage when shocks happen to the system, which is what's happened over the last couple of years. So certainly regionalizing our supply chain and completing the manufacturing facility we have in Japan, will help us over the next few years in terms of being able to take more inventory out of transit and being able to produce a bit closer to demand.

We also have implemented, and Fabrizio talked about our integrated business planning process which is leveraging some of the tools that we've invested in over the last few years to really improve the accuracy of our forecast to include a bit more of the commercial drivers that drive our business in our forecast, again, to improve the accuracy and have less excess inventory.

And then the actions that we're already taking this year to help improve our gross margins for next year is a significant pull-down in our production volume. So our production units this year are down about 25% from what they were last year. So even though we are anticipating now more modest growth given the update to our forecast, we are drawing down on the inventory that we have on hand as well as obviously some of the actions we're taking from a shipment standpoint to draw down the inventory that we have in trade in Asia travel retail. So there are number of actions that we're taking that will help gross margin.

We are going through a SKU rationalization program in addition to cutting some of our smaller dilutive innovation programs that were planned over the next year or two. So there are lots of actions we're taking. All of those actions are not finalized yet, but many of them are in flight. They just won't impact as much this year as they will future years.

And then, yes, we are looking at our expense base and how we operate going forward especially given our current level of sales and the lower base that we will be growing off of.

Operator: Our next question comes from Stephen Powers from Deutsche Bank. Please go ahead with your question.

Stephen Powers
Analyst, Deutsche Bank Securities, Inc.
Q

Yes, thank you, and good morning. I guess, probably, Tracey, for you as well, just – maybe you could help – provide a little bit more help bridging to the implied second half revenue and profitability outlook as implied in your guidance. It's a pretty significant step-up from where you will be as of the end of December based on the 2Q guide, and that's despite battling what sounds like it will be headwinds in Asia travel retail inventory that will extend into at least the third quarter?

So, again, maybe you can just – the building blocks there, your level of confidence and visibility, and alongside that, it might help just if you have a view on what consumption is for your brands through this first quarter and maybe through the first half versus what you're actually shipping. Because I think a big part of that bridge is that you start to ship more to consumption as you get out from underneath the inventory headwinds. But again, it's a very big step up, so just some clarity and some more detail there would be great? Thank you.

Tracey Thomas Travis
Executive Vice President & Chief Financial Officer, The Estée Lauder Companies, Inc.
A

Yeah, so, no, you're exactly right. The assumption is that we ship more towards – we're able to ship more towards the retail trends. I mean, as we said in the prepared remarks, our retail trends are ahead of our net trends in Asia travel retail, both still down because we are destocking the trade. And so the expectation is that that will be completed by the end of the third quarter, so in the second half of the year.

So a large part of the step-up that you see in the second half of the year are shipping more towards the retail trends that we are expecting in the second half of the year. That's a big part of it. And when you think about what happened to us and what we're anniversarying from the second half of last year where we had the policy changes first in Korea that impacted our third and fourth quarter and then the policy change or policy reinforcement in Hainan, which impacted our fourth quarter. We had in some parts of our travel retail business very low shipments given those policy changes. And so we are anniversarying as well some of the initial shocks of that.

Lastly, I would say that we are seeing travel come back slowly. So again more slowly than what we anticipated. We are seeing lighter levels of conversion relative to what we saw certainly pre-pandemic or even pre the significant changes in policy across the Asia region but we are seeing traffic pick up, and we are certainly expecting that conversion will gradually pick up as well in the second half.

So those are some of the things that are underlying our second half expectations and the reason you see that big step up in terms of volume. It's a combination of multiple factors, mostly in our Asia travel retail. A bit of it is a pickup as well in China also.

Fabrizio, I don't know if there is anything you want to add.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

I just want to add that our retail, underlining retail calendar year-to-date is a bit high-single digit already globally. And our estimate of retail continues to be actually improving on this point. So the retail base which is driven by the consumption of consumers, by the innovation, by the strengths of the brand, by the demand from the consumer standpoint is very solid.

Tracey Thomas Travis
Executive Vice President & Chief Financial Officer, The Estée Lauder Companies, Inc.

A

For calendar year.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

For calendar year-to-date.

Tracey Thomas Travis
Executive Vice President & Chief Financial Officer, The Estée Lauder Companies, Inc.

A

For calendar year-to-date.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

And as Tracey has said, the re-adjustment of inventories is the big things that we are dealing with and the evolutions of the policies that have created these readjustments is what has been difficult to predict and anticipate and has been pretty volatile.

