Lauder (Estee) Cos (EL) Earnings Report: Q2 2015 Conference Call Transcript

The following Lauder (Estee) Cos conference call took place on February 5, 2015, 09:30 AM ET. This is a transcript of that earnings call:

Company Participants

- Dennis D’Andrea; The Estee Lauder Companies; VP - IR
- Fabrizio Freda; The Estee Lauder Companies; President, CEO
- Tracey Travis; The Estee Lauder Companies; EVP, CFO
- Chris Good; The Estee Lauder Companies; President - UK, Ireland

Other Participants

- Olivia Tong; BofA Merrill Lynch; Analyst
- Lauren Lieberman; Barclays Capital; Analyst
- Ali Dibadj; Sanford C. Bernstein and Company; Analyst
- Connie Maneaty; BMO Capital Markets; Analyst
- Wendy Nicholson; Citi Investment Research; Analyst
- Caroline Levy; CLSA Limited; Analyst
- Michael Steib; Credit Suisse; Analyst
- Bill Schmitz; Deutsche Bank; Analyst
- Jason English; Goldman Sachs; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

Good day, everyone. Welcome to the Estee Lauder Companies' fiscal 2015 second quarter conference call.

Today's call is being recorded and Web cast.

For opening remarks and introductions, I will turn the call over to the Vice President of Investor Relations, Mr. Dennis D'Andrea. Please go ahead, sir.

Dennis D'Andrea (VP - IR):

Good morning. On today's call are Fabrizio Freda, President and Chief Executive Officer; Tracey Travis, Executive Vice President and Chief Financial Officer; and Chris Good, President of the UK and Ireland. Chris is going to discuss both the strategy and our current business in the area.

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 will find factors that could cause actual results to differ materially from these forward-looking statements. Our discussion of our expectations for the full fiscal year are before the impact of accelerated retailer orders that took place in the fourth quarter of fiscal 2014 July implementation of our strategic modernization initiative, which would have occurred in our fiscal 2015 first quarter.

You can find reconciliations between GAAP and non-GAAP figures in our press release and on the investor relations section of our Web site.
And I’ll turn the call over to Fabrizio.

**Fabrizio Freda** (President, CEO):

Thank you, Dennis, and good morning, everyone. Our global business delivered strong financial results in the second quarter of fiscal 2015. Net sales rose more than 5% in local currency, better than we anticipated and earnings per share also exceeded our forecast.

Many of our brands, channels, and countries contributed. And importantly, we expect this momentum will accelerate in the second half of our fiscal year due to the strength of our upcoming launch calendar.

Prestige beauty continued to grow, sustained in part by heavy spending by key companies and occurred against the backdrop of increasing volatile macro events, including sharp currency fluctuations, political unrest, and slower growth in some countries. We continue to invest in the future by acquiring four prestige brands that position us well for our sustained growth and profitability. I will further discuss these acquisitions later on.

Our results this quarter clearly demonstrated our strategy is working, since we were able to deliver solid performance when faced with market challenges and currency volatility. This is also a testament to our talent and the flexibility we have built into our business model to create resilience and agility. We are able to quickly adapt and change our focus when we see consumers and market dynamics shifting.

Our consistent success is rooted in our multiple engines of growth, which has enabled us to find opportunities across geographies, channels, consumer demographic brands, innovation, and acquisitions. We have strategically broadened our reach so when the unexpected occurs, we are less exposed and have more positive levers to pull.

Our strength in the second quarter was led by many of our prominent growth engines. Our luxury and makeup brands were standouts, which continued a recent pattern. We enjoyed excellent double-digit growth in the UK and most emerging markets and by channel in our online, specialty-multi, and freestanding stores.

Sales rose in most product categories. Skincare, our largest, was supported by recent launches, including Clinique's Smart custom-repair serum, which climbed to the number two position in prestige serums in the United States. Clinique’s Sonic System Purifying Cleansing Brush also performed well and is gaining momentum globally. It’s a strong seller in travel retail and in key Asian markets, it has overtaken its main competitor to become the bestseller device.

Throughout December, we estimate that nearly half of all North American consumers who purchased the brush also bought at least one of the Clinique 3 steps products. The brush is part of Clinique's strategical important three-step cleansing system and reinforces its authority in this area.

In other skincare news, Estee Lauder luxury Re-Nutriv Ultimate Diamond Dual Infusion has been well received and soon will be paired with the new lifting cream. We have had good consumer acceptance to the Re-Nutriv franchise, strengthening the brand in the high-end segment of skincare.

Our makeup momentum continued and we generated strong sales growth, most evident in our three makeup-oriented brands. M.A.C sustained its fantastic run, with growth in all regions and notably in many emerging markets, including China, Brazil, Turkey. Its holiday kits sold out in North America and business in its freestanding store worldwide was brisk.

Smashbox growth was also stellar, thanks to strong retail in specialty-multi and online, expanded global distribution, and popular new palettes. Within makeup, our brands are significant players in the key subcategory of foundations, one of the highest loyalty products.
Bobbi Brown Skin Foundation Stick and Estee Lauder Perfectionist and Double Wear products were bestsellers. Beyond Perfecting, Clinique’s newest liquid foundation, incorporates concealer and is beginning to launch in the stores now.

The Estee Lauder brand makeup business climbed high single digits globally, driven also by its hugely popular Pure Color Envy lip franchise. Also in the lip category, we expect the spring launch of Clinique Pop lip color and primer to generate excitement.

In fragrance, sales declined against heavy launch activity in the previous year period. However, our luxury scents from Jo Malone and Tom Ford continue to rise sharp double digits. And we had a nice lift from our successful Michael Kors collection.

In hair care, Bumble and bumble generated strong US sales and has two exciting hair care products launching this fiscal year that we expect to boost its salon business.

As you see, there is a great deal of product excitement across the portfolio that we believe will contribute to accelerating sales in the second half. We also continue to drive sales from several high-growth channels. Our E&M commerce business rose more than 30% in the holiday quarter, with double-digit increases on brand and retail sites and even larger gains on third-party sites.

