HUGO BOSS Nine Months Results 2016

Metzingen, November 2, 2016
Mark Langer (CEO)

- The spoken word shall prevail –

Good afternoon, Ladies and Gentlemen, and welcome to our Nine Months 2016 Financial Results presentation.

HUGO BOSS continues to operate in a challenging market environment. In Europe in particular, trends in the premium apparel industry continued to soften. The US market remained under pressure and highly promotional. And while the Chinese Mainland has started recovering somewhat, other Asian markets still face considerable challenges industry-wide. Affected by this difficult market backdrop, Group sales were down 4% in euro terms or 2% on a currency-adjusted basis in the first nine months.

In light of the top line challenges, we tightened our grip on cost management. The expansion of our savings program limited the decline of operating profit. EBITDA before special items was 18% below prior year levels in the period.

Taking into consideration a negative shift effect in our wholesale business as well, third quarter revenues declined by 3% year-over-year excluding currency effects. Operating profit was 14% lower in the quarter.

In Europe, performance weakened in the last three months. Third quarter revenues were down 2%. We attribute this to the following factors:

First, we suffered from weak demand in August and September, in particular in key European markets such as Germany, France and Spain. This was a reflection of overall market deterioration. In Germany, for example, market researcher GfK described the industry's most recent performance as "almost historically weak". Second, tourism has turned from a significant tailwind in 2015 into a headwind in 2016. The UK market is the only exception in this regard. However, with just a low-double-digit share of our business there generated with tourists, the demand increase related to the Pound devaluation only had a limited effect on our business. And third, the region's wholesale business suffered from negative timing effects in the quarter. In contrast, the second quarter benefitted from the fact that many retail partners had put a greater weight on the early themes of the Fall collection delivered in May and June already.

On a year-to-date basis though, the European market continued growing. By geography, the UK was the region's fastest expanding core market. In the first nine months, sales were up 8% on a currency-adjusted basis. However, sales in Germany, France and the Benelux markets all declined at mid- to high-single digit rates.

Nine month revenues in the Americas were 10% below the prior year period excluding currency effects. This was due to the US business which was down 17% year-to-date. Solid 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. In this channel, year-to-date sales are down 24% year-over-year. Around half of the decline is due to our conscious decision to exit distribution formats not in line with the positioning of our brands. Specifically, we have sharply reduced the volume of off-price business. This includes the discontinuation of business relationships with value retailers, but also the rightsizing of brand presence in department stores' off-price concepts.

We are confident that this quality upgrade of wholesale distribution will contribute to brand strength and desirability going forward, ultimately also benefitting trading in our own stores. At this stage, however, sales in own retail continue to be under pressure from the diversion of customer traffic into multi-brand formats which compete almost exclusively on price. Underlying retail trends were somewhat better in the third quarter compared to earlier in the year. However, this was largely due to an easing of the comparison base rather than a fundamental trend change.

Finally, sales in Asia Pacific recorded a 5% decrease in currency-adjusted terms in the first nine months. In the third quarter, however, performance improved sequentially. This was entirely due to China, where sales declines moderated to just 4% in the three month period. This represents a major improvement, considering that we reduced prices substantially and our store base has shrunk by 12 locations since the beginning of the year, including 17 store closures on the Chinese Mainland. In addition, Hong Kong and Macau, which account for around a fourth of total China sales, continued to record declines and dragged down the overall market.

On the Mainland alone, however, comp store performance was positive again in the third quarter, with strong improvements in August and September in particular. This compares to still high single digit negative rates in the first half year.

We attribute this success to four major factors:
First, we benefitted from the adjustments we made to our pricing and merchandising strategy. On the new, lower price levels, we broadened our offering at accessible entry price points on the one hand. On the other hand, we created exciting assortments by emphasizing high end concepts such as our BOSS Tailored range or Full Canvas suits.
Second, we improved merchandise planning and in-season management, avoiding stock out situations such as the ones we suffered from in the first half year.
Third, innovative marketing concepts, in particular in digital, supported brand momentum and customer engagement.
And fourth and finally, a gradual recovery of the Chinese premium and luxury menswear apparel market after two years of double-digit declines provided some tailwind.

