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The Estée Lauder Companies, Inc. (EL)

Q2 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to the Estée Lauder Companies Fiscal 2024 Second Quarter Conference Call. Today's call is being recorded and webcast. For opening remarks and introductions, I would like to turn the call over to the Senior Vice President of Investor Relations, Ms. Rainey Mancini.

Laraine A. Mancini
Senior Vice President-Finance and Strategy & Head-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 those 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 translations. You can find reconciliations between GAAP and non-GAAP measures in our press release and on the Investors section of our website.

As a reminder, references to online sales include sales 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.

And 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 today. For the second quarter, we delivered our outlook for organic sales decline of 8% and exceeded expectations for adjusted diluted EPS. Organic sales in our global travel retail business decreased 28%.

We retained sales trends better than organic performance reflecting both the execution of our priority to reduce trade inventory in alignment with the retailers and efforts by various local authorities to contain a structured market activity. We made meaningful progress with trade inventory levels in Asia travel retail, and continue to expect to be at normalized trade inventory levels by the end of the third quarter of this fiscal year.

The entire rest of our global business decreased 3% organically. This decline was primarily driven by the slowdown of overall prestige beauty in Mainland China, although our retail sales trends were much better than our organic performance. Our global retail sales growth excluding travel retail in Mainland China rose mid-single digits.

The markets of EMEA delivered mid-single digit retail sales growth, and Asia-Pacific excluding Mainland China rose double-digits as did Latin America, showcasing strong fundamentals for brand desirability and the success of our consumer engagement initiatives.

Encouragingly, we made progress across several strategic priorities in the first half. And beyond reducing inventories in the travel – in the trade of Asia travel retail, we improved working capital, realized higher levels of strategic pricing, and managed expenses with discipline.

For the full year, we are revising our outlook as we have tightened the growth range for organic sales primarily to account for risks of macroeconomic and volatility in some areas around the world and updated adjusted diluted EPS for an anticipated higher tax rate. In this revised outlook, we have maintained our prior outlook for full year operating profitability.

Looking ahead, we are at an inflection point. First, we are positioned to return organic sales growth for the total company in the third quarter and we expect organic sales growth to sequentially accelerate in the fourth quarter. Second, we are positioned for stronger profitability in the second half of this fiscal year compared to the first half. Third, we are preparing to meaningfully accelerate the rebuild of our profitability in fiscal years 2025 and 2026.

Indeed, since we spoke with you in early November, our teams have been actively engaged to operationalize the Profit Recovery Plan. In doing so, we have identified further opportunities to enhance profitability while also generating more resources to be invested in consumer focus areas to drive long-term growth. As a result, we are expanding the Profit Recovery Plan to include a restructuring program.

While this is a difficult decision, we believe it is now this larger plan will better position the company to restore stronger and more sustainable profitability while also supporting sales growth acceleration and increasing agility and speed to market.

For the consumer, we anticipate faster product and commercial innovation supported by strategic brand-building distribution and go-to-market advancement where digital leadership is at the core. Moreover, we intend to increase our speed and agility as an organization, enabling quicker and more localized decision-making to better create and respond to consumer trends.

The Profit Recovery Plan is now expected to deliver incremental operating profit of $1.1 billion to $1.4 billion, up from $800 million to $1 billion previously. In terms of timing, this incremental profit is anticipated to be realized in fiscal year 2025 and 2026, with more than half in fiscal year 2025.

We are confident that our multiple engines of growth strategy will be enhanced by the Profit Recovery Plan enabling our company to more fully capture promising long-term growth opportunities and remain a leader in global prestige beauty.

And to reinforce our commitment to execute this larger plan with excellence, we have engaged global consulting firm Alvarez & Marsal. They will provide strategic advisory services partnering with us on our restructuring program as part of the Profit Recovery Plan to drive the realization of a sustainable rebuild of profitability.

For the second half of the fiscal year, we have strategic initiatives and exciting innovation to drive in North America, reaccelerate growth in Mainland China, and drive momentum in markets that are thriving across developed and emerging markets in EMEA, Latin America, and Asia-Pacific.

Let me begin with Clinique brand. The brand will be doubling-down on its authentic dermatology brand heritage of over 55 years, deepening its relationship with the scientific community, strengthening its derma messaging, and engaging new consumers.

First, Clinique will be dialing up its derma education and consumer communications including on social, brand.com, and in-store with new dermatologist partnerships and ingredient communications. Clinique has also announced the establishment of the new Mt. Sinai Clinique Healthy Skin Dermatology Center. The center's research is expected to produce breakthrough advancement in the study of allergic skin and premature aging.

Next month, Clinique will return to the American Academy of Dermatology Annual Meeting to showcase its derma level science formulations as well as its unique eye safety promise. All of this is coupled with Clinique continuing innovation of allergy tested and 100% fragrance free products evidenced by Clinique new post procedure relevant claim on powerful products including Smart Clinical Repair Lifting Face and Neck Cream.