Also impressive is that nearly one-third of these sales came through mobile devices. Importantly, all metrics, traffic, conversion, and orders increased over last year. The lion’s share of our Company’s e-commerce business comes from the US and the UK.

In our second quarter, sales in each country surpassed the market’s overall online growth. The largest market for e-commerce in the world is China and we are making good progress there as well. We have now six brands online in China and their combined online sales increased nearly 200%.

We have tremendous opportunities to expand our online footprint by brand and country around the world. Our midsize brands are growing in importance to the Company overall and this is also true in travel retail. Aveda, Jo Malone, La Mer, Tom Ford accounted for much of the 4% increase in retail sales in the travel channel. Our net sales in travel retail declined approximately 4%, because retailers rebalanced inventories.

Additionally, the Chinese New Year holiday is later this year, moving [such shipments] to the third quarter. Sharp currency moves and political unrest in part of the world has curtailed travel and has affected groups that had large purchases of beauty products, including Russians, Brazilians, and Chinese. A bright spot was Japan, where travelers took advantage of a weak yen and we had strong retail growth.

Another positive factor is our continued expansion in the channel. We opened more airport stores for certain brands, which are generating good growth. From a geographic standpoint, we tailor our product and resources to where we see the best growth prospects.

We continue to believe China is one of the most exciting opportunities and will remain a key growth drivers over the next decade. China’s prestige beauty growth remains at high single digits and we see widespread opportunity to enter additional cities, doors, and channels and launch more brands.

Our net sales in China rose 4% in the quarter. We were competitive promotionally and our retail sales climbed 15%, with virtually all brands rising double digits.

Estee Lauder, the leading prestige beauty brand in the market, had a terrific performance, especially in December, when retail sales rose sharply and it wildly outperformed the industry. We expect its positive retail trend to continue for the rest of the fiscal year.

Chinese consumers are passionate about beauty products and branching out beyond skin care. M.A.C.,
Bobbi Brown, Tom Ford, and Jo Malone had fantastic results, pointing to higher makeup and fragrance consumption in that market.

M.A.C. emphasized Korean beauty trends that are popular throughout Asia, sending its sales up sharply. Emerging markets beyond China have been helping to drive our consistent growth, as our compass predicted.

The group which includes Brazil or India maintained its healthy momentum, up 25%. Our business in Europe, the Middle East, and Africa was strong. Net sales growth in constant currency in Western Europe rose mid-single digits. And we estimate we gained share in Germany, Spain, Switzerland, Benelux, and Nordic regions.

Emerging markets there grew more than 20%, driven by Russia, the Middle East, and Turkey. The UK has done a phenomenal job embracing the Company’s strategy with outstanding execution, strategic innovation, and local relevance.

There are many lessons we have learned in the UK that are applicable to other markets, which will foster future gains around the world. Chris will elaborate shortly.

Our net sales in Hong Kong declined slightly as protests and tensions impacted retail traffic, but our results were better than we had anticipated. Although spending by tourists is expected to remain slow, we anticipate a return to growth in the second half as political unrest abates.

Our sales grew modestly in Korea. Although local brands continue to gain share, we are encouraged that a number of our brands, including Aveda, Origins, Darphin, or Jo Malone are accelerating and some heritage brands are showing signs of recovery. In addition, we successfully launched Tom Ford Beauty in Korea with very strong demand.

Retail sales of prestige beauty improved in the USA, a trend led by many of our brands. The holiday period was promotional for all prestige beauty, culminating in a strong retail showing for the month of December. The consumer sought value and responded well to our holiday programs that were popular across brands and channel.

We expect sales to accelerate in the US in the second half, reflecting a strong launch calendar and marketing activities. We are working to extend our scope by reaching new consumers’ demographics.

And one of our most exciting initiatives come from the Estee Lauder brand, which signed 19-year-old Kendall Jenner as a spokes model. Kendall is savvy in social media and has a huge built-in audience, with over 18 million followers on Instagram.

The Estee Lauder brand remains focused on its core consumers, as evidenced by innovation in its luxury and [antiaging] business. However, at the same time, it is taking steps to broaden its appeal and be disruptive in a way that will draw the attention of a new generation. Our namesake brand has other exciting announcements and launches planned in its tries to attract more influencers and millennials.

Now I’d like to update you on the newness brand in our portfolio. Each one we recently acquired has a unique position in a fast-growing area of prestige beauty. RODIN Olio Lusso in oils. Le Labo in high-end fragrances and sensory body products, as we discussed last quarter. More recently, we added GLAMGLOW, a Hollywood skincare brand focused on fast-acting facial masks, with a robust presence in specialty-multi channels. And Editions de Parfums Frederic Malle, which offers a collection of luxury fragrances crafted by some of the world’s most talented perfumers.

Over the years, we have acquired many small brands that today are formidable global competitors in the prestige beauty space. Our creative and operational strengths position us well to develop these next collection
of brands into more sizable brands for the future.

We warmly welcome the brands and their entrepreneurial founders into the Estee Lauder Companies family. We look forward to accelerating the momentum of each of the brands by leveraging its strengths and together, we will develop their potential.

These brands are being overseen by two talented executives, who brings complementary skills and intimate knowledge to our Company. Caroline Geerlings, who most recently headed Tom Ford Beauty, is focused on commercializing the brands and their operations. Daria Myers, who has extensive brands and R&amp;D experience, oversees innovation, product development, and creative initiatives. Both executives report to Group President John Demsey.

Our long-term strategy emphasizes our many pillars of strengths, including a strong bench of talented leaders, diverse brand portfolio, balanced geographic presence, and most importantly, multiple engines of growth, highlighted in our compass. We are committed to strengthening our robust growth levers, finding new ones, and continue our journey to keep delivering sustainable profitable growth.

With a solid first half behind us and exciting programs ahead, we are confident we can execute against the global challenges and risks we may face and deliver another year of above industry constant currency growth. I want to thank all our talented employees who contributed to our excellent performance throughout their collaborative spirit and dedication and ability to steer through many volatile environments.

