HUGO BOSS First Half Year Results 2016

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Mark Langer (CEO)

- The spoken word shall prevail –

Good afternoon, Ladies and Gentlemen, and welcome to our First Half Year 2016 Financial Results presentation. I'm pleased to present to you in my new function as Chief Executive Officer today. However, as most of you have known me for years as the Group's Chief Financial Officer, let's skip the introduction and go right into business and our performance in the last six months.

In the reporting period, adverse market conditions magnified some company-specific challenges. In addition, we initiated some bold steps to make progress on our return to profitable growth, accepting a short-term negative impact on sales and profits. As a result, overall Group sales declined by 2% in currency-adjusted terms in the first half year. EBITDA before special items was down 21%.

In the second quarter, performance was comparatively better, although Group sales were still down 1% excluding currency effects. Strict pricing discipline and effective cost management curbed operating expense increases, so that the decline of EBITDA before special items was limited to 13%.

Europe was the best performing region in the second quarter and year-to-date.

In the second quarter, regional sales were 7% above the prior year level in currency-adjusted terms. Wholesale sales benefitted from a different timing of Fall collection deliveries. Own retail sales in Europe developed positively as well, supported by the contribution from new stores and takeovers.

By market, the UK continued to be the region's fastest expanding core market. Sales in the quarter were even up 14%. While this performance was helped by some timing effects in the wholesale business, momentum held up well also in the aftermath of the Brexit referendum. In the weeks following the leave decision, underlying retail sales even improved compared to earlier in the year and developed in positive territory year-over-year.

Performance in the rest of the region was mixed. Scandinavia and Italy developed very well. Key markets like Germany, France and the Benelux, however, registered declines. Here as well as elsewhere in the region, weaker tourist demand was a drag on sales.

First half year revenues in the Americas were 11% below the prior year period excluding currency effects. This was due to the US business which was down 19% year-to-date. Double-digit growth in Canada as well as Central and South America was not enough to offset weakness in the region's main market.

In the US, declines were driven by the wholesale channel. Beyond the effects from an overall recessionary market environment in premium apparel, around half of the sales decline in US wholesale in the first six months was due to our deliberate decision to exit distribution formats not in line with the positioning of our brands. Specifically, we started discontinuing business relationships with value retailers whom we had used in the past to help us clear excess inventories. In addition, we reduced the presence of the BOSS core brand in multibrand spaces, for example at Lord & Taylor and Dillards. Finally, there was a consolidation effect from the shop-in-shop takeovers at Macy's earlier in the year. These operations are accounted for as own retail now.

Own retail sales in the market continued to suffer from double-digit traffic declines which we could not offset with an improvement of average transaction sizes. In order to turn around visitor numbers, the expansion of omnichannel and other service offerings will be key. That's why we have made Click & Collect available in all freestanding stores in the US now. And a few days ago, we launched BOSS on Demand, offering customers a free pick up by Uber wherever they may be. The same way we have Uber deliver packages to customers' homes, offices or hotel rooms. Other services include express deliveries out of our new store in the Westfield Mall close to Wall Street, in-store stylist counseling and a program offering our most valued customers access to many events and gifts money cannot buy.

Finally, sales in Asia Pacific recorded a 6% decrease in currency-adjusted terms in the second quarter as well as year-to-date. Growth in all other major markets in the region partly compensated for declines in China.

In Greater China, sales were down 14% in local currencies in the first half year, negatively impacted by substantial double-digit declines in Hong Kong and Macau. In addition, we have now started annualizing the consolidation effect from the franchise takeover in China in April last year.

In the first six months, the closer alignment of price levels in China with European levels meant that average selling prices in Mainland China declined by around 20% in the first six months. However, the pricing effect was largely offset by volume increases. Unit growth amounted to more than 15% year-to-date. This underlines the improvement of our brand's value proposition which we communicated very consistently in-store and across all digital channels.

We also progressed with the upgrade of our store network. In addition to several refurbishments, we closed eleven stores and shops on the Chinese Mainland in the first six months. Remember that we outlined our plans to close a total of 20 margin- and image-dilutive retail locations in the market over the course of 2016, so we are around halfway through the process now. Upon completion, we will run a more productive, high quality network of stores in premium locations, supporting the ambitious plans we have for the brand's long-term future in this important market.

By distribution channel, Group own retail sales developed broadly stable in the first half year. This was primarily due to the contribution from expansion and takeover activity in the prior year. On a comparable store basis, however, revenues declined by 7%.

In the second quarter, comp store sales performance deteriorated to negative 8% against a tougher prior year comparison base. All regions performed in negative territory, although Europe still outperformed the rest of the world. Nonetheless, trends in the Group's home region weakened slightly compared to the first three months, explained by the strong growth Europe saw in the second quarter of 2015.

Globally, an increase of average transaction sizes had a positive impact on own retail sales despite the significant price reductions in Asia. However, this effect was more than offset by traffic declines, most notably in the Americas but also in Europe.