Turning to the Estée Lauder brand, for over 15 years, it has been a pioneer in longevity age reversal research, the frontier of skin biology for its Re-Nutriv luxury franchise. Last August, I spoke with you about how Re-Nutriv should be extending upon its successful Ultimate Diamond Transformative Brilliance Serum with compelling innovation. The franchise breakthrough soft cream with cutting edge patented SIRTIVITY-LP technology for visible age reversal is now launching globally.

And in makeup, there is a companion serum cream foundation amplifying the franchise's skin longevity science across categories. We are encouraged by the global appeal of this innovation from China to Japan to the US.

While early, the franchise is welcoming new consumers at compelling rates and we look forward to all that is to come for Re-Nutriv as launch events continue around the world.

Moreover, the brand is collaborating with the Stanford Center of Longevity as the inaugural sponsor of a new program of aesthetic and culture.

Beyond Re-Nutriv's striking innovation, we have more standout launches across brands in the third quarter led by M·A·C and TOM FORD. The new M·A·Cximal Silky Matte Lipstick, modernizes M·A·C icon with a new silky matte finish, lip conditioning benefits, and innovative packaging.

For TOM FORD, Oud Minérale is primed to carry forward the brand's winning streak of innovation from Café Rose in the first half.

In the second half, we expect this initiative and new product launches to build upon the strong momentum of several brands. Indeed, The Ordinary, La Mer, and Le Labo among others achieved terrific performance in the second quarter. The Ordinary delivered an excellent first half as the brand again realized double-digit organic sales growth in the quarter.

Its new Soothing & Barrier Support Serum which launched during the first quarter is the brand's most successful launch ever and is already among the top ten brand products in the US prestige serum category. The Ordinary continues to excel in specialty multi globally and is also realizing very promising uptake on the new TikTok Shop in the United States through engaging live streaming and creator content.

La Mer further contributed to our strong underlying fundamentals in skin care. The brand's luxurious high quality product from the iconic cream the La Mer to the new lifting serum along with its exceptional services proved high sought after by discerning consumers around the world. In Mainland China, La Mer grew double-digits at retail to realize strong share gains in prestige skin care.

Our luxury and artisanal fragrances also performed quite well. Le Labo led the broad-based strength, and Jo Malone London, TOM FORD, and KILIAN PARIS and Editions de Parfums Frédéric Malle each rose organically fueling double-digit sales growth in Asia-Pacific and gains in the Americas.

For the second half, we expect to return to organic sales growth in Mainland China driven by a rich innovation pipeline for a greater contribution to sales from new products in the second half than the first half, and we are investing in exciting go-to-market initiatives across brick-and-mortar and online.

Impressively, we entered the third quarter in Mainland China with momentum in brick-and-mortar having expanded our prestige beauty share offline in the second quarter driven by strong double-digit retail sales growth in each of department stores, specialty multi and free standing stores.

For online, while the channel was especially pressured by softness in overall prestige beauty and the 11.11 Global Shopping Festival, our brands performed strongly on the win rising triple digit organically to partially offset lower sales for the event.

The Estée Lauder brand ranked number 1 in prestige beauty on the win, having also ranked number 1 for store live streaming.

For the fiscal year, we remain focused on North America returning to organic sales growth and are encouraged by the low-single digit growth delivered in the first half. While makeup was pressured in the second quarter by the cadence of major new product launches, we are very excited by the innovation coming to market across the second half, beginning with M·A·C's M·A·Cximal Silky Matte Lipstick we launched last week.

Moreover, skin care grew for the second consecutive quarter in North America driven by The Ordinary and Estée Lauder. Our luxury and artisanal fragrances rose double-digits in the quarter as our strategic initiative from expanded consumer reach with KILIAN PARIS to strong engagement on TikTok by Jo Malone London are proving successful.

In closing, we are at an inflection point, poised to return to organic sales growth in the second half and deliver sequentially stronger profitability than the first half, as well as expansion from a year ago.

We are well positioned to deliver stronger profitability in fiscal year 2025 and 2026, given the initial progress we have made for our Profit Recovery Plan as well as its new restructuring program. And we are well positioned to invest in consumer-facing areas to capture exciting growth opportunities in global prestige beauty.

I wish to extend my gratitude to our leaders and their amazing teams for the hard work and dedication which has taken us to this inflection point of a renewed sales and profit growth trajectory.

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. I'll start by reviewing our second quarter financial results followed by our third quarter and full year outlook. I'll also provide details on our expanded Profit Recovery Plan.

As Fabrizio mentioned, our second quarter organic net sales decline of 8% met our expectations. Additionally, through tighter expense management and despite experiencing a higher tax rate due to the shift in our geographical mix of business, our earnings per share of $0.88 exceeded our initial outlook for the quarter.

From a geographic standpoint, organic net sales in our Europe, the Middle East, and Africa region declined 14% mainly attributable to the persistent challenges in our Asia travel retail business. The impact from business disruptions in Israel and other parts of the Middle East accounted for a 2% reduction in the region's overall net sales growth. The markets in the region had mixed results leading to overall flat growth across all markets.