Now I will turn the call over to Chris to talk about our fantastic UK business, which, on a local level, mirrors the terrific global collaboration and execution I just discussed. Chris?

**Chris Good** (President - UK, Ireland):

Thank you, Fabrizio, and good morning, everyone. I am delighted to be here. I have been with Estee Lauder Companies for 15 years in a variety of leadership roles in Asia and Europe. And for the past three years, as President of the UK and Ireland.

The UK was the first market to be opened by the Company outside of North America in 1960 and indeed it remains our second-largest market after the US, representing more than 8% of total Company sales and an even greater share of profits.

Fabrizio spoke of the Company’s multiple areas of growth and the UK is one of the largest engines. Our Company is number one in prestige beauty in the UK and number two in total beauty, which includes mass.

The UK business is large, complex, and has a very different distribution profile from Continental Europe. Many would view the UK business as mature. Average growth for total beauty has hovered between 3% and 5% for the last few years, with prestige beauty growing at approximately 5% on average.

However, we view our UK business as an emerging market. What we mean by this is that we pursue high-growth opportunities across geographies, channels, categories, and consumer segments. This approach has resulted in three years of growth trending well above the market.

Our net sales in constant currency grew 11% last year and we are currently up 13% for the first half of fiscal 2015. Strong results in an economy, with GDP growth of only 2.6%.

The UK is one of the world’s most diverse nations and a top tourist destination. We go to great lengths to offer the most ethnically appropriate mix of business at every counter. We ensure our staff and merchandising is well suited to the consumers of each location.

Our approach is also successful by product category. Prestige skincare is growing modestly across the UK,
but if you look at specific subcategories within skincare, there is good growth to be had if you have the right product and the right targeting.

For example, masks are a high-growth subcategory where we are a leader. Origins has the number one rank in prestige masks in the UK. Creme de la Mer has jumped up to number three, following the launch of its intensive revitalizing mask and lifting and firming mask, with its mask sales quadrupling in value.

Our brands combined show a growth of plus-28% for the first half in masks, more than double the prestige growth.

In fragrance, our best performers this year have been the luxury brands Jo Malone and Tom Ford, which both grew at over 20% against prestige fragrance as a whole at 3%. This bodes well for the new acquisitions of Frederic Malle and Le Labo, where we are poised to take advantage of the UK consumers’ strong appetite for luxury fragrance.

A further area that illustrates our granular approach is our distribution. We have continued to expand our freestanding stores into new areas, including major transportation hubs. M.A.C. and Jo Malone stores opened at St Pancras international train station and both are now trading ahead of plan.

Further opportunities exist for distribution in areas that might not be the most obvious choice, but quickly prove their worth. A new Jo Malone freestanding store in the popular tourist golfing destination of St. Andrews in Scotland is an example.

We have also had success with new formats, such as pop-up stores, to test and learn in new locations. Examples are Jo Malone in Brown Thomas in Dublin and Clinique in London’s Covent Garden.

Our well-balanced portfolio of brands is helping drive growth. We’ve had solid single-digit growth from our heritage brands Estee Lauder and Clinique. Clinique is the number one brand in the UK and it continues to resonate with consumers. The brand’s new launches, Smart Serum and the Sonic System, propelled facial skincare growth of 10% retail during the first six months.

The heritage brands are fortified by strong double-digit sales growth at M.A.C. as well as the next tier of brands, such as Jo Malone and Bobbi Brown. And this, the next tier, including Tom Ford, Smashbox, and Bumble and bumble, are all demonstrating well above industry growth rates.

This balanced portfolio of brands at different phases of their evolution allows us to continue to grow at above-average rates overall. For this reason, we are very excited about our latest acquisitions, which have tremendous potential.

The UK has a successful history of growing new acquisitions. When we bought Jo Malone 15 years ago, it had just 2 locations in the UK. Today it has 53 stores and counters and is the fastest-growing fragrance brand in the top five.

Throughout our business, we deliver high touch at everything we do. We have 7,500 dedicated sales representatives at retail in our freestanding stores, bringing high touch services to the consumer.

I believe that in this era where a consumer can get whatever she wants whenever she wants it, the brands that can provide unparalleled service are best positioned to grow.

The UK has a higher percentage of mobile shoppers than any other European country and we have made great strides. All our brands in the UK have mobile sites. According to a recent survey by industry think tank L2, we have the top five mobile sites for beauty.

Our retail growth for the second quarter was led by strong results from Jo Malone, M.A.C., Smashbox, and
Tom Ford, each of which saw sales rise 20% or more. The UK recorded its strongest ever Cyber Monday, with online sales up 46%. At Jo Malone, great demand for personalization, such as the new online engraving service for cologne, candles, and bath oils boosted sales, while e-gift cards, click and collect, and same day delivery service in London strengthened the brand’s omnichannel experience.

We had strong results across our channels, with several growing double digits. During the holiday season, online was a marked success, with our own sites growing at 32% and retailer sites 36%. The developing click and collect capabilities of many retailers are a key factor in their growth rates.

In our own channels, we have also started to offer click and collect services for Jo Malone and Bobbi Brown, which helped drive for success and demonstrated our high touch approach to the consumer.

The specialty-multi channel had healthy growth in the quarter, up more than 10%, led by Boots. As part of our strategy to expand brands in specialty-multi retailers as appropriate, our Smashbox and Bumble and bumble brands expended their presence in Boots.

And our freestanding store channel was a huge success, growing up more than 30%. Department stores remain a key channel for us in both brick-and-mortar and online. We had solid growth overall and double-digit sales gains in a number of our largest department store partners.

Going forward, we remain optimistic about the macroeconomic situation in the UK and confident in the continued growth in prestige beauty. Thanks to our tremendous team in the UK and our proven ability to execute with excellence, we remain committed to pursuing the best opportunities to grow our business ahead of the industry and continue to be an important growth engine for the Company overall.

I will now turn the call over to Tracey.

**Tracey Travis** (EVP, CFO):

Thank you, Chris, and good morning, everyone. First let me briefly review our fiscal 2015 second quarter results and then I will share with you our expectations for the third quarter and the full year.