This highlights the importance to improve our digital proposition to make sure we effectively lead customers into our stores. In the US, we made a lot of progress in this regard by completing the rollout of Click & Collect in all freestanding stores. In Europe, we will launch the same service in September, starting with selected stores in Germany, Austria and the UK. In 2017 then, Click & Collect, Order from Store and the convenient handling of returns across channels will be introduced in all European online markets.

So while the rollout of omnichannel is progressing, the performance of our online business has been disappointing in the first half year. Channel sales declined by 5% over the period on a currency-adjusted basis. First and foremost, this reflects the clear priority we have placed on the insourcing of fulfillment in the last few months. So while the insourcing of the complete order handling process from our previous partner Arvato was completed successfully at the beginning of May, there was not enough management attention and time spent on further improving the online store. The upcoming relaunch of the site in October will address a number of weaknesses we are currently suffering from. However, from a more structural point of view, we will also have to find an answer to the challenges posed by the growing importance of mobile. The dramatic increase of the share of traffic coming from mobile devices has started to have a meaningfully negative effect on our online conversion rate, meaning that sales are down currently despite ongoing traffic increases.

Turning to our physical store network, we are in the midst of shifting focus from expansion to maximizing the quality of our existing store base. This means three things:

- First, we continue to selectively add new stores in underpenetrated markets and retail areas as the opening in Lyon demonstrates.
- Second, we seek to further improve successful stores through targeted renovations. Our newly renovated flagship store in Seoul is a telling example here.
- And third, we use expiring rental contracts to discontinue operations in locations that have not lived up to our expectations.

The latter does not only apply to freestanding stores, where we closed twelve locations in the first half year, but also shop-in-shops. In the last six months, we discontinued operations in more than thirty shop-in-shops at retail partners in Germany, the Netherlands and Belgium in particular. We did so with a view to the small contribution these operations made to our global retail business, often not in sync with the management attention required in day-to-day operations.

All of these closures represent the normal course of business for a company with retail operations of our size. However, earlier in the year, we also announced twenty store closures in China and committed to a global review of underperforming retail locations. The latter formed an important part of our measures to safeguard the Group's long-term profitability. As a result of the review, we have now decided to close around twenty freestanding stores and several shop-in-shops over the course of the next eighteen months. These closures relate to loss-making stores in all three Group regions, among them almost a handful of flagship locations opened in the last three years. In the financial year 2015, they diluted the Group's EBITDA margin by around 60 basis points.

While we are still in the process of negotiating the final exit conditions with landlords, the majority of stores are forecast to close either at year-end 2016 or over the course of 2017. Based on the remaining maturity of rental contracts, we expect to incur one-time expenses of 46 million euro predominantly related to early termination payments. In addition, impairments on furniture and fittings will amount to 6 million euro. As a result, provisions and impairments in a total amount of 52 million euro were booked in the "other operating expense and income" line in the second quarter and treated as special items. The cash effect is expected to amount to a low double-digit million euro figure in 2016, with the remainder to be incurred in future years.

Closing these stores is a painful exercise without a doubt. However, having had the choice between swallowing a bitter pill today and suffering from ongoing margin dilution going forward, we decided for the first. While the effect on 2016 results will be marginal based on the timing of closures, we expect a first positive impact on profits in 2017 before the realization of the full benefit in 2018.

Wholesale revenues declined by 6% excluding currency effects in the first half year. A solid performance of our European wholesale operations supported this development and partially offset the declines in the Americas that I discussed a few minutes ago.

Channel revenues in the second quarter benefitted from a higher sales share of the Fall collection compared to the prior year. This was a result of the relatively better demand among wholesale partners for some of the collection themes with earlier delivery dates. Adjusted for this effect, second quarter wholesale sales would have been down at a mid- to high-single-digit rate instead of the reported minus 1% in currency-adjusted terms. Obviously, this shift will be reversed in the third quarter, where we consequently forecast wholesale sales to decline more significantly again, reflecting cautious customer ordering in light of subdued market trends.

Finally, let us look at top line development by gender. In the first half year, menswear and womenswear performed broadly in line. BOSS Womenswear continued its positive momentum, albeit growing at lower rates than in the previous year. Once more, this underscores the structural health of the womenswear business which will continue to be an important part of our Group also going forward.

Nonetheless, we are placing an even higher emphasis on our key menswear business. This is true from a brand communication perspective, where menswear is benefitting from a far bigger share of our communication budget again, as well as from a merchandising perspective. In particular in Europe, we have just implemented some tactical changes to our retail floor space allocation. First of all, we shifted some space to menswear formalwear, our most productive concept. Secondly, we changed the layout of some of our womenswear selling spaces, making sure that they are sufficiently intimate and detached from the rest of our offering.

In the months ahead, we will concentrate on defining future brand strategy and the creative direction of our collections going forward. In this context, I'm pleased to announce that Ingo Wilts will join the Managing Board as the Group's Chief Brand Officer in less than two weeks from now. I'm sure that his arrival, earlier than initially planned, will be instrumental in driving progress in this important part of our business.

Ladies and Gentlemen, I hope that I have been able to convey the different sources of top line pressures in the first half year. Some of them were market-related, others company-specific. Some of the pressures we were not able to avoid, others we accepted in order to strengthen our base for future growth.