Organic net sales in our Asia-Pacific region fell 7%, reflecting continued challenges in Mainland China. While our results in Douyin more than doubled, our total online sales declined due to softer than expected performance on Tmall during the 11.11 event. The overall online performance more than offset the increase in brick-and-mortar sales which was led by double-digit growth in our free standing stores.

In the rest of the region, we saw strong organic net sales growth led by double-digit growth in Hong Kong SAR and Korea as well as high-single digit growth in Japan. Our luxury fragrance brands Le Labo, Jo Malone London, and TOM FORD drove double-digit fragrance growth in the region which was fueled by both effective commercial activations as well as compelling holiday product offerings.

Organic net sales in the Americas declined 1% driven by a prior year benefit from changes made to M·A·C's take back loyalty program in North America last year. Excluding this benefit, net sales were relatively flat in North

America reflecting growth in specialty multi and our free standing stores and offset by softer performance experienced in department stores and online.

In Latin America, organic net sales rose double-digits reflecting continued growth in nearly every market and strong performance during holiday and key shopping moments.

From a category standpoint, organic net sales fell 10% in skin care and 8% in makeup. In skin care, the ongoing challenges in Asia travel retail and Mainland China drove the majority of the decrease. Organic net sales from The Ordinary and La Mer grew across every geographic region. The Ordinary saw double-digit growth in specialty multi, including ongoing expansion and continued its focus on education-first content to drive successful social media activations. Net sales from La Mer increased both online and in brick-and-mortar, benefiting from captivating social media and holiday product activations.

In makeup, the persistent challenges in Asia travel retail were compounded by the prior year benefit from M·A·C that I previously mentioned.

Organic net sales fell 6% in hair care and were flat in fragrance. Net sales from Le Labo grew double-digits fueled by both targeted expanded consumer reach and same-store sales. The brand's ethos and high-touch services persistently attract both new and loyal consumers as evidenced by the double-digit net sales growth in our free standing stores as well as strong performance during holiday and key shopping moments.

For Jo Malone London, results from the brand's holiday collection were strong and net sales increased in nearly all channels of distribution. This growth was offset by a decline from Estée Lauder due to the timing of holiday shipments compared to last year.

Our gross margin decreased 60 basis points compared to last year. The positive impacts from brand mix and net strategic pricing actions were more than offset by higher costs due to promotional items and foreign currency.

Operating expenses increased 260 basis points as a percent of sales driven largely by the reduction in sales. Selling, advertising, and promotional activities and innovation collectively accounted for 160 basis points of the increase compared to last year as we supported retail growth while also continuing to destock certain accounts in Asia travel retail.

Operating income declined 25% to $577 million, and our operating margin contracted to 13.5% from 16.6% in the prior year.

Our effective tax rate for the quarter was 37.7% compared to 24.9% last year. The increase in rate was primarily due to a true-up in the quarter to reflect the now higher estimated tax rate on our foreign operations for fiscal 2024 as a result of the change in our geographical mix of earnings. This also reflects an unfavorable impact related to previously issued share-based compensation.

Diluted EPS of $0.88 decreased 43% compared to last year, including a dilutive impact of $0.19 from the change in the effective tax rate. The impact from this business disruptions in Israel and other parts of the Middle East was $0.02 dilutive to EPS in the quarter. The acquisition of the TOM FORD brand was neutral to EPS as interest expense related to our debt financing was offset by the combined benefits derived as the licensor of the brand from royalty revenue this year and savings from no longer having to pay licensee royalties.

During the quarter, we generated $937 million in net cash flow from operating activity compared to $751 million last year. The increase from last year reflects lower working capital partially offset by the decline in net earnings. The favorability from working capital was largely due to the actions we have taken to reduce inventory, primarily finished goods and semi-finished goods, that resulted in a significant improvement in our days to sell.

We invested $527 million in capital expenditures and we returned $474 million in cash to stockholders through dividends.

Turning now to our outlook for the remainder of fiscal 2024, which excludes the impact from the remaining payment for the outstanding DECIEM equity anticipated to occur in May 2024 and includes Clinique's heightened focus in active derma, while we delivered on our Q2 expectations we are lowering the high end of our fiscal 2024 organic net sales outlook range to reflect continued risks from evolving macroeconomic volatility and geopolitical tensions in certain areas around the world.

Despite this change to our sales outlook, we are maintaining our full year operating profitability expectation. Furthermore, we are updating our EPS outlook primarily to reflect the increase in our estimated full year effective tax rate largely due to the anticipated geographical mix of our earnings. This is expected to more than offset the EPS benefit from foreign currency translation.

Using December 29 spot rates of $1.107 for the euro, $1.273 for the pound, $7.109 for the Chinese yuan, and 12.90 for the Korean won, currency translation is anticipated to negatively impact reported sales for the third quarter and diluted EPS for both the third quarter and the full year.