Reported net sales for the second quarter grew 1% compared to the prior year and rose 5% in constant currency, exceeding the top end of our expectation. December sales accelerated beyond what we expected, driven by the strength of our holiday programs as well as the results in Hong Kong being better than what we had anticipated, despite the disruption from the political protests.

Our gross profit margin of 81.2% was 50 basis points above the prior year, primarily reflecting favorable manufacturing variances and foreign exchange. Operating expenses rose 140 basis points to 60.4% of sales. The largest driver of the increase was higher general and administrative costs of 150 basis points, primarily reflecting strategic investments in capabilities, such as R&D and information technology, as well as our acquisition activities.

Retail store expenses rose 40 basis points, reflecting the addition of almost 150 freestanding retail stores over the past year. Partially offsetting these increases was 60 basis points of favorability in advertising, merchandising, and sampling expenses due primarily to the mix impact from the strong growth of our lower advertisement brands as well as the cadence of major launch activities for our heritage brand.

As a result, operating margin decreased 90 basis points to 20.8%. Earnings per share came in at $1.13, approximately $0.08 above the top end of our guidance range, up 3% from the prior year due primarily to the impact of the better-than-expected holiday results, an improved tax rate, and a decision we took to shift some of our marketing investments to the second half of the fiscal year to support planned strong launch activity.

EPS would’ve been $0.07 higher on a constant currency basis for the quarter, resulting in strong EPS growth
All elements of working capital continued to improve during the quarter compared to the prior year. Inventory days to sell decreased by 15 days to 171 days, which was driven by a combination of both currency translation as well as improvements in service levels.

During the first six months of the fiscal year, we generated approximately $1 billion of cash from operating activities, a healthy increase of 27% or $211 million versus the prior-year period, which is primarily due to the improvements we achieved in working capital. We reinvested $187 million in capital projects to support the business as we continue to primarily invest in customer-facing areas, such as counters and new retail stores, to support our brand growth plans.

And regarding return of capital to stockholders, we also took the opportunity to accelerate our stock repurchase activity, deploying $479 million of cash to repurchase approximately 6.4 million shares of stock. This level was more than twice the amount we repurchased during the first half of last year.

And as a result of the accelerated share repurchase activity that we began last year and are continuing this year, we have reduced our diluted shares outstanding by approximately 9 million shares from the prior-year period, which has also contributed to our earnings-per-share growth.

In addition to our share repurchase activity, we have also distributed $169 million in dividends to stockholders in the first half of this fiscal year, which was a 14% increase to the prior year’s first half. Over the past five years, we have steadily increased the total amount of annual cash distributed to stockholders with steady increases in both our dividend rate and stock repurchase level in addition to delivering solid earnings growth.

During the second quarter, we also completed the acquisitions of RODIN Olio Lusso and Le Labo, which we funded outside of our free cash flow with a combination of cash on hand and commercial paper. We are proud that our financial performance generates ample free cash flow to reinvest back into our business to fund growth, while at the same time, allowing us to continually increase our distribution of cash to our stockholders.

We ended the quarter with $1.2 billion in cash and cash equivalents and $500 million in short- and long-term investments.

As you are aware from our earlier remarks, we have again utilized our strong liquidity in the third quarter to acquire two additional brands: Editions de Parfums Frederic Malle -- Fabrizio says that much better -- and GLAMGLOW and to continue to opportunistically repurchase shares and support our dividend program. We are well positioned to fund our new acquisitions with a combination of cash on hand and leverage as appropriate.

Let me now turn to our outlook for the third quarter and for the full fiscal year. To provide additional clarity on our underlying business performance, my commentary for the full year continues to exclude the impact of the acceleration of retailer orders that shifted sales from the first quarter of fiscal 2015 into the fourth quarter of fiscal 2014 related to our July roll-out of SMI.

As a reminder, the impact of that shift was $178 million in sales and $127 million in operating income, equal to approximately $0.21 per share. Reported and adjusted results are also reflected in the press release you received this morning.

As we complete the first half of this fiscal year, we do continue to expect global prestige beauty growth of 3% to 4% this year. However, we remain cautious with respect to the macroenvironment, given the high degree of political and economic uncertainty.
So now let me walk you through our guidance for the year and try to clarify for you the expectations for our underlying business performance, the impact of currency headwinds we are experiencing, and the initial impact of our acquisitions. In our outlook for the remainder of the fiscal year, we are reconfirming the range of our constant currency sales and EPS guidance. That means that our sales growth guidance for the fiscal 2015 full year remains at 5% to 6% in constant currency.

The four acquisitions we’ve completed to date are relatively small today and are expected to contribute a combined incremental 40 basis points to sales growth this year, still within our full-year guidance sales range.

As you are all aware, the US dollar has continued to strengthen since we provided guidance last quarter and currency translation is now expected to negatively impact our full-year sales growth by approximately 4 percentage points, which equates to approximately $480 million in sales. Our estimate assumes current stock exchange rates for the remainder of the year of $1.13 for the euro, $1.51 for the pound, and $1.18 for the yen.

On a reported basis, our sales growth guidance, including the negative currency impact, is 1% to 2%. Regarding earnings per share, we are also reconfirming our previous guidance for the full fiscal year in constant currency and that growth expectation remains at 7% to 10%. This excludes the impact of negative currency translation on our earnings, which, with a 4% negative sales impact, equates to approximately $0.23.

Therefore, our revised expectation for reported EPS, including the negative currency impact, is a range of $2.93 to $3.01. So an extra $0.10 from what we had expected last quarter. This compares to our fiscal 2014 EPS of $2.95 before charges and the accelerated orders.

The impact of our acquisitions is expected to delete operating margin by approximately 40 basis points and EPS by approximately $0.06. We expect to manage the EPS impact of these acquisitions within our previous guidance range.

Our sales in the third quarter are expected to grow 6% to 7% in constant currency or flat to last year on a reported basis due to the impact of the strong dollar. Contributing to the sales acceleration on a constant currency basis in the third quarter are multiple new skin care and makeup launches from Estee Lauder and Clinique, as Fabrizio mentioned, coupled with strong marketing support; 70 basis points of incremental growth from acquisitions; a recovery in Hong Kong; a return to more normalized growth in travel retail; and easier retail comparison in North America against the prior year’s severe weather and late Easter; and an easier comparison in Venezuela, now that we will anniversary the transition to SICAD II.

