First Half Year Results 2015 Presentation

Metzingen, August 4, 2015
Mark Langer (CFO)

- The spoken word shall prevail –

Good afternoon, Ladies and Gentlemen, and welcome to our First Half Year 2015 Financial Results presentation.

Let me start my presentation with a review of financial performance in the last six months.

Overall Group sales increased by 12% in the first half year and amounted to 1.3 billion euro. Adjusted for currency effects, revenues were up 5%.

In Europe, sales were 5% above the prior year level due to double-digit growth in own retail. Up 11% on a currency-adjusted basis, the UK continued to be the region's fastest expanding core market. In Germany and France, sales momentum in own retail picked up over the course of the period. Both markets generated growth of 5%.

Revenues in the Americas were 3% higher compared to the prior year in local currencies. Growth in own retail more than offset a low-single-digit decline of wholesale sales. The key US market was up 2%.

Finally, Asia Pacific recorded a 3% sales improvement in currency-adjusted terms. China grew 1%. Australia and Japan performed much stronger, generating growth of 13% and 6%, respectively.

In the second quarter, momentum accelerated across all regions, particularly in Europe. Here, growth picked up in almost all markets. Sales in the Americas benefitted from improvements in Canada as well as Central and Latin America, while the US market remained lackluster. Finally, Asia recorded a better second quarter as well. This was due to continued good momentum in Australia and Japan as well as takeover effects in Korea and China. In both cases, however, performance was below initial expectations as a result of the outbreak of the MERS disease and the challenging market environment on the Chinese Mainland, respectively. In addition, sales development in Hong Kong deteriorated due to further weakening customer footfall. Excluding takeover effects, the Asian business was up 1% in the second quarter. This compares to 5% in reported, currency-adjusted terms.

In the first half year again, global tourism flows did shift demand between regions. For example, our business with Chinese travelers in Europe increased by more than 50% in the first six months, including a doubling of sales in Italy. Chinese customers have now become the most important foreign consumer group in our European business, overtaking visitors from Russia. However, keep in mind that our overall tourism exposure continues to be lower compared to some of the pure luxury brands, with tourism accounting for less than 15% of retail sales in Europe.

By distribution channel, first half year own retail revenues were 9% above last year's level. Online was the best performing retail format, recording a 23% improvement. The outlet channel outperformed full price distribution as a result of strong consumer demand in Asia in particular.

Retail sales increases were driven by new openings and takeovers as well as comp store growth of 5%. Europe's comp store sales performance exceeded the Group average, while the Americas and Asia trended in low-single-digit territory in the first half year. Throughout the period, increases were driven by volume growth and, to a larger extent, price/mix improvements. The latter underlines our success in trading up consumers to higher price, higher value products in own retail.

In the second quarter, comp store sales growth improved to 6%. This acceleration was almost entirely fuelled by region Europe, where momentum picked up across the board. The other two regions recorded performance in line with the first quarter. A better full price business meant we were able to narrow the performance gap vis-à-vis the outlet channel in the second quarter. The latter, however, continued to generate increases above the Group average in the second quarter as well. Supported by a higher sales contribution from new space related to openings and the two takeovers discussed before, second quarter retail sales growth amounted to 12% in currency-adjusted terms.

Wholesale sales declined by 2% in the first six months with a slightly more negative, takeover-induced performance in the second quarter.

And finally, the Group's license business was up 10% in the period thanks to double-digit increases in eyewear and watches.

Moving below the top line, first half year gross margin remained unchanged versus the prior year level of 66.0%. The positive mix effect from above-average growth in own retail was offset by higher rebates in this channel as well negative inventory valuation effects. The latter reflects the adjustment of inventory book values in anticipation of future discounts necessary to clear the merchandise.

In the second quarter, the gross profit margin declined by 20 basis points as higher rebates related to the clearance of prior season merchandise predominantly in the Americas and negative inventory valuation effects, though smaller than in the first quarter, weighed on margin development. These factors more than offset the positive channel mix effect.

First half year cost development reflects the impact from currency as well as continued investment in retail, marketing and organizational strength.

Selling and distribution expenses were up 16%. In addition to a double-digit increase of marketing expenses, retail expansion and refurbishments had a significant impact on cost development. The takeovers in China and South Korea as well as several large-scale renovation projects executed in the first half year, many of them including at least temporary store closures, diluted margins. On a like-for-like basis, however, retail profitability improved.

G&A expenditure growth was mainly related to the ongoing strengthening of retail processes, systems and competencies throughout the Group, reflecting the Group's continued transformation towards a strictly consumer-focused business model.

The other operating income and expense line, in which we book special items, had a neutral impact on profit development in the first six months. A mid-single-digit million euro positive effect from the successful divestiture of our US production facility in Cleveland (Ohio) was compensated by charges related to early contract terminations with sales agents and service providers as well as organizational changes in Europe and the Americas.

EBITDA before special items grew 6% to 255 million euro, resulting in a margin decline of 120 basis points in the first half year. Taking into account higher depreciation charges, Group EBIT was up 3%. Net income attributable to shareholders improved 2% to 146 million euro, translating into earnings per share of 2.12 euro.