We expect organic net sales for our third quarter to increase 3% to 5% as both our businesses and Asia travel retail and in Mainland China are expected to return to growth. In Asia travel retail, this growth assumes the continued reduction in retailer inventory as well as the anniversary of some business disruptions we experienced last year.

Currency translation and the potential risks of further business disruptions in the Middle East are each expected to be dilutive to reported net sales by 1 point.

We expect third quarter adjusted EPS of $0.36 to $0.46 for a decrease between 3% to 24%. Currency translation and the potential risk of further business disruptions in the Middle East are each expected to dilute EPS by $0.03. Adjusted EPS in constant currency is expected to range between an increase of 3% to a decline of 18%.

For the full year, we expect reported and organic net sales to range between a decline of 1% and an increase of 1%.

Our plants have been running at reduced capacity reflecting the pull-down of production in line with our lower shipments and to support the reduction of inventory levels both in-house and in the trade. This has resulted in inefficiencies in some of our manufacturing locations and may trigger a requirement to recognize the related manufacturing costs as in period costs instead of when products are sold. We have reflected this potential expense and the corresponding pressure to gross margin in our outlook for the balance of the fiscal year primarily in the third quarter.

Our full year operating margin outlook remains unchanged and is expected to be between 9% and 9.5%, a contraction from 11.4% last year and plan to partially offset the incremental pressure to gross margin through disciplined expense management.

We now expect our full year effective tax rate to be approximately 35% compared to 26.5% last year. The increase reflects a larger mix of our expected fiscal 2024 earnings in higher tax jurisdictions as well as the unfavorable impact of previously issued share-based compensation.

Diluted EPS is expected to range between $2.08 and $2.23 before restructuring and other charges. The potential risks of further business disruptions in Israel and other parts of the Middle East and currency translation are expected to dilute earnings per share by $0.08 and $0.07, respectively. In constant currency, we expect EPS to fall between 34% to 38%.

Given the progress we have made in strategic initiatives the first half of the year, we expect to return to organic net sales growth and stronger operating profitability in the second half.

In November, we announced a Profit Recovery Plan to support the progressive rebuilding of our profit margins in fiscal years 2025 and 2026. Today, with the announcement of a two-year restructuring program, we have further expanded this plan. As Fabrizio mentioned, we are focused on strategically leveraging our strengths to accelerate our return to more sustainable profitable growth while elevating our consumer activations and increasing our operating agility. The restructuring program is designed to right-size and streamline select areas within our organization, which unfortunately necessitates us making the difficult decision of an expected net reduction in positions globally of 3% to 5%.

The restructuring program is expected to begin in the third quarter and continue for the duration of the Profit Recovery Plan. We expect to take charges of between $500 million and $700 million and generate annual gross savings of $350 million to $500 million before taxes. A portion of these savings is expected to be reinvested in consumer-facing activities to drive long-term sustainable profitable growth.

We now expect to drive incremental operating profits through all initiatives under the Profit Recovery Plan of $1.1 billion to $1.4 billion inclusive of net benefits from the restructuring program announced today. The plan is expected to yield almost all of the anticipated benefits by the end of fiscal year 2026 with slightly more than half of these benefits realized and contributing to operating profitability in fiscal 2025.

In closing, we express our sincere gratitude to our teams around the world as they work tirelessly to execute against our priorities and drive our business forward. We believe that with the work that is being done to position us to return to growth in the second half of the fiscal year and beyond and with the successful execution of our expanded Profit Recovery Plan, we will be better positioned to return our company to long-term sustainable growth and profitability.

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

QUESTION AND ANSWER SECTION

Operator: The floor is now open for questions. [Operator Instructions] Our first question today comes from Dara Mohsenian with Morgan Stanley. Please go ahead.

Dara Mohsenian
Analyst, Morgan Stanley & Co. LLC

Q

Hey. Good morning, guys. So first, just a couple clarification questions under the restructuring and profit recovery program. Can you just give a little more detail on the structural changes in the program beyond the job cuts? And in the past, you've done a pretty good job of delivering upside to savings goals, so how do you think about other savings areas that could potentially emerge over time, and are you pushing beyond what's potentially announced?

And then, if you'll be generous enough to entertain a question on China. I think clearly there's some structural changes that have emerged in China beauty, the consumer perception of the category itself, willingness to be ostentatious, et cetera, changes in daigou selling, promotional impacts, mass brand performance. There have been impacts to Estée brand share. So maybe, Fabrizio, just take a step back and broad thoughts on the opportunity in China from here but also specifically how do you adjust to these changes? What are your focus points from here in this new China reality? That'd be helpful.

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

A

Thanks. So, Dara, I'll start with your question on the Profit Recovery Plan. What we shared in November was our primary focus of the plan is to rebuild our gross margin, which is where we've lost as you all know quite a bit of margin.

So some of the strategies that we spoke about at that time that we were putting in place is really to focus on more profitable channel mix to get our inventories under control, which should improve our obsolescence as well as some of the discounting that has gone on over the last few years.