So while we cannot and we are not satisfied with the Group's current top line momentum, we have been able to limit the effects on operating profit as far as possible. In the second quarter, gross profit margin improved by more than 100 basis points, meaning that we almost reversed the declines of the first quarter, where gross margin had suffered from higher rebates and some scrapping of old merchandise in China.

In the second quarter, we even reduced rebates compared to the prior year, despite an overall still highly promotional market environment. In doing so, we sacrificed sales for the sake of brand protection. Even more importantly, however, we benefited from tighter inventory management compared to the previous year. In addition, some price increases in other markets, most notably in Russia, limited the negative effects from the price reductions in Asia.

Below the gross profit line, the efficiency program announced a few months ago has clearly started taking effect. This was true for selling & distribution expenses, where successful rent renegotiations in particular in Asia limited cost growth. However, the effect was even larger in the G&A line, where tight operating overhead cost management meant that costs remained stable versus the prior year.

Nonetheless, we took great care not to touch expenses vital to reaccelerate brand momentum. Marketing expenditures, for example, remained on the prior year level.

Despite the measures to protect profitability, EBITDA was down 21% compared to the prior year. As a consequence of special items and higher depreciation and amortization expenditures, the Group's EBIT and net income declined even more significantly.

From a regional perspective, profitability held up reasonably well in Europe. In the Americas, operating deleverage from the severe decline of sales as well as somewhat higher rebates led to margin contraction. In Asia, the profitability decline was largely due to the lowering of selling prices in China and some other markets at the beginning of the year which was only partially offset by tighter overhead cost management.

Let's turn to the balance sheet.

At the end of the first half year, trade net working capital was up 1% in currency-adjusted terms, but down by the same rate in reported terms. Relative to sales, this represents an improvement of 20 basis points compared to the prior year period.

Inventory growth continued to be well contained, irrespective of the negative top line development. At the end of June, inventories rose 2% excluding exchange rate effects. Increases were entirely due to growth in Europe. In the two other regions, the inventory position decreased substantially.

In line with our guidance, investments were down compared to the prior year and amounted to 79 million euro in the period. The decline was primarily a result of the non-recurrence of last year's one-time investment related to the relocation of our New York City showroom. Overall own retail expenditures remained virtually unchanged. However, while store renovation expenditures increased, spending for new openings declined – a pattern we also project for the rest of the year.

Lower capex and trade net working capital improvements were not sufficient though to compensate for the earnings shortfall, so that free cash flow declined to 54 million euro year-to-date. As a consequence, net debt was above the prior year level at the end of the period.

In the full year of 2016, we now expect Group sales to develop weaker than originally expected. This is due to a weaker than expected sales performance in own retail in the first half year. In addition, we have decided to accelerate the structural changes in our US wholesale business. As discussed earlier, we started reducing the BOSS brand's exposure to off-price distribution formats in the first half year. In the second half year, the clean-up will be even more comprehensive than initially planned. As a result, we reduce our full year sales outlook for the wholesale business and now expect a decline of up to 10% in currency-adjusted terms.

In our own retail business, we are obviously working towards an improvement of like-for-like sales in the second half year:

- First, the comparison base will ease significantly in all three regions.
- Second, we are adjusting our merchandise offering in China to better cater to the demand that our price adjustments have created.
- And third, we will continue to drive the Group's digital transformation by rolling out omnichannel services also in Europe.

However, we expect an ongoing difficult and volatile market environment in the remainder of 2016. As a consequence, our visibility on any potential improvement of trading in own retail remains low. We hence assume a second half year comp store sales performance equal or better compared to first half year levels. As a result, overall Group sales are now projected to decrease by up to 3% on a currency-adjusted basis.

A stable gross margin development in the full year and disciplined cost management should continue limiting the operating deleverage from a flat to declining sales trend. Consequently, we expect EBITDA before special items to decrease between 17% and 23% in 2016. Unchanged to our previous communication, investments should amount to between 160 million euro and 180 million euro. Following the adjustment of our sales outlook, however, we now expect a slightly smaller cash contribution from working capital improvements. As a result, free cash flow is projected to decline slightly compared to prior year levels.

Ladies and Gentlemen, we have initiated a number of measures to address our current challenges. We cut down on cost growth. We adjusted prices in Asia to improve the consistency of global brand presentation. We initiated far-reaching steps to improve our distribution in the US wholesale channel. And we decided to rightsize our store network by discontinuing operations in underperforming locations.

These decisions are painful in the short term, but they had to be taken because they are right for the long term. There will be more work to do, of course. Irrespective of the prevailing market environment, we need to further strengthen our brands and our business model. We will have to become more customer-centric, faster and more flexible. These attributes will guide our definition of future strategy and the measures derived from it. I'm excited about what this will mean for the future of HUGO BOSS. While it is too early to go into detail today, I look forward to sharing our medium- and long-term plans with you when we will meet for our Investor Day on November 16 in London.

But before this, I'll be pleased to answer your questions on today's set of results and our outlook for the remainder of 2016.