As I mentioned earlier, the cadence of our launch activity is greater in the second half of the year and we plan to increase marketing support for these launches at a level greater than sales growth in the quarter. Additionally, we expect approximately $0.02 dilution from acquisitions. Therefore, we anticipate that third-quarter EPS will come in between $0.45 and $0.50.

The approximately 6% to 7% negative currency impact on sales growth in the quarter equates to approximately $0.07 per share.

The momentum we have experienced in our business in the first half of the year in markets like the UK, which Chris shared with you, our emerging markets in EMEA, and a powerful and resilient brand portfolio, which we have recently expanded, coupled with the strength and dedication of our global teams gives us the confidence that our strategy is working and that we will continue to manage well through these volatile times and achieve our long-term goals.

That concludes our prepared remarks and we'll be happy to take your questions at this time.
QUESTIONS & ANSWERS

Operator:

(Operator Instructions)

Olivia Tong, Bank of America Merrill Lynch.

Olivia Tong (Analyst - BofA Merrill Lynch):

First, just a shorter-term question.

I think it’s impressive that you’re expecting improved growth in Q3 relative to Q2 on a like-for-like basis, and you walked through a couple of the key drivers just now.

But which ones are trending better relative to your going-in expectations?

Fabrizio Freda (President, CEO):

Our business is accelerating. First thing, our Clinique and Lauder brand are accelerating. And in the third and fourth quarters, we are going to have some important launches, with very solid advertising spending and support in some key regions of the world. So that’s the key factor, one of the key factor for acceleration.

The second is the (inaudible) continuous growth of our midsize brands that is continuing to accelerate. And these also is acceleration in distribution around the world entering other markets.

And then the amazing performance of M.A.C.

So that’s on the brand side.

And then as we -- Tracy just explained, we have the expectation of a recovering Hong Kong. We have a return to normalized growth in travel retail that as we explained has been growing 4% in the second quarter. But the net was minus 4% because of adjustment of retailer stocks that we are expecting to be finished.

So the combination of these factors combined with a relatively easier base period for what Tracey explained, like, for example, the very severe weather conditions in the United States make us believe that we are going to accelerate our growth trend.

Operator:

Lauren Lieberman, Barclays.

Lauren Lieberman (Analyst - Barclays Capital):

I have so many questions. I guess two things. One was just on the acquisition mass. I understand the 40 basis points drag, but was just curious if you are including transaction costs in that?

And then the second thing was I know it’s very early and it’s just been announced, but Fabrizio, your perspective on how Macy’s acquiring Blue Mercury could impact your business. Are there brands that you currently distribute in Blue Mercury that have less distribution in the US? That sort of thing would be great.

Thank you.

Tracey Travis (EVP, CFO):

Lauren, on the 40 basis points, yes, it includes transaction costs. It includes the performance of the acquisitions for the time that we've owned them, and it also includes our current preliminary estimate for purchase counting. So it includes all of those things.
Fabrizio Freda (President, CEO):

And on Blue Mercury, yes, no, I think your observation is correct. We have some brands which are in Blue Mercury which have a lower distribution in general in the US. And they are doing very well within Blue Mercury.

So the plan that Macy's announced yesterday of expanding Blue Mercury and to continue build their business the way they announced yesterday will be very favorable to our brands and to the distribution strategy of some of our high-end brands in the United States.

Operator:

Ali Dibadj, Bernstein.

Ali Dibadj (Analyst - Sanford C. Bernstein and Company):

A couple things. One is, I just want a little bit more clarification. On the one hand, we hear about bullishness and acceleration, which is great.

And on the other hand, I'm trying to understand how that translates to EPS, because you are taking down basically by $0.10, as you said, the back half of the year -- I don't know whether it's your guidance. But that's on top of an $0.08, $0.09 beat on the quarter. So it's kind of a bigger take down on EPS than one would've expected from currencies. So want to understand kind of the bridge there a little bit more.

And then in that context, secondly, if you can talk a little bit more about your expectations in the rebound in Hong Kong and in China more broadly. You know, when we were there visiting recently, we found that there was certainly a social unrest aspect to it. But there's also a lot of discussion around the Chinese consumer trading down and that might be more secular. So I'd love your point of view about that, if possible, too, please.

Tracey Travis (EVP, CFO):

So on the first question, in terms of our EPS guidance, we spoke about the fact that we did make a decision within the last quarter to shift some of our marketing funds into the third quarter, primarily, and some into the fourth quarter to support our secondhand -- our second half launches. Particularly for our heritage brands, given some of the strength of those programs. So that's a piece of it.

And then the other piece is us, from an EPS standpoint within the range, covering the dilution effect of the acquisition. So those are the two pieces that are impacting that.

Fabrizio Freda (President, CEO):

And just I want to underline that there is a conscious decision to support our new innovation on Lauder and Clinique in a significant way, because one of our priorities is to accelerate the growth trend of our Clinique and Lauder brands. And if we are able to do that, obviously this will further improve our really strong strengths as an overall Company.

Now to answer your second question is the -- so what is our expectation? Hong Kong, we expect to go back to growth. But we agree and our expectation is not that we'll go back to the kind of growth that was there a couple of years ago.

It's a fact that there is less traffic than before in the stores of Chinese tourists. And it's a fact that the Chinese tourists are -- not trading down probably is not the right word. But the profile of the Chinese tourists, which is in this moment in Hong Kong, is less high high-end than used to be.
So because of this, we are prudently assuming that Hong Kong will go back to growth, but we are not assuming [back to the] the kind of growth there was a few years ago.

In terms of the Chinese having a overall attitude to trade down, I don’t think so. I think Chinese are just -- the high-end Chinese, which continue to spend well, are just changing their destinations. And it’s true that Hong Kong saw less of this kind of profile, but it’s also true that places like Japan are seeing more, that places like London or Paris are seeing more, so the travel of high-end Chinese in Europe is actually on an increasing trend.