We are being more granular in terms of some of the strategic pricing initiatives that we have. And we also talked at that time about from an expense standpoint implementing an incremental indirect procurement program to reduce some of our expense areas. So that – those were some of the initiatives that we spoke about, that made up the $800 million to $1 billion in terms of the Profit Recovery Plan at that time. And then obviously we've announced an additional element to the program with the restructuring that we saw.

China?

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

A

Yeah, so on the China, on the China question, first of all, we had some soft consumer sentiment in the recent periods that the drive lowered the prestige sales growth. First of all, we remain very optimistic about the long-term opportunity in China and are continuing to invest for growth.

The second point is you asked about the brand health and what's changing. Our brands are really, really, really strong. The retail sales growth has been much better than the net growth and been extraordinary double digit growth of many of our brands particularly in luxury like La Mer, TOM FORD, Jo Malone, Bobbi Brown, KILIAN, Frédéric Malle, and Aveda. Also, Le Labo continues to thrive.

In terms of market share, importantly we gained market share over the fiscal year in quarter two despite there was a small reduction of market share in quarter two. But we gained market share in skin care category 80 points. We gained in fragrances, we gained in hair care. And there are several important of our brands we had really top ranks in 11.11.

Another element to support the strengths of our equity is the free standing store double-digit growth both in total and in [ph] Leidos (00:33:42) in Mainland China. And I should also mention the strength in Hong Kong where we grow substantial market share as part reflecting the success with the Chinese consumers.

So where we go from here? As I said, we are going to continue to invest in China, and we believe we have a great team there and determination to continue to building market share winning in the long-term. The first step is building our distribution and winning online channels that this will continue, particularly accelerating the win in the short term and continue to build market share in new cities in brick-and-mortar where I would like to underline in quarter two we grew substantial brick-and-mortar market share in China.

We also continue to leverage our current trend where retail sales [ph] clearly ahead on that (00:34:40). And we will support very strong holiday plans, which as you know, there is a high concentration of sales in China during the various holiday plans in the course of the year.

We also believe that there is a particular strong opportunity in the luxury area among our luxury brands, which as I said are doing very well. And I'm referring to Estée Lauder Re-Nutriv launch, which I mentioned in my prepared remarks. La Mer, TOM FORD, Le Labo, Bobbi Brown have extraordinary aggressive plans. Strong innovations plans in H2 by the way will continue. It will accelerate leveraging our new labs, the new laboratory in Shanghai which is an important opportunity for us.

And it's important – you asked what is changing in the various other aspects. So in the relationship with travel retail and in the managing of the overall pricing and promotional across the Chinese consumer framework, we have dramatically improved the model or the process between the China team and the TR team in making decisions about promotionality, pricing, channel [indiscernible] (00:36:00), and this is working better and better for the future.

And also about the development of local brands, for the moment they're mainly en masse but we completely acknowledge there will be a continuous development of local brands and the strengths of our innovation and the differentiation of our brands is going to be key. And so we'll continue to invest in this differentiation and in these strengths.

The investment in our local lab that will develop local innovation is part of the answer to how to compete in this evolving environment as well.

Last, we are shortening the supply chain with a factory in Asia-Pacific and the ability to plan more accordingly to demand and to be more agile responding to demand is the other big capability that will increase the flexibility, the agility of our China team in following demand. So net we have a strong business in China. We have strong market share, and we are determined to continue to invest for the long-term in China.

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

Bryan D. Spillane
Analyst, BofA Securities

Q

Thank you, operator. Good morning, Fabrizio and Tracey. So my question is just related to maybe how you're going to measure yourself as an organization over the next two years. So the 2025 to 2026 timeframe. And I guess I ask that in the context of stock clearly today reflecting an inflection, right, a positive inflection. But at the same time, there's a lot of mixed things, right. China slower than it was, but again optimistic for the long-term. You've got a lot of work to do underneath the hood, right, to execute on the restructuring program and improve margin.

So just I guess I'm just curious how you're thinking about how linear this improvement would be and again, just are you going to change the way you're going to maybe measure yourselves in the near term just given how much work you've got to do and how maybe different it was versus business as normal over the last couple years? Thanks.

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

A

Yeah, absolutely. And your question will give me the opportunity to give an overview of what we're trying to do. I hope you realize that the work we've done in the last several months that culminate today in what we define an inflection point is first of all acknowledging the need of some important changes to align to the future opportunity to address our key pressure points developed in this post-COVID environment.

So I'd like to summarize first of all what we are doing and then I will measure ourselves. The way we look at it is that first of all we are addressing the need to change, and we are addressing the key pressure points. The first is the meaningful progress we have done on retail stocks in TR Asia that as we said as of April, they should be aligned and this will determine the ability to align in the future retail and net in this very important channel for us and for the industry in general. That's a big pressure point that we are addressing.

The second part that was driving margin was obviously the need of gross margin – addressing our gross margin, addressing our cost structure, and right-size our organization. And so the Profit Recovery Plan enlarged and the execution of it which is strongly advanced and the additional restructuring are addressing decisively our ability to recover profitability at accelerated pace.