Based on these factors, we are confident to sustain the positive momentum also in the months ahead.

By distribution channel, Group own retail sales were up slightly in the first nine months. This was primarily due to the contribution from expansion and takeover activity in the prior year. Keep in mind that stores opened last year will only become part of the like-for-like universe in 2017. On a comparable store basis, revenues declined by 7%.

In the third quarter, comp store sales performance improved gradually to negative 6%. However, all regions continued to perform in negative territory. Europe and also Asia/Pacific performed better than the Group average, while trends in the Americas remained subdued. Traffic declines continued to be a major drag of performance here.

Disappointingly, our online business had a negative impact on comp store sales as well. It was down 8% in the first nine months, including a mid-teens decline in the third quarter. As we had flagged at our last results presentation already, the steep increase of traffic coming from mobile devices is having a negative impact on sales performance at the moment as it dilutes conversion rates. We are addressing this in multiple ways: Most importantly, we focus on improving the mobile website checkout funnel, where we lose far too many consumers at the moment. In October, we also launched a mobile app where the checkout process is easier compared to the mobile site. Finally, at the beginning of October as well, we relaunched hugoboss.com with the goal of improving usability on mobile devices in particular. In addition, we have made obvious progress when it comes to the look and feel of the site, enhancing the quality of product presentation as well expanding editorial content. We got encouraging feedback from customers on the new site, but we will clearly have to put more work into further improving usability and on-site merchandising to turn around online sales trends.

Our physical store network grew by a net new 14 freestanding stores in the first nine months. While we added 33 stores via openings and takeovers, we also shut down 19 locations. Europe was the focus region in terms of expansion but also closures. Most of the closures here as well as in the other regions related to locations where we simply chose not to renew the rental contract, so they reflect the normal course of a retail business and came at no exceptional cost.

However, we are also actively closing underperforming stores as part of our program to safeguard the Group’s long-term profitability. Earlier in 2016, we announced that we intended to close twenty stores in China, and, much more importantly from a financial perspective, an additional twenty margin dilutive stores worldwide. In doing so, we accepted substantial one-time costs for the benefit of eliminating losses in future years. In China, we are largely done – by the end of September, 17 points-of-sale, some of them counted as shop-in-shops, have been closed. The global closing program is on track for completion by year-end 2017. As of today, we exited three points-of-sale, including our former flagship store in Moscow.

As a reminder, provisions for the expected exit costs had been booked as special items in the second quarter already, so these closures had no direct earnings impact in the third quarter.

Wholesale revenues declined by 8% excluding currency effects in the first nine months, in line with our expectations for the full year. The distribution changes in the US I outlined a minute ago were the key driver here. In addition, weak demand from retail partners in both Europe and the Americas also had an effect.

In the third quarter, channel sales declined by 11%, affected by the reversal of the timing effect mentioned before which had supported revenues in the second quarter.

Let us turn below the top line, where we made good progress in limiting the impact from the current top line pressures.

In the year-to-date period, the Group's gross profit margin remained unchanged compared to the prior year period. While we benefited from a positive channel mix effect, the price reductions in Asia had a negative effect.

In the third quarter, the overall picture was similar. At 64.7%, gross margin was virtually the same as in the prior year. In addition to a positive channel mix effect, we reduced rebates in all distribution channels. On the negative side, the devaluation of the British Pound caused an adverse translation effect. Price changes, however, were not a swing factor in the quarter any longer. This was due to the fact that the effect from the adjustments in Asia is now abating, given that we had started reducing price levels in the second half of 2015 already. In addition, increases in Russia and Germany in particular had an offsetting effect.