So Chinese consumer remains good travelers, remain heavy spenders when they travel, remain very passionate and interested in beauty, and they remain interested in very high-end prestige beauty products. But the destinations are switching and that’s why what we were saying before, our agility and our ability to manage these traveling corridors in the best way and to evolve our traveling core management, depending on how they travel, is a big strength. And I think you’ll see the results of this in the next months.

Operator:

Connie Maneaty, BMO Capital Markets.

**Connie Maneaty** (Analyst - BMO Capital Markets):

A couple of things. On the acquisitions, is the dilution limited to purchase accounting? And will it last a quarter or two? Or will it also stretch into next year? Then I have a question on China. Thanks.

**Tracey Travis** (EVP, CFO):

Okay. So the purchase accounting -- or the dilution is related to three things. One are the deal acquisition costs. So those are one-time costs. They will not continue forward, obviously.

The second is just the operating performance of the combined acquisitions, which is small. And then the third piece is purchase accounting. And right now, we have an estimate for purchase accounting for a couple of the acquisitions.

We have not closed the purchase accounting yet and you will certainly see all of that reflected in our Form 10-Q when we issue it later today. And that will continue forward the purchase accounting impact.

So -- but obviously, we have great expectations for the four brands. Chris talked about how excited he is to have them in his market and what he thinks the UK can do from an acceleration standpoint with the brands. So we would expect that dilution to mitigate over certainly into the next few years.

**Connie Maneaty** (Analyst - BMO Capital Markets):

Okay. And then on China, I think you said sales rose 4%. But what did same-store sales do?

**Fabrizio Freda** (President, CEO):

You mean the same doors? Sorry, what is the question?

**Connie Maneaty** (Analyst - BMO Capital Markets):

Yes. Same-store sales growth in China. What did that do?

**Fabrizio Freda** (President, CEO):

Plus-4%. So the numbers in China this second quarter were plus-15% retail growth, plus-4% same door retail growth, and plus-4% net sales.
Tracey Travis (EVP, CFO):

A trend change from the first quarter.

Fabrizio Freda (President, CEO):

Yes, big acceleration for the previous quarter. And as I said in my prepared remarks, with the acceleration across all brands, with a great performance of the biggest brand in prestige beauty in China Estee Lauder, and an acceleration all our midsize brands as well at the same time.

Operator:

Wendy Nicholson, Citi Investment.

Wendy Nicholson (Analyst - Citi Investment Research):

(technical difficulty) on Asia. Can you tell us what local currency sales in Asia would have been, excluding..

Fabrizio Freda (President, CEO):

Sorry, Wendy. We lost your first part of the sentence. Could you repeat?

Wendy Nicholson (Analyst - Citi Investment Research):

Sure. Sorry about that. Just following up on Asia. Number one, can you tell us what local currency sales growth in Asia would've been if you excluded the pressure from Hong Kong?

And just to put that in the context of kind of your long-term revenue growth target of 6% to 8%, Asia has been trending -- I know it's very bumpy quarter to quarter, but it's been trending actually slower than your other regions. And I'm wondering your confidence -- just long term with the challenges in Korea and you call out Taiwan and Singapore all being weak. Does Asia go back to growing, you know, at the higher end of the other regions? Or are we in sort of permanent slowdown mode in Asia?

And then my other question is, just going back to sort of your enthusiasm about Clinique and Estee Lauder, specifically, it's awesome that those brands are re-accelerating, but doesn't that puts some margin pressure on you because that's where you advertise more heavily? So if you can talk about your confidence about your margin goals, given the fact that those brands are accelerating, that would be helpful, too. Thanks.

Tracey Travis (EVP, CFO):

So let me start with Asia, Wendy. And thank you for those questions. In terms of APAC, excluding Hong Kong, APAC for the second quarter would have grown low single digits.

Fabrizio Freda (President, CEO):

Okay, so on Asia, it's a fact that in this moment, as we explained, Asia is not at the top growth of our [average] for the reason you summarized. Meaning Hong Kong is low. China has slowed down on average, although we had excellent quarter. Two, Korea is flattening and Japan has been in this recession environment.

So it's a fact -- interestingly, one of our best performing countries in Asia at this moment is Australia and New Zealand. So yes, it's a fact that today, Asia has a moment of softness.

Now my point of view, our compass, and our strategic world for the future counts on the fact that this will change. Asia will be and though it will be volatile, it will be up and down. This is a down moment. But Asia is a long-term opportunity and a very strong region in term of projecting long-term growth.
And the reason for that is obviously the huge increase of the middle class. The growth of the persistent overall prestige channel overall in these markets. The fact that we have deployed to Asia only a small percentage of our portfolio for the moment. The distribution opportunity which are in Asia.

So when you look at the opportunity for growth and assume a stabilization of political, of economical turmoils, Asia is definitely continue to be a long-term opportunity. And as I said in my prepared remarks, China, particularly, continues to be a very important long-term opportunity for the Company. And Chinese consumers, wherever they travel, particularly.

Last, I don’t want to omit the travel retail. You know, Asians are formidable travelers and are very heavy spenders in travelers. So we really are going to drive the travel retail channel in Asia the best we can, and we believe we continue to be a success story in the long term.

Now your second question on Lauder and Clinique, yes, we are speaking about acceleration. But to be clear, Lauder and Clinique today are growing less than the average of the Company. And so our [end to there] is just for the beginning of this acceleration. But frankly, more to come.

And that’s why we want to invest in making this happen, because that will be the other important engine that we want to activate at its maximum extent. But as I said before, I’m very pleased to see that we are delivering an exciting growth ahead of average of the industry, even if for the moment, the engines of Lauder and Clinique are not full speed. And so our intention is to bring these two engines full speed.

Now when we will do this, I don’t -- this will not be dilutive to our profit. Actually, Lauder and Clinique combined are profitable brands. It’s a fact that we want to invest into this in advertising, but not to be confused, the other brands, they have less advertising. Lauder and Clinique have costs in other areas of their P&amp;L.