And at the same time, this Profit Recovery Plan is designed to resource our future growth plans more aggressively and to develop the right agility, speed to market in the organization. And we are going to measure this and to measure ourselves on that.

For agility, I mean agility to allocate resources in this more volatile world more promptly and faster as the one for example supply chain as I just mentioned in the previous question and the speed to market of innovation to better compete with local brands.

The other important part of profitability margin was skin care, and obviously we need to recover our skin care growth to address the profitability as we discussed in [ph] several hours' time. (00:40:34)

I just want to clarify that the skin care growth during quarter two was very strong in the Americas, in EMEA, in APAC ex-China. In China, we didn't grow skin care during quarter two but we grew market share skin care as I said before in a very strong way.

So we are addressing the skin care opportunity, and the innovation of skin care that we are announcing, the one on Estée Lauder the La Mer fresh, the La Mer future innovation, the Clinique repositioning actually leveraging its heritage position, The Ordinary activation and the future of The Ordinary globally, all these are engines that should continue to grow also in the long-term our skin care now that as [ph] of lately (00:41:22) the retail stocks in TR will build.

So that's the first big pressure point that we addressed. The second was the China growth and the China focus in the long-term. I believe I addressed this in my previous answer.

The third one is accelerating our plan to stabilize market share in the US, and we are addressing this first of all attacking very clearly our opportunity in active derma and with the Clinique heritage positioning and with The Ordinary extraordinary success. We will continue to address our distribution mix improvement needs towards a consumer growth segment and a channel segment. We are accelerating our fragrance sales growth, which is very important in the region, and also would like to remind that we have the top two brands in skin care and in makeup in the region, and in skin care with the arrival and growth of The Ordinary, now we have four of the top five skin care brands in the market. And The Ordinary gained 200 points [ph] per ship (00:42:31) in prestige market just in quarter two.

So we are addressing very decisively the future opportunities [ph] obviously (00:42:40) in our North America. So second big point is we want to continue building on our strengths and we said we have strengths clearly in APAC ex-China in this moment with the comeback of Hong Kong which is a very important improvement versus [ph] recovery (00:42:58) period.

In EMEA we continue to have strong growth for example in skin care in markets like Germany, Italy, Spain, Turkey. Our emerging market grew [ph] mid (00:43:08) double digit and we believe we have strong opportunities in emerging markets where we have very strong market share position in every one of the top ones for the future acceleration.

Our direct to consumer business, our free standing store grew double digit supporting also our brand strengths in equity. So we will continue building on all these strengths and our plans focus on this. We remain confident in the future of the prestige beauty market, so there remains very attractive – we remain focused as a pure-play on this very high growth [indiscernible] (00:43:45) market of – in the consumer goods industry.

And finally as I said, the Profit Recovery Plan and the restructuring will be a key enabler of all the strategies in our future.

So, yes, we see it. We are at an inflection point, and we are going to measure ourselves on all these elements combined, meaning we are going to measure ourselves on with the pace of recovery of our profitability with going back to a growth – sustainable growth model and investing in our brands for the future and readdressing the needed changes in our organization to improve agility of resource allocation and speed to market.

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

Olivia Tong
Analyst, Raymond James Financial, Inc.
Q

Great. Thanks. I wanted to talk a little bit about just first a follow-up on your US distribution comments in terms of stabilizing US share. With Clinique and The Ordinary sort of towards the entry level price point in prestige, how do you think about further diversification in US distribution effectively as department store exposure continues to come down? Thanks.

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

A

We are, as you know, we are working on this for some time, and the way we address it is that we are going to continue to increase the focus on high growth channels. We have done some extraordinary improvement in the specialty channel in the last year, and that will continue to be our focus.

We are also obviously focusing our support to our department store partners and where we have high market share and we are managing this business carefully.

And we are continuing to accelerate online with various opportunities that we have in this world. And the consumer is shopping more and more omni-channel. And so we are going to continue to put focus on the opportunity of omni-channels growth that we have in the United States. So that's what we're doing, and you will see this strategy to be implemented step by step in the next 12 months accordingly to these opportunities.

Operator: The next question comes from Oliver Chen with TD Cowen. Please go ahead.

Oliver Chen
Analyst, Cowen & Co. LLC

Q

Hi, Fabrizio and Tracey. You mentioned agility many times. What are your thoughts on the priorities in terms of what you'll do there, as well as direct-to-consumer and digital and community engagement as you know is very important in terms of user generated content and making sure to embrace a lot of new formats?

And a follow-up. As we model inventory in the back half, your inventories are in much better shape, but what gives you the conviction that the inventory levels related to Asia travel retail will be healthy in terms of the back half? Just some key aspects and being more confident there. Thanks a lot.

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

A

Thanks, Oliver. So I'll start with the inventory levels. We made significant progress as we said in our prepared remarks on inventory and bringing down the levels of inventory in the trade that were high in pockets of Asia travel retail. So we are pretty comfortable that we will be able to bring those down to levels that are healthier, that are expected to drive regular replenishment levels, and therefore be the net sales accelerator that we have embedded in our guidance for the second half of the year.

