HUGO BOSS First Quarter Results 2016

Metzingen, May 3, 2016
Mark Langer (CFO)

- The spoken word shall prevail –

Good afternoon, Ladies and Gentlemen, and welcome to the presentation of our First Quarter Results 2016.

The premium apparel industry had a difficult start into the year and the same is true for HUGO BOSS. Cautious customer spending globally and some specific challenges in particular in the US market had a significant negative effect on the Group's top and bottom line development.

Nonetheless, we made important progress in our initiatives to protect margins and cash flow. At the same time, we started implementing some far-reaching changes to brand and price positioning in the US and Chinese markets, respectively.

But let's start with our largest region, Europe.

Here, sales declined by 1% in currency-adjusted terms, affected by a notably weak month of March. Tourism played a negative role throughout the quarter with particular weakness among the Chinese clientele against a very tough prior year comparison base. However, the business with locals, which accounts for around 85% of sales in the region, also moderated compared to 2015 levels.

By market, the UK continued to outperform and grew by 4% in currency-adjusted terms. In Italy, sales were even up at a double-digit rate. Germany recorded a mixed performance, with sales declining by 2%. Wholesale outperformed own retail here, underlining the sustained positive reception of our change of distribution strategy implemented last year. The Benelux and France were among the weakest performing markets regionally, clearly affected by the terrorist attacks and the resulting drop in tourism.

In the Americas, performance differed significantly by market. Our business in Canada and Central and Latin America grew at double-digit rates. The latter in particular benefitted from a repatriation of local demand following region-wide currency depreciation. Sales in the US, however, declined by 16% in currency-adjusted terms, so that the overall region was down 8% in the quarter.

The double-digit sales decline in our US wholesale business is indicative of the difficult state of the overall market on the one hand. As a result of weak sell-throughs over the course of the second half of 2015 in particular, most retailers are buying very cautiously at the moment. On the other hand, we have started scaling back our off-price business in the wholesale channel, although the related sales impact has still been relatively small in the quarter.

We are also in the process of implementing the category migration concept, so we are reducing the exposure of the BOSS core brand in multi-brand spaces in exchange for HUGO and BOSS Green. This substitution will become visible on the floors of partners such as Dillard's and Lord & Taylor over summer. At Macy's, this change was implemented in February. Responsibility for the entire BOSS core brand business at Macy's – now limited to eight shop-in-shops in key flagship locations as well as an online concession – has been transferred to us and we are busy upgrading store concepts, the assortment and the quality of staff.

Admittedly, however, current weakness in the US is not limited to the wholesale channel. In own retail, we suffer from substantial like-for-like sales declines predominantly related to a double-digit decrease of visitors. As a result, we are intensifying our efforts to improve the in-store experience including the rollout of more personalized service options and the expansion of omnichannel services.

In Asia, overall sales were down 5% in currency-adjusted terms.

Momentum continued to be positive in Japan. Some smaller markets such as South Korea also grew very strongly. In the key Chinese market, there was light and shadow. Overall sales were down 11% in local currencies here. In Hong Kong and Macau, the decline was even much more pronounced. On the Chinese Mainland, however, trends improved compared to the end of last year, although we had lowered prices by another 20% with the launch of the Spring/Summer 2016 collection in January. On a comp store basis, sales on the Chinese Mainland were still down in the high-single-digits, purely reflecting the impact of the price adjustment. However, traffic stabilized and volumes were up by around 10% compared to the prior year. And in the first few weeks in April, this trend even accelerated.

We attribute this to the following factors:

- First, the price adjustment and its consistent in-store communication helped us activating existing customers more effectively. In addition, we are now addressing an additional group of aspirational customers for whom the brand had been seemingly unaffordable in the past.
- Second, we significantly changed our marketing strategy to prioritize digital over print. Employing Wallace Huo, one of the most popular actors in the country, as a spokesman for our Man of Today campaign, we generated unprecedented brand interest and drive-to-store. As an indication, the number of users following us on WeChat has quadrupled within just a few months.
- And third, we benefitted from some repatriation of local demand. Our offer to Chinese customers visiting our key stores in Europe and other parts of Asia to register with us on WeChat and make alterations free of charge in their local store back in China, has been well received and we exploited cross-selling opportunities.

