Nine Months Results 2015 Presentation

Metzingen, November 3, 2015
Mark Langer (CFO)

- The spoken word shall prevail –

Good afternoon, Ladies and Gentlemen, and welcome to our Nine Months 2015 Financial Results presentation.

With me on the call today is CEO Claus-Dietrich Lahrs. Claus is traveling at the moment, but the two of us will answer your questions in the second part of this call. But before this, let me recap financial performance in the first nine months and update you on our operational and financial outlook on the rest of 2015.

Overall Group sales increased by 9% in the first nine months and amounted to 2.059 billion euro. Adjusted for currency effects, revenues were up 3%. As we had reported in mid-October already, third quarter sales came in below our expectations. Q3 sales grew 4% in euro terms, but were down 1% in local currencies.

In Europe, first nine months sales were 5% above the prior year level due to double-digit growth in own retail compensating for a slight decline of wholesale revenues. Up 14% on a currency-adjusted basis, the UK continued to be the region's fastest expanding core market. Germany and France generated growth of 5% and 4%, respectively. Sales in the Benelux markets declined by 3% as a result of ongoing account rationalization in the wholesale channel.

Third quarter trends were broadly in line with the first half year despite some temporary weakness in August. In the quarter as a whole, retail trends were particularly strong in the UK and France. Among the smaller markets, Italy and Scandinavia outperformed.

Nine months revenues in the Americas were 1% below the prior year in local currencies. Growth in own retail was offset by a high-single-digit decline of wholesale sales. The key US market was down 2%, while Canada as well as Central and Latin America trended in positive territory.

In the third quarter, performance weakened significantly. Sales in the overall region were 7% below the prior year. This was primarily due to the US, where revenues declined by 10% in currency-adjusted terms. Retail performance deteriorated in August and September, suffering from a double-digit decrease of footfall. Wholesale sales were affected by weak replenishment sales and some short-term order cancellations.

Finally, Asia Pacific recorded a 2% sales decline in currency-adjusted terms in the first nine months. Momentum differed significantly by market: while China was down 6%, Australia and Japan performed much stronger, generating growth of 9% and 6%, respectively.

Similar to the American region, trends in Asia also deteriorated in the third quarter. Sales in the region overall decreased 12%, dragged down by lower sales in China. Our business in China declined by 20% in the third quarter, impacted by weakness on the

Mainland as well as even more pronounced decreases in Hong Kong and Macau. A lack of footfall was the main negative factor here, too. The upgrade of our offering, that means the introduction of richer, more refined styles at unchanged price points, supported the BOSS value proposition but was not enough to withstand the overall market weakness.

Note that tourism caused visible sales shifts between the regions again. In Asia, Japan and Korea benefitted from Chinese tourist demand. And in Europe, too, our business with visitors from China was up by more than 50% in the third quarter again. While Italy was the main beneficiary in this respect, our UK business was supported by a sharp increase of demand from US-American tourists.

By distribution channel, year-to-date own retail revenues were 8% above last year's level.

Retail sales increases were driven by new openings and takeovers as well as comp store growth of 3% year-to-date. The latter was due to solid growth in region Europe. The Americas and Asia, however, recorded low-single-digit comp store sales declines in the first nine months. In the third quarter, Group like-for-like sales were in line with the previous year, with August and September trending visibly weaker than July. While performance in Europe remained positive, comp store sales declined at a mid-single-digit rate in the Americas and at a high-single-digit rate in Asia.

As mentioned before, declining store traffic across all regions exerted the biggest drag on comp store sales performance. In Europe, we were able to offset this with a better conversion rate and – above all – bigger basket sizes. In the Americas and in Asia, however, the effect from fewer store visitors could not be fully compensated.

Group-wide, the outlet channel developed better than directly operated stores, especially in Europe and in Asia. In the US, however, trends did not differ materially between the channels. Here, the outlet channel suffered from similar sales declines compared to full price retail in the last three months.