And so that's the adjustment. But the underlying fundamentals are already strong. It's not that we need to develop them in order to deliver the retail in the future with just to continue evolving on these fundamentals.

Stephen Powers
Analyst, Deutsche Bank Securities, Inc.

Q

That's very helpful. Thank you very much.

Operator: Our next question comes from Jason English from Goldman Sachs. Please go ahead with your question.

Jason English
Analyst, Goldman Sachs & Co. LLC

Q

Hey. Good morning, folks. Thanks for slotting me in, and thanks for sharing that encouraging data point on retail sales. Tracey, you're talking about how shipments way down last year and kind of following the story for the last year, we've been thinking once you get leverage back in, once you're able to turn back on the sales, catch-up retail sales, it's going to give you a lot of operational leverage to, a, the gross margin recovery and that's really a sales problem.

But if I objectively step back and look at the composition of the P&L, it does tell a slightly different story. I mean, it doesn't look like a revenue problem. Revenue is actually just round trip to where you were in the first quarter of 2019. It looks like it's really a cost problem. Despite revenue being back where it was in first quarter 2019, COGS up $250 million, SG&A up $320 million, and this is despite a cost-cut program that you announced in late 2020 which so far doesn't appear to have yielded any savings.

So can you help us understand what's caused the cost to run up so much over the last couple of years? Where have the efficiency savings gone so far? And I guess, you are announcing the new actions to kind of go after it. Is that enough to kind of take that back out with the initiatives you have in place?

Tracey Thomas Travis
Executive Vice President & Chief Financial Officer, The Estée Lauder Companies, Inc.

A

Yeah, no, great question, Jason. So if you look back to the composition of the P&L in fiscal 2019, you'll see that our gross margins were higher. And certainly, our costs as a percent of sales was a bit lower and obviously given the pull-down that we've had in this latest guidance review, our cost as a percent of sales are higher as well.

But we've had two cost saving programs. We had the Leading Beauty Forward program and then we had the Post-COVID Business Acceleration Program. In both of those instances, certainly Leading Beauty Forward gave us runway. We were actually expanding operating margins by over 100 basis points a year, anywhere between 60 basis points, 80 basis points to 100 basis points a year through that program. And that program allowed us to reinvest in capabilities that we needed, in particular, to accelerate some of our digital marketing activities, to create some shared services structures in some of our functional areas and to be able to leverage costs better in those areas.

So those programs – that program was successful in both delivering margin expansion and expense leverage at the time. Advanced allowed us to close some of our underproductive brick-and-mortar doors and take a little bit of org adjustments as well.

But we have over the last few years invested in a number of capabilities that have been needed in terms of in our regulatory area, that includes cyber, but also in the regulatory area given the increasing regulations in all of the countries that we do business with and the claims that we need to support our brand marketing initiatives going forward. We've made investments in areas like our sustainability program. So we have made a number of investments that other than the shocks that we've had over the last couple of years have been investments that were needed in the company.

Certainly, as we look forward, we are looking at, as I said before, the profit recovery program is both focused on gross margin because we're not back at the gross margin levels that we were at in fiscal 2019 or even before. And we also are looking at expense areas, everything from our procurement program where we expect that we can get some savings there to other org efficiency.

So more to come in January-February, actually when we give you our second quarter results on what the final plan will look like. But believe me, we are as focused on the P&L structure recovery as you are, Jason.

Jason English
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thanks.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Yeah, Jason, just would like to add the point on the fact that in really the profit recovery plan needs to rebuild gross margin and as you said also our new capability that we invested in, that Tracey mentioned also in IT, in many other areas, needs to align to our current sales levels and that's the work we are going to do as well.

So those are the two big areas of focus. And in February, we will give much more specifics and details, how it will affect – will impact 2025 in the majority and 2026. And so it's a pretty clear plan. I just want to say the entire organization is aligned on this plan. We have teams already working on this. We are completely committed to deliver that.

And I just want to make a clarification on the programs that we announced in 2020 because you said it didn't deliver savings. It did deliver savings in the area of selling. That was the focus. Remember, this program was tailored a lot to the fact that the COVID disrupted the go-to-market part of the business and increased our sales online versus the sales in brick-and-mortar.

So we need to reallocate resources more to online, less to brick-and-mortar and to create the right future balance, of course, between the two areas. That's what we did. In fact, we invested in the online progress and today we're still leveraging the benefits and we did reduce our cost in the brick-and-mortar selling areas accordingly to the trends that COVID had created. So when we did in the past these kind of programs, we've been pretty successful in delivering what we wanted.