In addition, what we spoke about is we've also at the same time of bringing down inventory levels in the trade brought inventory levels down in-house, and that is part of the benefit that we saw in terms of the cash improvement in the quarter. And we expect with the tools that we've invested in and having healthier levels of inventory overall, largely driven by the pull-down in production that we did in the first quarter that we spoke about, that we are going to be in a much better shape as we support some of the upcoming innovation that we have as well as in the future in terms of bringing inventory levels into better control.

Obviously, the investment that we've done as Fabrizio mentioned in our Asia supply chain allows us to have shorter lead times in the region, and be able to better manage any volatility that may occur in the future, now that we have a plant and an R&D center in the region.

So all of those things help us in terms of creating better inventory agility having – being able to produce faster to market demand than we have been in the past.

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

A

Then your question on agility, there are two measures of agility that we look as very important. One is agility in responding to volatility faster, reallocating resources, so the action in this area has been the shortening of our supply chain in Asia for example. And the [ph] way (00:49:28) you asked it on even the way we are repositioned. We are leveraging the historical heritage position of Clinique and doubling down on it in active derma, the way we are leveraging The Ordinary strengths in the active derma, so in other words how we are responding to the consumer trend of active derma now very decisively.

So those are elements of agility. We want to improve our ability to do these things faster and more promptly in the future.

The other aspect of the agility is the way we go to market. So reaction to, for example, the new platforms. We are learning how to operate with TikTok globally much more. We are focusing on our media value much more, our organization, including the resource allocation but also the training and the development of the understanding of the various models. We are doing this in all markets of the world at the same time.

We are modernizing our promotional models and making them more relevant to the current consumer trends and importantly as an umbrella concept we are becoming more and more able to react to trends. So there are two kind of trends we are working our organization development on. The first is the long-term trends. The fundamental changes in consumer preferences where frankly we have been always pretty strong and we are further refining this ability. And then there are the short-term trends, the trends that could change in a week, in a month, what's going to be popular online in a certain country in a certain moment where we have developed better and better models to react to short-term trends with our brands, with our execution, with our resource allocation.

And by the way, the work of our organization on the Profit Recovery Plan is also tailored to improve our ability in both these areas. Meaning the agility in resource allocation and the agility in reacting to trends and to the new models of marketing around the world.

Operator: The next question comes from Dana Telsey with Telsey Advisory Group. Please go ahead.

Dana Lauren Telsey
Analyst, Telsey Advisory Group LLC

Q

Hi. Good morning, Fabrizio and Tracey. As you think about pricing and with the new launches that you have coming, how do you think about pricing both for existing [ph] hero (00:51:58) and new products and how it's changing? And then as you continue to enhance the specialty multi distribution, how do you see engaging with the department stores and how – what that relevance – how that relevance changes? Thank you.

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

A

So we have a pretty sophisticated, Dana, pricing model for new products launches, and I think we had spoken about even under the Profit Recovery Plan making sure that our new product launches actually are accretive to our overall margin.

So we have actually cut some of our new product launches that were planned for fiscal 2025 in order to do that and re-looked at our innovation pipeline to make sure that what we are launching is in fact accretive.

But the sophistication that goes into our new product pricing model in terms of looking at what the competitive benchmarks are relative to that particular launch, also from a market standpoint, making sure again that the new product is positioned appropriately, we look at if it's replacing an existing franchise, measure the product and pricing differential related to added content, added benefits, added packaging, et cetera. So there are a number of things that factor into it.

I think that as we mentioned, we've got some very exciting new product launches in the second half of this year. M·A·C is relaunching two of their largest franchises, Studio Fix and the M·A·C Lipstick. We've got Estée Lauder Re-Nutriv with SIRTIVITY that is quite exciting, really playing on the longevity focus that is accelerating in the market.

So Fabrizio just talked about trends. We've got quite a bit of trend-based, but highly efficacious from a quality standpoint products launching in the second half of the year, all of which have been priced appropriately for the benefits that they are contributing.

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

A

Yeah, and on the different retail channels, we obviously support every one of the retail channels, so specially, multi, department store, everyone, but every retail channel is going to be supported more and more in a tailored way, meaning tailoring to their model, to their strategy, to their specific consumer profiles. And this will be very different country by country. There are countries where certain channels grow faster than others and maybe the opposite happening in other countries.

So it's not about preferences or changing strategies. It's about tailoring the strategies to each channel and supporting every one of our partners. The end result of this is that the mix of our business in every country of the world will be focused on growth. It will be focused on leveraging the channels that the consumer is in that specific moment will choose or the different target of consumer will choose in every channel. So it's about tailoring to all the opportunities wherever they are.

Operator: The next question comes from Steve Powers with Deutsche Bank. Please go ahead.

Steve Powers
Analyst, Deutsche Bank Securities, Inc.