In contrast, the online business continued to grow strongly. In the third quarter, it registered a 20% increase. Driven by last year's relaunch of hugoboss.com and the now far more performance-driven approach to digital communication, the number of store visitors continues to be up at a robust double-digit rate. Year-to-date revenue growth now amounts to 22%.

The Group's store base grew by a net 64 new locations compared to the year-end 2014. In Europe, expansion focused on selective shop-in-shop openings and takeovers in markets such as the UK, Spain and France. In the Americas, the implementation of the concession business model at Mexican department store El Palacio de Hierro accounted for the bulk of additions. Expansion in Asia concentrated first and foremost on the two franchise takeovers in Korea and China earlier in the year.

66 closures related predominantly to smaller shop-in-shops of limited commercial importance. In particular, we exited almost 30 spaces in the Netherlands we deemed no longer relevant in light of recent freestanding store expansion. Nine closures in China reflect our initiatives to upgrade our network in this market.

Wholesale sales declined by 4% currency-adjusted in the first nine months. In the third quarter, revenues were down 7% in this distribution channel. In addition to weaker sales development in the Americas, takeover-induced sales shifts contributed to the decline, above all in Asia.

In Europe, however, feedback to our strategy change in wholesale distribution continues to be positive. As a reminder, we are limiting the BOSS core brand's distribution in the wholesale channel to shop-in-shops. Multi brand areas, so called category floors, are now served by the other three brand lines, substituting the previous BOSS offering. This migration has now been completed in most of Europe. In Germany - one of the first markets in which the change was executed – our partner's sell-out performance has reportedly been in line with expectations. This is also mirrored in the order intake for the Spring 2016 collection completed in August.

And finally, the Group's license business was up 7% in the period thanks to double-digit increases in watches and eyewear. In fragrances, our most recent launch "BOSS The Scent" has been off to a strong start. Spearheaded by the brand's newest face, British actor Theo James, "BOSS The Scent" has gained market share quickly. In Germany and several other European markets, it ranks among the top three best-selling fragrances, complementing the brand's historical stronghold "BOSS Bottled".

Our overall menswear business was up 3% year-to-date as a result of solid increases in our BOSS core brand and HUGO businesses as well as double-digit growth at BOSS Green.

Womenswear developed in line with menswear. After nine months, sales were 3% above the prior year. Similar to prior quarters, this reflects different dynamics by brand line. While HUGO and BOSS Orange developed weaker than the overall segment, affected by a reduced space allocation in own retail, business in the core brand was up 10% year-to-date.

The presentation of Jason Wu's latest collection at the New York Fashion Week in September received a very positive press echo again. Editors highlighted the soft and feminine interpretation of tailoring, referencing the Bauhaus artistic movement. With a multitude of activities across different channels, including an interactive 360-degree recording of the show, HUGO BOSS offered a more engaging digital experience than ever before.

Moving below the top line, the Group's gross margin was up 10 basis points compared to the prior year and amounted to 65.4% year-to-date. The positive mix effect from above-average growth in own retail was partly offset by higher rebates as well negative inventory valuation effects.

In the third quarter, the gross profit margin improved by 40 basis points. Positive channel mix effects supported the increase. However, higher rebates predominantly related to the clearance of prior season merchandise in the Americas impacted gross margin development by around half a percentage point. Inventory valuation effects, which had played a negative role earlier in the year, were not a factor anymore in Q3. Operating expense development in the first nine months reflects continued investment in retail, marketing and the organizational transformation towards a customer-centric

business model. To a lesser extent, currency translation effects also drove cost growth in euro terms.

Selling and distribution expenses were up 15%. In addition to a double-digit increase of marketing expenses, retail expansion had a significant impact on cost development. The takeovers in China and South Korea, new openings, as well as several renovation projects including at least temporary store closures, diluted margins.

Higher G&A expenditures were mainly related to the ongoing strengthening of retail processes, systems and competencies throughout the Group. In the third quarter, however, the rate of cost growth moderated compared to the first half year.