So the overall profitability of Lauder and Clinique, the moment the two brands grow at the right level is definitely accretive to the profitability of the Company. So it will be a very good thing. And that’s why in our prepared remarks, we are saying that we are continue to be comfortable with our long-term margin acceleration objectives.

Operator:

Caroline Levy, CLSA.

Caroline Levy (Analyst - CLSA Limited):

I actually did want to just pursue that margin conversation a little bit. Because as you see these opportunities behind launches, how do we think about what your goals are, you know, coming off what will be a very low margin year because of SMI -- I mean, because of -- yes, the transitions.

You know, do you see maybe fiscal 2016 being an unusually strong margin year? How much are you going to let flow to the earnings level versus invest behind these ideas?

Fabrizio Freda (President, CEO):

Yes, I’ll let Tracey add what she wants to it. But I want just to frame the point. We are trying to manage this company-for the long-term sustainable profitable growth. And you see out there the amount of volatility and continuous changing environment and continuous competitive environment that we are facing.

I believe that what we have built, meaning our agility and flexibility to respond to these external and internal challenges that we face in this long-term evolution, is a strength. And so in order to manage this strength the best, we have given you our long-term objectives. And within that, we will be managing for optimization,
So the mix of, as we said, mix of our brands, growth, leverage, ability, productivity improvement, combined with cost savings that come from SMI. It comes from many other opportunities that we are constantly working on. And the growth acceleration in the region.

And as -- and sorry. I should mention that the channel, the acceleration of the very high profit channels that we are managing, like travel retail, online, etc. This combination we believe will definitely deliver the long-term goals. How we will do it by quarter or by six months is the flexibility we are trying to preserve, to be able to leverage our key strengths, which is the agility to win in a very volatile world. Tracey?

Tracey Travis (EVP, CFO):

I think you said it well. The only thing I would add is you know, we spoke a quarter or two ago about the program that we have established for the next few years on cost savings. And we have quite a structure around that. The team is delivering results in multiple areas: in direct procurement, returns, there's focus on obsolescence.

And as I mentioned in my prepared remarks, some of the benefits that you are seeing from inventory and working capital is a result of the efforts of the teams working together on really improving supply/demand match and starting to bring -- with increased service levels, starting to bring inventory levels down. So more of that will be coming over the next few years and we certainly see a bigger year from an impact standpoint in fiscal 2016.

That is supporting, as Fabrizio mentioned, some of the investments that we are making in these other areas for long-term growth. So we are very pleased with the model we have, the combination of cost savings and investments, for long-term growth.

Operator:

Michael Steib, Credit Suisse.

Michael Steib (Analyst - Credit Suisse):

Fabrizio, I wanted to follow-up on your comments regarding the performance in the travel retail channel, if I may. It's been such a strong growth driver over the years. I think this quarter, you mentioned it was growing at about mid-single digits.

So a bit of a slow down, but you expect it to return to more normal growth patterns going forward. I wonder what that confidence is based on? Is this based on innovation or are you expecting to gain share going forward? Thanks.

Fabrizio Freda (President, CEO):

So we are gaining share in travel retail. [I want to if I did that] on travel retail of retail, which are available through now, are the first nine months of the calendar 2014. And in these nine months, we are continuing to grow ahead of the market.

So we continue to grow market share in travel retail and we plan to continue to grow market share in travel retail. The key drivers of that are the expansion of our brand portfolio, the continuous expansion of airport and opportunities, and the growth in the existing high traffic airports, which is driven mainly by increased conversion, meaning today between 10% and 15% of the travelers buy anything.

And so just one or two points increase in this conversion is a great growth opportunity. So the combination of this will provide growth. The amount of traffic in airports, which is the other factor we monitor, as you know is
So the slowdown versus the traffic in this last period is not attributable, in my opinion, to any long-term trend. It's to a very specific situation and is mix of travelers. Basically, it's not only we have been growing slightly below traffic, but the entire industry has been growing. So we are still ahead of the industry. The industry is below traffic.

The reason for that -- the moment the traffic, which is the mix is changing and the increase of travelers are Americans and Europeans and the decrease of travelers are Brazilian, Russian, and Chinese. You understand that unfortunately, the level of growth in the selling, meaning in the conversion changes.

So it is a temporary mix of travelers’ impact that makes the growth of the travel retail sales be slightly below the growth of traffic. As soon as the balance, the mix of travelers will again evolve, this will change again. And I believe the conversion factor will push again sales growth well ahead of traffic.

Now we have a competitive strength in this area, because we are the market leader of both skincare and makeup combined and we, on the contrary, are not the market leader in the fragrance part of the business. So when we have populations which are very interested in makeup and skincare being the traveling -- sorry, the growing part of the traffic, we have an advantage. And that's why in our compass clearly show that we should be favored by the traveling mix in the long term.

Operator:

Bill Schmitz, Deutsche Bank.

Bill Schmitz (Analyst - Deutsche Bank):

I have a couple housekeeping questions and then a broader strategic question. The first is on the FX impact. Is that transaction and translation or just translation? And then maybe like sort of how you view pricing versus if there is any pre-buy ahead of maybe some pricing and some mix to offset some of the currency hit.

And then on the acquisition side, sort of the math is $40 million of sales, but it seems like based on your guidance for the EPS solutions, it's a $33 million loss. So I'm just trying to figure out how that happens. And then the longer-term strategic question is first, Greater China, if you included Hong Kong, Macau, travel retail, and the Mainland, what that would be as a percentage of sales.

And then the implications -- it sounds like wholesale prices in China might be going down, because I guess there's some stuff going on with e-commerce, where they waive the duty on products there. So do you think that shifts consumption back to Mainland and maybe away from some of the other faster-growing channels, like travel retail. That would be really appreciated. I'm sorry for the long-winded question.

Tracey Travis (EVP, CFO):

No, that's fine, Bill. Let me start. In terms of the foreign exchange impact that we spoke about, both for the quarter and the year, we were speaking about translation impact. However, embedded, obviously, in our reported results is the impact of transaction of foreign exchange.