By distribution channel, own retail sales were up 1% in local currency terms. The sales contribution from openings and takeovers in 2015 and in the first three months of the year more than offset a comp store sales decline of 6%. The latter was primarily related to weakness in the US and Greater China, which caused like-for-like sales in the Americas and Asia/Pacific to decline at low-double-digit rates. The European business was in slightly negative territory on this metric. The Group's overall comp store sales decrease was mainly driven by lower traffic. The price adjustment in Asia had a comparatively much smaller impact.

Unlike in previous quarters, online only performed in line with the rest of own retail. This was due to the overall slowdown in our business, but also the fact that the pace of on-site innovation has temporarily been slowed ahead of the insourcing of online fulfillment and the major site upgrade scheduled for August. Since yesterday, we have taken over sole responsibility for the fulfillment of our European operations from our partner Arvato. The transition progressed very smoothly, helped by extensive testing over the last few months. We now focus our resources on offering omnichannel services as quickly as possible. In August, we will launch pilots for Click & Collect and In-store Online Ordering in the UK, followed by the full implementation of these services in all European online markets later in 2016 and in 2017.

With regard to physical retail expansion, we opened 12 new freestanding stores in the first quarter, most of them in Europe. In addition, we took over four stores from franchise partners, including three in Malaysia. Net of closures, the number of freestanding stores increased by 8 to 438 at the end of March.

As communicated at the analyst conference, the pace of retail expansion is going to slow over the further course of 2016. Following the review of our store opening plans, we only expect to open another around fifteen freestanding stores this year. This includes several cases, where we relocate our presence within the same retail area. At the same time, we are also analyzing the performance of those ten to twenty stores which had the most dilutive impact on retail margins in 2015. Pending the negotiations with landlords currently ongoing, we will most likely close several locations in order to improve the structural profitability of retail operations. We will update you on our findings latest in August at the time of the Half Year Results presentation.

First quarter wholesale sales declined by 9%, in line with our full year outlook. This was predominantly due to the US, where cautious ordering and weak short-term replenishment demand dragged down performance in addition to the effect from converting part of the Macy's business into own retail. However, in Europe as well, the negative overall market sentiment weighted on demand.

Finally, the license business was up at a double-digit rate, also benefitting from a positive delivery shift which we don't expect to recur. However, also on an underlying basis, the fragrance business in particular developed very well. BOSS THE SCENT continues to play a major role in this respect. Launched in autumn last year, it has helped us achieving overall market leadership in Germany now, for example.

However, good growth in male fragrances was not enough to lift our overall menswear business in the first quarter. While this had to do with many rather cyclical, market-related factors discussed earlier, we strongly believe in the need to continuously strengthen the brand in what is the DNA of HUGO BOSS.

We do so in different ways:

- First, the recent appointment of a Managing Board member exclusively responsible for brand and creative management underscores the importance the company is placing on this area. Ingo Wilts combines creativity with a strong

business acumen. And while he knows the company inside out from his previous assignments here, Ingo is also bringing in a fresh perspective from his experience at major, US-domiciled peers.
- Second, we decided to re-allocate a sizeable portion of our marketing spend back to menswear. In the wake of this change, the importance of digital is only growing further.
- And third, based on a review of sales productivities in our own retail network, we will expand the retail floor space allocation to menswear again, in particular in the US market.

To make this very clear – this does not change our commitment to womenswear. BOSS Womenswear has prospered under Jason Wu's artistic direction and gets enormous recognition from the press and our customers. We will continue on this journey and we remain dedicated to investing in the opportunity that womenswear represents. However, we will carefully balance these investments with the goal of maximizing overall commercial performance, acknowledging the paramount importance of our menswear business.

In the first quarter, overall womenswear sales were down 4%. The BOSS Womenswear business continued performing better than the overall segment.

Let me now go through our quarterly results in more detail.

Gross margin was down 140 basis points year-over-year and reached 64.1%. An increase of rebates mainly in the US market and inventory write-downs were the main reasons for the decline. The latter was due to the scrapping of old inventory taken over from previous franchise partners in the Chinese market. As a result, we now have significantly more flexibility in this market to adjust our merchandising to the new pricing strategy, whose implementation just had a smaller negative impact on gross margin development in the quarter.

The first results of our cost saving initiatives led to a more moderate operating expense growth compared to the prior year. Supported by the first benefits from the successful renegotiation of store rental contracts mainly in Asia as well as by a slight reduction of marketing expenditures, the increase of selling and distribution expenditures was limited to 5%. G&A expenditures were up 6%, reflecting our measures to digitalize our business model.