Jason English
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thank you. I'll pass it on.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Thank you.

Operator: Our next question comes from Olivia Tong from Raymond James. Please go ahead with your question.

Olivia Tong
Analyst, Raymond James Financial, Inc.

Q

Great. Thank you. A bit of a multi-part question and follow-ups to a few. But first, just a point of clarification on the global retail number that you gave of mid to high-single digits. Was that for you or for the category?

And then on travel retail, can you give us a sense on your visibility into how much inventory is still sitting with the groups or individuals versus in the brick-and-mortar duty-free channel which we have a little bit better clarity in? Thank you.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.
A

Yeah, yes, it is our retail sales I was referring to. So calendar year-to-date in 2023, our trend of retail is mid, high-single digit up to date. And our estimate for the future is to continue improving that trend.

So my point is that retail is solid, and the negative net sales that we see in this first six months for sure are – these months of the fiscal year are related to the readjustment of inventories that Tracey was mentioning.

Second, on the visibility on these inventories in travel retail, and by the way, when we say this retail, we say ex the travel retail numbers.

Tracey Thomas Travis
Executive Vice President & Chief Financial Officer, The Estée Lauder Companies, Inc.
A

Yeah.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.
A

Just one clarification. So it's once the travel retail number. The point we're trying to make is that when the travel retail number, they, retail and the net, will be aligned and we said they will be aligned as of the end of the third quarter. As of this moment, the solidity of the retail progress is already in the making. That's the point we are trying to make.

Anyway, on travel retail, we had a significant stock reduction in this first quarter. And we aim to be in line with inventory expectation of retailers by the end of March, and we have visibility into these numbers. We have visibility. We have exactly the understanding with each one of our retailers on where we are today, what are the programs that we are doing in order to accelerate sales retail of the existing stocks, and what are the programs to obviously replenish and sell-in innovation and all what we need to do in these areas. And finally, how by end March, we aim to have the retail and the net aligned. That's the program.

Operator: Our next question comes from Filippo Falorni from Citi. Please go ahead with your question.

Filippo Falorni
Analyst, Citigroup Global Markets, Inc.
Q

Hey, good morning, everyone. So I wanted to ask a question on Mainland China. It's the first quarter where you guys talk about a bit of a slowdown relative to prior quarters. So maybe, Fabrizio, can you give some context on the level of slowdown that you're seeing in the category? And then from a competitive standpoint, we've seen some local brands doing a little bit better, more on the mass side, but have you seen any trade-down within the category both on Skin Care and cosmetics? Thank you.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.
A

Yeah, no, first of all, the market was growing 2% in the first quarter in China. Our retail during this quarter was flat, but our retail in China calendar year-to-date is growing. We are building market share. But in that specific quarter, the market growth went down to 2%.

Now, our estimate of the recovery of the beauty market in prestige was higher than that, and that is one of the key readjustments we're making in projecting the year. That's the point and so this 2% is the current trend level. Also as I said in my prepared remarks, the resell period of [indiscernible] (00:58:09) and particularly, in general, the single day, confirms a softer trend versus year ago, and that's why we are reflecting this confirmation. Now, we are more optimistic about the next part of the single day events in November, but the pre-sell was confirming a softer market.

In terms of your second part to the question is that local brands in mass and in Masstige which are doing well and which start doing well in China for sure. In prestige, the input of that is for the moment limited. And so we see prestige being solid in comparison to mass in general. And we don't see a big movement from prestige to mass at this point in time.

Filippo Falorni
Analyst, Citigroup Global Markets, Inc.
Q

Great. Thank you.

Operator: Our next question comes from Bryan Spillane from Bank of America. Please go ahead with your question.

Bryan D. Spillane
Analyst, BofA Securities
Q

Thanks, operator. Good morning, everyone. I wanted to go back to Jason English's question regarding margins. And I guess, as we kind of look forward and try to think about the rebuild to the previous margin aspirations, how much of it do you expect to come from the expanded cost savings and how much is just resetting the business mix? Because travel retail is so profitable. And so do we need travel retail to get back to, kind of, a similar percentage of sales as where it was three years ago, or would you be able to get there if travel retail ended up being smaller for reasons given how cyclical it is?

Tracey Thomas Travis
Executive Vice President & Chief Financial Officer, The Estée Lauder Companies, Inc.
A

Yeah, no, it's a great question. Given where travel retail is right now and certainly we – I'm sure many others are thinking about the future of travel retail, which we are very encouraged by in terms of a return to growth, but a return to the prior levels, don't know. You have much now of the volume that has shifted to the local market, and I would expect to continue to see growth in the local market as well. So there may be a rebalance as it relates to the consumption for the Chinese consumer, in particular, as well as perhaps other consumer groups.