So I did mention that on cost of goods, we actually had a benefit in transaction foreign exchange. And that is related to some of the favorable hedges that we have in place, which, over time, will mitigate. But it is primarily the reported numbers that I gave you were translation numbers.

As it relates to the acquisitions, again, there are three parts to that dilution effect for this year. A portion of it is one-time and that is the deal-related costs for four acquisitions. A portion of it is purchase accounting and, again, that is preliminary purchase accounting and we will certainly true that up in the next -- within the next
And then a portion is the operating performance -- a smaller portion is the operating performance of the acquisitions, which should be accretive, certainly -- at least the operating portion of the acquisitions accretive in the next year or so. The purchase accounting, because of the structure of the deal, is dilutive and will be dilutive, but not nearly as dilutive as this year.

**Fabrizio Freda** (President, CEO):

Okay. And on Hong Kong China and you know, this part, I would exclude the traveling. But Hong Kong China is about 10% of our business. And the travelers is -- we don't look at it in this way, because we look at travel retail via corridors. And wherever there are Chinese shopping, there are also Korean, Japanese, so it's very difficult to define it as Greater China.

So -- but the Hong Kong China is about 10%. And then obviously, there is a very interesting part of travel retail which is attributable to traveling Chinese consumers.

We -- and we believe this -- as I said, this remains a very big opportunity of growth for the long term and we have a extremely solid portfolio. We are the market leader in this segment. We have an amazing portfolio of brands, but we have not yet deployed to these group of people all our strengths.

For example, we have not yet deployed also our new acquisitions. So the only changes or regulations in China, frankly, there are frequent evolution and changes, but I don't believe that, again, there will be an impact on travel retail and other winning channels like online.

I personally believe that the online channels within China will continue to grow, just because the consumer habits and the consumer preference or the way you are shopping will continue to go in that direction. And we are ready to gain market share over time in that area.

And travel retail, again, is the result of the passion for -- of Chinese for traveling and for buying during their travel. And so even if the price differential had to go down, I still believe there will be a very interesting growth factor on traveling Chinese.

**Tracey Travis** (EVP, CFO):

I would just add -- Fabrizio called out the results that we saw in the last quarter, as China is accelerating in terms of performance. So I think in terms of what is going on now with e-commerce and the ports, we are not seeing an impact yet from any of that activity.

**Fabrizio Freda** (President, CEO):

Okay.

**Operator:**

We have time for one more question. Your last question is from Jason English, Goldman Sachs.

**Jason English** (Analyst - Goldman Sachs):

Thanks for squeezing me in. A couple questions. One on margins and one on top line. So I was getting excited about your gross margin this quarter. I think it's the highest quarterly gross margin we have on history, at least for the last decade or so we have modeled.

But Tracey, you took a little bit of it out, the excitement out, when you said there is hedge gains in there. So can you walk us through that gross margin, what's driving it, and how much of that benefit is transitory?
And then secondly on top line, I love the enthusiasm behind your heritage brands on Estee and Clinique. It’s hard to buy into some of that enthusiasm, based on what we've been seeing in the US -- or seeing, hearing about in terms of market share trends, the sluggish performance, which I think you once again called out in the press release this morning. So can you zoom in a little bit more in the US and talk about the initiatives you have to revitalize these two core brands in the US?

**Tracey Travis (EVP, CFO):**

We are glad we squeezed you in as well. In terms of the gross profit margin, about 20 basis points of the 50 basis points that I spoke about was related to transaction -- foreign exchange transaction gains. And then the balance was related to manufacturing variances and a little bit of mix.

So as you know, mix, category mix, and geographic mix has a big impact on our gross profit margins, as does obviously the impact from pricing as well. So we certainly expect that we will continue to see benefits. But they will vary quarter by quarter, depending on our region mix and depending on our channel mix. But that's really -- that was the impact in the quarter specifically related to the transaction gains.

**Fabrizio Freda (President, CEO):**

Okay. And on the acceleration on the brands, given what you say you are seeing in the US, on the Lauder and Clinique brands, first of all, our enthusiasm is for the beginning of an acceleration process. I want to again be very clear -- it's only the beginning of an improvement.

And second part of our enthusiasm is for our belief in the programs, which have in front of us, in the next 12 months, 18 months on these two brands. So we are enthusiastic about seeing early improvements and we are enthusiastic about the programs of the next 12 months, 18 months. And we understand if you are not yet fully buying into it and we need to prove it to you.

The second thing we are enthusiastic is in the learning we are taking when we put these two brands in the condition to win, where we can show the strengths which is in these original brands. Clinique and Lauder are among the best brands of the industry since a long time.

And in fact, one of the things that was in the UK presentation, we show you what these brands can do when they are in the right distribution support and initiated the mood.

So I'd like also Chris to explain in a few moments what are the learning in the US that we will actually transfer to other regions, including -- sorry, the learning in the UK that we will transfer to our regions, including the US, which is the other part of our belief in the future acceleration. Chris?

**Chris Good (President - UK, Ireland):**

Thank you, Fabrizio. Well, first and foremost, it’s really about growing the consumer base. And in that sense, we've been working very hard on sourcing from mass and we've seen great results in that area. And also specifically targeting many of the new consumer groups, like the multiethnic consumer and the growing emerging consumer in that area.

Also broadening the breadth of product usage of our existing customers, so getting to buy across the brands and across the portfolio. Playing the portfolio very strongly indeed, because we have in the UK the full portfolio of brands or almost the full portfolio.

Reaching consumers in the way that they want to shop. So really building upon and developing the omnichannel experience. And finally -- and very importantly -- executing with excellence the terrific innovation that the brands deliver for us.
**Fabrizio Freda** (President, CEO):

And with these conditions implemented, the current innovation plan, Lauder and Clinique are growing mid single-digit in the UK as we speak.

**Chris Good** (President - UK, Ireland):

Absolutely.

**Fabrizio Freda** (President, CEO):

So, even before the acceleration programs.

**Operator:**

That concludes today's question-and-answer session.

(Operator Instructions)

That concludes today's Estee Lauder conference call.

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