On the cost side, the efficiency program announced a few months ago has generated even better results than initially anticipated. Selling & distribution expense growth was curbed by successful rent renegotiations in particular in Asia. Additionally, we reduced marketing expenses proportionately to sales. G&A expenses benefitted from tight operating overhead cost management.

All in, we now expect to exceed our original savings goal in the full year. Instead of the 50 million euro targeted earlier in the year, we now forecast expenses to come in 65 million euro below the original budget. The additional benefit has to do with a better retail cost management as well as the streamlining of marketing expenses.

Nonetheless, EBITDA before special items was still down 18% in the first nine months. The Group's EBIT and net income declined even more significantly as a consequence of special items largely incurred in the first half year as well as higher depreciation and amortization expenditures. However, keeping in mind that especially retail sales remained depressed also in the third quarter, this represents a better outcome compared to our expectations just a few months ago.

From a regional perspective, profitability held up the best in Europe relative to the two other regions. In the Americas, operating deleverage from the severe decline of

sales led to margin contraction despite the strict containment of costs. 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 expense management.

Corporate unit costs were unchanged year-over-year, reflecting strict expense control in central functions.

Finally, let me discuss some key balance sheet and cash flow developments.
At the end of September, trade net working capital was down 5% in currency-adjusted terms as well as in euro terms. Relative to sales, this represents an improvement of 10 basis points compared to the prior year period.

Inventories continued to be well contained, irrespective of the negative top line development. At the end of September, inventories declined by 1% excluding exchange rate effects, driven by double-digit percentage decreases in the Americas and Asia.

In line with our guidance, investments were down 16% compared to the prior year and amounted to 119 million euro in the period. The decline was due to lower retail expenditures, primarily as a consequence of more moderate expansion, as well as the non-recurrence of several prior year projects. This includes the relocation of our New York City showroom and the expansion of our production in Izmir in 2015. In contrast, IT investments remained on prior year levels, reflecting the insourcing of online fulfillment in Europe now completed as well as other ongoing digital initiatives.

As a result of lower capex and trade net working capital improvements, free cash flow increased by 14% to 106 million euro year-to-date. Net debt, however, was still above the prior year level at the end of the period, owing to the earnings decline and the dividend payout in May.

Our expectations for the full year of 2016 remain unchanged. Group sales are projected to decrease by up to 3% on a currency-adjusted basis. In own retail, the contribution from new space should compensate for declines on a comp store basis. Sales in the wholesale business will decline by up to 10% in currency-adjusted terms.

A stable gross margin development and disciplined cost management should continue limiting the operating deleverage from the negative sales trend. Consequently, we project EBITDA before special items to decrease between 17% and 23% in 2016. While we have not changed our profit outlook despite higher savings, even stricter than initially expected cost management should keep us well above the lower end of the guidance range for EBITDA even if comp store sales performance did not improve versus year-to-date levels in the remainder of the year.

Investments should amount to between 160 million euro and 180 million euro, visibly below 2015 levels. And as we also expect working capital management to

make a strong positive contribution, free cash flow is projected to remain on prior year levels despite the earnings decline.

Our most recent performance testifies to the effectiveness of the measures we have initiated over the last few months. The price adjustments in Asia are starting to pay off. The containment of rebates in own retail supported brand strength and contributed to the stable gross margin trend. Strict inventory management and disciplined investment activity will ensure that free cash flow will be on prior year levels in 2016. And even greater than planned cost savings limit profit declines.

Ladies and Gentlemen, we are a company that has run a very successful business for many years. This has made the developments over the past twelve months all the more sobering not just for me, but for everyone at HUGO BOSS. We take pride in having adjusted our cost structures very quickly to a more difficult industry environment and company situation. There is no doubt that HUGO BOSS continues to stand on a very solid basis. But we all have the ambition to return to growth the sooner the better. On our Investor Day on November 16, we will be giving you a detailed account of our plans for the medium and long term.

But before I will meet you there, let me answer your questions on today's set of results and our outlook for the remainder of 2016.