Let me underline that year-to-date expense development was in line with our original planning, reflecting our commitment to invest in the Group's medium- and long-term growth potential. Nonetheless, operating profit developed weaker than expected. This was due to a disappointing top line development, first and foremost in the third quarter, as well as a gross margin increase below expectations. As a result, EBITDA before special items remained virtually stable year-over-year at 423 million euro, resulting in a margin decline of 190 basis points in the first nine months. Taking into account higher depreciation charges, Group EBIT was down 4%. As a result of a more negative financial result and an unchanged tax rate, net income attributable to shareholders decreased 9% to 235 million euro. This translates into earnings per share of 3.40 euro.

As a quick aside, let me explain financial result developments in more detail.

In the third quarter, the Group's financial result was impacted by a negative, non-cash effective charge of around EUR 16 million related to adverse exchange rate movements. This effect was mainly due to inter-company liabilities in Brazil, denominated in US Dollar, and Switzerland, originating from loans used to finance the Group's operations in these markets as well as inter-company sourcing transactions. As a result of the devaluation of the Brazilian Real and the Swiss Franc, the translation of these liabilities into the local markets' functional currency resulted in a significant liability increase at the end of the third quarter.

In the meantime, we have taken steps to prevent similar effects going forward. First, we changed the financing of our Brazilian subsidiary from the US Dollar to the Brazilian Real in order to manage all currency risks centrally. Second, we have now hedged around 75% of our Swiss Franc net exposure.

While the extent and magnitude of exchange rate movements will remain impossible to predict, we have taken steps to lower the Group's interest expense, too. In early October, we refinanced the Group's syndicated loan in an amount of 450 million euro before maturity. The new loan has the same volume, a term of five years, carries a variable interest rate and can be flexibly drawn. Based on its attractive terms, we expect future savings to more than compensate a negative low-single-digit million euro effect in the fourth quarter mainly related to the close-out of derivatives used to hedge interest payments of the old financing.

Currency translation effects also distorted our segmental reporting. Keep in mind that just around a third of our sourcing is denominated in US dollar terms, so the regional profit development in the Americas and Asia is flattered by positive currency translation

effects on the top line outweighing the headwind in COGS. In Europe, however, the currency impact is broadly neutral on the top line, but negative in COGS.

As a result, the European margin would have increased when excluding currency effects, despite higher operating expenses. The other way around, the American margin development would have been negative adjusted for currency. This was a consequence of higher rebates and negative inventory valuation effects impacting the region's gross margin. In Asia/Pacific, finally, depressed retail performance in the region's key market China, margin dilution from takeovers and investments in retail and marketing drove an overall profitability decline.

Let's turn to the balance sheet, where we made good progress in managing working capital. In particular, the rate of inventory growth has slowed sequentially despite a weaker than expected retail sell-through in the US and China in particular.

At the end of September, inventories rose 12% in euro terms or 3% excluding exchange rate effects. This growth rate includes different dynamics by region: on the one hand, we are clean in Europe. On the other hand, further progress will be needed in the Americas. Here, we will continue clearing excess merchandise in a margin and brand protective way predominantly via the outlet channel while at the same time adjusting our merchandise planning for future seasons. In doing so, we are confident in our ability to minimize the impact on future gross margin development, accepting that there will be further work to do still in the first half of 2016.

For the sake completeness, receivables were down 8% in local currencies, in line with the sales trend in our wholesale business. Finally, trade payables were up 8% in currency-adjusted terms. As a result, overall trade net working capital declined by 4% excluding currency effects at the end of September.

In line with our guidance, investments increased compared to the prior year and amounted to 141 million euro in the period. Retail, including the two franchise takeovers in Asia, made up around two thirds of this. The relocation of our New York City showroom as well as the expansion of our Turkish production facility contributed to the increase as well. Finally, investments related to the planned insourcing of online fulfillment in 2016 accounted for around 10 million euro, reflecting first and foremost the upgrade of our logistics and IT infrastructure.

Higher capex more than offset operating cash flow improvements, so that free cash flow declined to 92 million euro year-to-date. As a consequence, net debt was above the prior year level at the end of the period. Based on the seasonality of our business, we expect strong free cash flow generation in the fourth quarter. Nonetheless, we forecast net debt at year end to still amount to between 50 and 100 million euro.