Obviously though, tighter cost management was not enough to avoid significant operating deleverage related to the weak top line development. As a result, EBITDA before special items declined by 29% to reach 93 million euro in the quarter. Also considering special items of 7 million euro mainly associated with the change in Management as well as a 20% increase of D&A, EBIT and net income dropped by almost 50%.

By region, profitability in Europe held up relatively well considering that the reported margin decline of 270 basis points includes a substantially negative currency impact related to the around 30% share of sourcing denominated in US dollar terms. In particular, we reduced rebates in our European business in the first quarter.

In contrast, currency continues to have a favorable impact on American profits. Excluding the supporting effect from the appreciation of the US dollar, regional profits would have been down more severely. Higher rebates and operating deleverage owing to the weak top line were the primary factors here.

The same effects were also at work in Asia/Pacific. Coupled with the negative gross margin effects in connection with the price adjustment and inventory scrapping in China, the regional margin dropped significantly by almost 13 percentage points in the first quarter.

Turning to the balance sheet, we continued to improve working capital management sequentially. The just 1% increase of inventories in the first quarter represents the lowest growth rate in the last ten quarters. Tight merchandise management and cautious planning of sourcing and production was instrumental in this respect. With the inventory scrapping in China, we are now clean in this market, too, and even in the US, the pressure from having had too much stock has eased considerably.

Investment activity also started moderating compared to prior year levels, although the reduction of capital expenditures in the first quarter was still smaller than what we expect in the full year. Investments in the first three months predominantly focused on own retail. However, while store renovation expenditures increased, spending for new openings declined – a pattern we also project for the full year.

The improvement of working capital management offset the decline of earnings, so that free cash flow developed even slightly better than in the prior year period. Nonetheless, net debt was still up compared to the levels achieved at the end of March last year.

Improving free cash flow remains the key goal in 2016. To this end, we have reviewed all non-committed investment plans as outlined at the analyst conference in March. In addition to the cancellation of several store openings, we also decided to streamline our IT investments. Here, we will focus our resources on the faster implementation of fewer projects, prioritizing those most critical for the digital transformation of our business. Also factoring in the postponement of some expansion projects at the Group headquarters, we now expect investments in 2016 to amount to 160 to 180 million euro, compared to 220 million euro last year.

We also made progress with the cost review announced in March: we have now identified cost savings of around 50 million euro compared to our original budget for the year. The successful renegotiation of store rental contracts, a tightening of operating overhead cost management and the streamlining of marketing initiatives will contribute the lion's share to these savings. However, unchanged to our previous plans, we will continue to invest in the growth of digital.

Our sales and profit outlook remains unchanged: we continue to project Group sales to increase at a low-single-digit rate in currency-adjusted terms, driven by growth in Europe and the own retail channel. This implies an improvement of trends predominantly in the second half of the year. In addition to an easier comparison base, we also expect the various measures we are currently implementing to take effect.

Gross margin is projected to remain on prior year levels in 2016 as a whole. Compared to the first quarter, we expect performance to improve in the quarters to come. A reduction of rebates in combination with further optimization of the inventory position, the ongoing quality upgrade of our US distribution and a positive channel mix effect should drive this. Nonetheless, EBITDA before special items is forecast to decline at a low double-digit rate. While the cost savings identified will help cushioning the effect from weak top line trends, we still expect considerable operating deleverage in 2016, even factoring in stable own retail like-for-like trends in the year as a whole.

Ladies and Gentlemen, the results of the first quarter highlight the challenges we are currently facing. Obviously, we won't be able to change overall market conditions. However, we know where we will have to improve our business in order to bring HUGO BOSS back on growth track. Our measures in the US and Asia will strengthen the consistency of our global brand and price positioning. And our focus on digital will greatly enhance the brand and shopping experience for the benefit of our customers.

There clearly is a lot of work to do, so 2016 will be a difficult year of transition. We are pressing ahead with changes, but we will also have to accept that returning to profitable growth is not a quick fix in light of the current market backdrop. Nonetheless, I have been impressed by the energy and determination of our people to turn things around. The passion for the brand and the company that I've come across in the last few weeks is an important reason for my confidence in the Group's long-term outlook.

I will now be happy to answer your questions.