So we're not counting on travel retail to get back to prior levels. If it does, that's great. But our profit recovery program combined with some of the growth plans that we have for our markets and brands going forward are not relying on that to return to the profit margins that we had previously.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.
A

And I would like to offer a bit of historical perspective on what happened during this COVID period and the volatility that this brought. I mean – because you were comparing your question versus before COVID, versus the three years ago, previous in – so takes 2019. Our business in Mainland China versus 2019 is more than doubled. Our TR business today globally versus 2019 is by now with this estimate that we are giving to you now is actually well below.

So – but it's true that during this COVID period, the TR business also driven by the structure phenomenon that we have discussed previously was actually up. But then by now, this has been reabsorbed. So the profile of the business with Chinese consumers in 2019 was that there was the base sales in Mainland China, there was a lot of the sales to Chinese consumers that were happening around the world in their travel.

This was estimated to be up to 40% of what was the total consumption at that time before COVID. And a lot of this was in travel retail and also was in the cities that were visited like London, Paris, New York, Hong Kong, Tokyo, et cetera. So now during COVID, obviously the [ph] front tier (01:03:03) were all closed.

So this consumption came back into Mainland China. In fact, our business in Mainland China today as I said is doubled to what it was. And some of it went into travel retail like Hainan development and all the other things that happened which are very good for the long term. And some of it went into the unstructured business which is actually going down now and is part of the readjustment and is a positive thing for the long term.

And so the result of all these movements is frankly solid and sustainable for the long-term. Because the results is solid business in Mainland China which we are supporting and will continue to support. We're building R&D center. We have created all the abilities to be more locally relevant in the future, and to continue to support this business and invest in this business and invest in this very important market for us in the long term that we believe is core to also to our future growth algorithm.

At the same time, the amount of volatile business that went into the TR in the period of COVID has been de-risked and is going down. And as we said, we need to continue to de-risk it in this fiscal year, and that's what we are planning and that's what we are announcing in terms of the resulting guidance of that.

And the travel business, meaning the regular travelers and Chinese consumer that are traveling the world, this is gradually going up again. And so we'll create good consumption by regular travelers. And this moment is going up more in Asia than in the West. Traveling to the West is still relatively limited but we forecast this over time to continue to improve. And the lending place of these movements will be the sustainable profitable business that we are coming back to.

Bryan D. Spillane
Analyst, BofA Securities
Q

Okay. So to be clear, we can get back to kind of the previous profit algorithm even if travel retail and basically Hainan is not as big as it was previously?

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.
A

Yes, we believe so.

Bryan D. Spillane
Analyst, BofA Securities
Q

All right. Perfect. Thank you very much.

Operator: And, ladies and gentlemen, with that, we've reached the end of today's question-and-answer session. I'd like to turn the floor back over to Fabrizio for any closing remarks.

Fabrizio Freda

President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

Thank you. And I just wanted to try to summarize this enormous moving part and make sure that we give you the clarity of what we are focused on at this point in this moment. So we expect calendar year 2023 to be the final and frankly painful post-COVID reset period for the company.

We move forward with confidence as our fundamentals are strong in this attractive prestige beauty industry. Our calendar year-to-date retail sales performance remain very solid in all recovery markets and in general, both developed and emerging in a mid-single high-digit that I quoted before. Our brand portfolio is better than ever with the recent acquisition of TOM FORD solidifying our luxury strategy and The Ordinary, which we didn't talk a lot in this call, but it's becoming a powerhouse brand at the entry of growing active derma segment and is definitely our fastest-growing brand in our portfolio.

Our innovation pipeline is robust for fiscal year 2024 but it gets even better and bigger and stronger in fiscal year 2025 with the expansion into white spaces opportunity that we have identified. We are on track to align retail and net sales via inventory reduction with our retailers in China, private retail as discussed during the call.

We are focused on accelerating a more balanced growth in the future by market, by channel, and importantly, by the profit recovery plan, we are preparing to rebuild gross margin, leverage our new capabilities to align our expenses to our current sales level, and further strengthen our consumer-facing activities.

And we have the strategic focus and the talent to do this work and together intend to return to our historical cadence of delivering sustainable sales and profit growth. And thank you for your time and for your attention today.

Operator: Ladies and gentlemen, with that, we'll conclude today's conference call and presentation. We thank you for joining. You may now disconnect your lines.