Let me give you some insights into regional trading.

We expect our European business to grow solidly also in the remainder of 2015 against an easing comparison base. This expectation is based on ongoing strength in the UK, good performance in Germany and France as well as robust growth in some of the region's smaller markets, in particular Italy and Scandinavia. Tourist demand, especially from Asia, should continue to support performance.

In the Americas, however, we expect recent weakness to persist in the final months of the year as well. Market-wide traffic declines, an overall shaky consumer sentiment as well as high promotional activity by retailers have only intensified the need to address the challenges HUGO BOSS is faced with in this market: From a short term perspective, we will clean inventory levels to reduce rebate pressure and improve the flexibility of future merchandising decisions. In 2016, we will also work on elevating the quality of brand presentation in the wholesale channel by bringing the concept of category migration to the US as well as expanding direct brand control. In addition, we are optimizing key processes and systems to improve merchandise planning and allocation as well as the quality of retail execution.

Finally, we forecast mixed trends in Asia to continue. Most importantly, we do not project the market environment in China and Hong Kong to fundamentally improve versus most recent trends. Based on the insight we have into peer trading in premium and luxury apparel, we rather believe that our segment has been disproportionately affected by more cautious consumer spending following the economic slowdown and stock market turbulence. In this environment, we focus even more on building brand strength, in particular in men's formalwear, on upgrading our retail network and on improving retail execution.

In financial terms, this means we expect Group sales to increase between 3% and 5% on a currency-adjusted basis in 2015. EBITDA before special items is forecasted to grow at the same rate.

As communicated a few weeks ago, this outlook is based on the assumption of stable to positive retail comp store sales development in the fourth quarter – an expectation confirmed by trading in October. Full year wholesale sales are expected to decline at a low- to mid-single-digit rate. However, this implies a somewhat better sales development in this distribution channel in the fourth quarter compared to the third quarter.

In addition to this moderate acceleration of top line trends in an anyway much more retail-heavy quarter, fourth quarter operating profit increases will be driven by a better gross margin. As we expect to reverse at least most of the negative impact from higher rebates given in the prior year quarter, we forecast the fourth quarter to generate the best gross margin improvement in 2015. Cost trends, however, will remain broadly similar to earlier in the year also in the final three months of 2015. The upgrade and expansion of our retail network, marketing and organizational investments will drive operating expense increases. Nonetheless, the non-recurrence of prior year special items as well as a less negative financial result compared to the past three months will support net income growth in the final quarter of the year.

The rest of our outlook remains unchanged: investments will amount to between 220 and 240 million euro in 2015 with the majority being related to own retail expansion, refurbishments and takeovers. More specifically, we will open around 65 new retail points-of-sale, approximately 20 of them being freestanding stores. In addition, we will execute around 75 takeovers, but also a similar number of closures.

Ladies and Gentlemen, in the last three months, trends have deteriorated sharply in the key Chinese and US markets. We were clearly surprised by the speed with which

performance weakened and the magnitude of declines unforeseeable at the time of our last earnings publication.

While we will have to accept the lower visibility ingrained in a retail business model, we will have to continuously improve our organization's ability to flexibly react to changes in the operating environment. In doing so, we need to connect even more closely with our customers – to engage them, to excite them and to learn about their likes and dislikes. The customer is BOSS – and he has to feel this whenever he is in touch with the brand.

I am convinced we have got the right strategy in place to ensure exactly this and to address the challenges posed by the current market environment. We are confident in our ability to record a better fourth quarter performance for an overall solid 2015. But of course, there will be more work to do still in 2016.

In this context, let me remind you of our invitation to our annual Investor Day to be held on November 24 at Group headquarters in Metzingen. The event will offer broad-based insights into our plans for 2016 and beyond, including a mix of strategy presentations, showroom tours and an inspection of our new distribution center involving key senior management members.

But before meeting you in person later this month, let us answer your questions on today's set of results.