Q

Hey, thank you, and good morning. So back to the Profit Recovery Plan, I think your outlook today at the midpoint implies roughly $1.5 billion or so of operating profit in fiscal 2023, and you frame the recovery program as incremental profit from here, which assuming the benefits are all off a fiscal 2024 base, it implies $2.5 billion to $3 billion or so of operating profit in fiscal 2026. And I think that's before considering presumed underlying growth in the business over those next couple of years. So can you...

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

A

That's correct.

Steve Powers
Analyst, Deutsche Bank Securities, Inc.

Q

...can you confirm that? Okay. Great. So I guess the question is – the question is how do you protect – I guess that objective you're saying, how do you protect against those incremental profits being essentially countered by incremental investments that emerge over that time so that you're saying the expectation for investors today that the profit comes, it's pretty firm objective but I'm just – how do you guard against other costs creeping into the model over the next couple years?

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

A

So, no, it's a great question, Steve. And, look, we are certainly realistic that with regulatory changes, with what happens with inflation, there are a lot of things that we in the base business the floor of the Profit Recovery Plan need to be able to manage.

And one of the things that we are working through with our organization is how do you make those choices in terms of what to invest and disinvest in, in terms of the base business? So those are areas that we are keenly focused on as we look at just what the base progression which you're very familiar with what our normal progression is outside of obviously this unusual period of post-pandemic disruption that we've experienced. So we certainly have in the past been able to do that, and believe that we can do it in the future as well.

We've also stood up a very disciplined and strong project management office in order to be able to track all of the savings that we are committing to, and also obviously with the base business making sure that we're meeting our normal base expectations as it relates to regular growth and margin expansion.

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

A

And I just would like to add one point is that as you said, the $1.1 billion to $1.4 billion have been defined as extra profitability which means that the reinvestment part in building our brands and accelerating growth comes from more savings than what we define as extra profit.

So be clear, there will be more savings. Some of them will be reinvested in consumer-facing growth acceleration. And the $1.1 billion to $1.4 billion is our target for extra profitability, and that's why we've been very clear on that.

And the investment in growth that will be done or the extra investment in growth for the future that we want to develop capabilities for are for consumer-facing. We are not planning to invest in many new capabilities, but rather we want to leverage the capabilities we have built in the last period in a very efficient way. So that's the way to think, I believe, about the Profit Recovery Plan.

Operator: Our last question today comes from Lauren Lieberman with Barclays. Please go ahead.

Lauren R. Lieberman
Analyst, Barclays Capital, Inc.

Q

Great. Thanks. Good morning. So I had two things I wanted to touch on. The first was just I think during the prepared remarks you commented that retail sales ex-China and travel retail are up mid singles, but organic also [indiscernible] (00:59:40) was down 3%. So I know you've spoken very explicitly about the inventory dynamics in

Asia travel retail, but I was just curious about inventory dynamics outside of those markets and why that disconnect was that large. So that was question one.

And then question two was just on the go-forward plan around unstructured market across Asia. So of course we all know there's been regulatory change in China and Hainan, but you've spoken many times in the past, Fabrizio, about how that market tends to shift and move with the travelers and currency and all sorts of things that can impact where it's taking place. So was curious on your thoughts about that unstructured market going forward, what you are or aren't going to do in terms of regulating the degree of participation. [indiscernible] (01:00:33) has a lot to do with how we should be thinking about and modeling the absolute size of the travel retail business in dollar terms as we look out over the next several years. Thanks.

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

Thanks, Lauren. So I'll start with the retail and on organic. When we have especially in the second quarter, obviously when we have big events like 11.11 and you have holiday, and in the case for us when those events don't go as well as expected, obviously our retailers pull back and we pull back on some of the shipments that we have to those retailers in order to bring things back in line. So you will see from a quarter to quarter standpoint, there may be some disconnects related to that. But it averages out over the course of a year. So we don't have any issues in any other markets like what we have been experiencing in Asia travel retail for you all to be concerned about.

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

And on the unstructured market, our focus is on travelers and travelers conversing and that is getting better and better around the world, just to be clear, apart from the China situation that we have discussed many times. In the rest of the world there is an extraordinary progress in this area. Double digits in some cases, triple digit in every market of the world.

So this will happen more and more also in China, also in Korea, and also in the part which has been the slowest to recover in that direction. So the first part of the answer is the focus in continued growing in travelers and continuous improving the travelers conversion as we have seen from the data of the market, the travelers has been improving very, very nicely, but the conversion of the travelers for the moment has been below expectations.

The unstructured market as such is reducing and I want to say is reducing also for regulations for the intentions of the governments, of the retailers, so there is a trend to reduce the amounts. And obviously this is also what we are doing, and so the way you should expect is that the unstructured market will be reduced in my opinion, will reduce also as a market, will be reducing for us, will be reducing in a gradual way as the travelers improve and increase over time.

Operator: That concludes today's question-and-answer session. If you were unable to join the entire call, a playback will be available at 1:00 pm Eastern Time today through February 12. To hear a recording of the call, please dial 877-344-7529 passcode 1939290.

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