Currency translation effects contributed positively to Group profit development. On a segment level, however, the impact differed by region:

In Europe, negative currency effects related to the non-Euro denominated portion of sourcing in connection with higher sales and marketing expenses exerted margin pressure. In the Americas, however, positive currency effects overcompensated the effects from higher rebates in particular, so that operating margin improved by 190 basis points. 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.

At the end of the first half year, trade net working capital was up 18% in reported terms and 5% in local currencies.

Inventories rose 15% or 4% excluding exchange rate effects. This represents visibly slower growth compared to the end of the first quarter, when we recorded a double-digit currency-adjusted increase. Nonetheless, we will be working towards further improvements in the second half year. This is particularly true for the Americas, where stock levels continue to be too high.

Receivables were up 1% in euro terms and down 6% in local currencies, in line with the sales trend in our wholesale business. Finally, trade payables were down 7% in currency-adjusted terms, reflecting a slightly different timing of production compared to the prior year.

In line with our guidance, investments increased compared to the prior year and amounted to 87 million euro in the period. Beyond regular retail openings and refurbishments, the increase was primarily a result of the two takeovers in Asia, for which the acquisition price amounted to 21 million euro. In addition, we made a low double-digit million euro investment in the relocation of our New York City showroom.

Higher capex more than offset operating cash flow improvements, so that free cash flow declined to 73 million euro year-to-date. As a consequence, net debt was slightly above the prior year level at the end of the period. Remember that cash flow generation at HUGO BOSS is skewed towards the second half year owing to the seasonality of our business, so we do expect net debt to be virtually zero at the end of the year.

With this, let me update you…

…on our most recent progress in the different pillars of our growth strategy – BOSS brand elevation, womenswear, own retail and omnichannel as well as global growth.

Starting with the first one, the brand elevation process outlined earlier this year is progressing as planned.

In own retail, we are focusing on the BOSS core brand more and more exclusively. In new and refurbished stores, floor space will be increasingly dedicated to our core brand alone. Across its offering, we are gradually elevating the product mix through a stronger emphasis on BOSS Tailored and BOSS Made to Measure. As outlined in my discussion of year-to-date like-for-like sales performance, this strategy is supporting mid-single-digit increases of average selling prices in directly operated stores. Keep in mind that this reflects an upgrade of the offering rather than simple price hikes.

In wholesale, we are limiting the core brand's distribution to shop-in-shops. Multi brand areas, so called category floors, will be served by the other three brand lines going forward, substituting the previous BOSS offering. In Germany, Austria and Switzerland, this change has now been implemented across the vast majority of retail partners and many key accounts have upgraded BOSS' distribution to a shop-in-shop format. While it is too early to report back on sell-out trends at our partners, order development for upcoming seasons and sell-in have been in line with our original expectations.

In the seasons ahead, we will further optimize the HUGO and BOSS Green collections in order to compensate for the planned discontinuation of certain entry price points in the BOSS core brand. At the same time, we will be expanding this strategy to the rest of Europe with the delivery of the Pre-Spring 2016 collection later this year.

In womenswear, our second growth pillar, we can report back on a successful first half year as well. Sales of our overall womenswear business were up 5% currency-adjusted in the first six months of 2015. While BOSS Orange and HUGO continued to suffer from the loss of retail space following our new format strategy, BOSS continued to outperform. Sales of our core brand, which accounts for around 65% of total womenswear sales, grew 12% in the first half year.

This reflects the strength of the brand in tailored product in particular. At our upcoming September fashion show in New York, Jason Wu will take the upgrade and refinement of our collections one step further. At the same time, we are strengthening and expanding our essentials business. The new Fundamentals collection addresses the needs of the modern business woman looking for classic, timeless pieces she can flexibly combine with the seasonal collections.

Visiting a HUGO BOSS store today will also highlight the growing focus on shoes and accessories. As part of our Fall 2015 collection, we launched our new iconic bag - the BOSS Bespoke bag. Capitalizing on Made in Italy and using exquisite materials, it merges the menswear DNA of BOSS with subtle femininity. From September onwards, customers will be able to personalize their bag, selecting from different colors and materials according to their own truly bespoke needs.

While shoes and accessories are small categories for us at the moment, accounting for around 10% of womenswear sales, we acknowledge their importance when it comes to defining brand identity and driving desirability. As a result, we are allocating more retail space to shoes and handbags. This is particularly true for 30 ambassador stores worldwide, among them Regent Street and Sloane Square in London as well as our newly refurbished Frankfurt store.

Overall, we invested almost 20 million euro in the renovation of existing stores in the first half year. In addition, we added almost 7,000 square meters of retail space in the first half year via new openings and takeovers, representing a 4% increase compared to the end of 2014.

Europe was the focus region in terms of new openings. Important projects included the opening of a travel retail store at Milan airport, the expansion of our retail presence in Moscow and the opening of additional shop-in-shops at Galeries Lafayette in France. Takeovers related primarily to our former franchise businesses in Korea and China.

Looking out to the rest of the year, we now expect to open around 65 new stores and shop-in-shops in 2015. Among the additional opportunities identified most recently is a relocation of our Regent Street store in London to another building close by. Doing so will more than double net selling space to above 800 square meters in a better accessible, less complicated store layout. Finally, we have reached an agreement with El Palacio de Hierro, one of the leading department stores in Mexico, to take over 14 HUGO BOSS shop-in-shops in the next few months.

Beyond physical retailing, we have made the implementation of an omnichannel business model one of the cornerstones of Group strategy. In this context, we are encouraged by the pickup of momentum in our online business. In the first half year, online sales were up 23% in currency-adjusted terms. In the second quarter alone, the increase amounted to 34%.

This performance is a result of the improvements we have implemented since around the same time last year: based on the Demandware platform now fully controlled by us directly, we upgraded the store in terms of its look and feel, features and usability. The relaunch of hugoboss.com and the now far more performance-driven approach to digital communication has driven a strong double-digit visitor increase. In addition, average order values improved at a high-single-digit rate, underlining our success in upgrading product presentation and facilitating cross-selling, for example through the promotion of entire campaign looks.

At the same time, the preparation for the roll-out of Omnichannel is progressing as planned. As a reminder, we will insource online fulfillment in the first half of 2016 - a key prerequisite to offer consumers a seamless brand and shopping experience across all distribution channels. Over the next few months, we will launch several innovations supporting consistent customer data management and personalized service, driven directly by the store personnel. Expect a comprehensive update on these initiatives at our Investor Day on November 24th.

Ladies and Gentlemen, before finishing with our financial outlook, let me give you some insights into regional trading.

Based on the recent acceleration of trends in Europe, we expect the region to grow solidly also in the second half year. Ongoing strength in the UK as well improvements in Germany and France, in particular, should drive sales. In addition to the recovery of domestic demand, increased travel flows, especially from Asia, will continue to support performance.

In the Americas, we forecast trends to remain broadly similar to first half year levels. A continuously promotional retail environment has made us take a very cautious approach to US wholesale. As a result, we are rather limiting sell-ins where necessary in order to improve full-price sell-through. At the same time, we expect retail performance to start benefitting more significantly from merchandising and operational improvements only next year.

Finally, we forecast mixed trends in Asia to continue. While Australia and also Japan should continue to perform well, we do not project the market environment in China and Hong Kong to recover anytime soon. As a result, we focus on building brand strength, in particular in men's formalwear, on upgrading our retail network and on improving retail execution. The latter includes the strengthening of our retail management team, merchandising changes and a stronger focus on CRM. Finally, we expect some stimulus from the collection upgrade we have just implemented in China, offering higher value products at unchanged price points.

To sum up,…

… Group sales are expected to grow at a mid-single-digit rate on a currency-adjusted basis in 2015. Thanks to positive currency translation effects, increases will be higher in euro terms. While wholesale sales are forecasted to decline slightly, our own retail business will grow stronger than the Group average thanks to productivity improvements and new space. Based on second quarter performance and current trading, we have even raised our outlook for retail comp store sales growth to mid-single-digit.

Nonetheless, our operating profit forecast remains unchanged: adjusted EBITDA is expected to grow by 5% to 7% in reported terms, implying an operating margin decline also in the full year. Gross margin is expected to improve due to a better channel mix, driven by solid increases in the second half year. However, the flat gross margin development in the first six months means the full year increase will be lower compared to original expectations. We will also continue to invest in future growth. As a consequence of the upgrade and expansion of our retail network, selling expenditures will increase more sharply than sales. In addition, marketing expenditures are expected to grow disproportionately. Finally, G&A cost development will reflect investment in people and systems, supporting the Group's ongoing transformation to a consumer-centric business model.

Based on our increased store opening outlook as well as updated exchange rate assumptions, we have also upped our capex forecast. Investments will amount to between 220 and 240 million euro in 2015 with the majority being related to own retail expansion, refurbishments and takeovers. Omnichannel investments, the expansion of our production facility in Turkey and the relocation of our US headquarters within New York City represent other important investment areas.

Ladies and Gentlemen, in the first half year we faced a difficult operating environment: In Europe, the apparel industry has hardly benefitted from the overall upswing in private consumption. In the Americas, industry trends have been mixed throughout the period. And China and Hong Kong have not seen light at the end of the tunnel yet.

Given these challenging market conditions, we can be satisfied with what we achieved. First half year financial results performance is in line with our full year expectations, so our confidence to reach 2015 targets has grown further.

However, in an industry which is growing at a far slower pace compared to historical levels at least at the moment, our operating environment has turned even more volatile and competitive. This should not make us focus on short-sighted sales and profit maximization. We are convinced that our company’s future rather depends on nurturing growth potential for the long term. This is exactly what we are doing in the different areas of our strategy, even though this clearly comes at a cost. Nonetheless, the progress we are making in all of them gives us confidence that HUGO BOSS will continue to stand for the attribute with which customers associate our brand first - success.