HUGO BOSS

HUGO BOSS Q1 2017 Analyst Conference Call

Transcript – Q&A Session

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Zuzanna Pusz (Berenberg): First of all, on the wholesale business. I understand that the different timing of the deliveries supported your performance in Europe in Q1. Would you be able to quantify that? What was the impact, was it sort of low-double-digit million euro?

Secondly, on the gross margin. The 30 basis point gross margin improvement year-on-year seemed a bit light, given the non-recurrence of the inventory write-downs from Q1 2016. Would you be able to walk us through the actual gross margin drivers, including any negative effects, the channel mix and any underlying improvement you may have seen from reduced discounting?

And a follow-up question on gross margin. You recorded another inventory write-down in the U.S., which I guess wasn't expected. Can you explain what was the decision, why the decision right now, and could that mean that also for the full year, you will see less of an improvement in the gross margin than initially expected?

Mark Langer (CEO): We benefited on a quarterly basis from delivery shifts. We did not manage this in a way, but it was the consequence of the buying behavior of our wholesale customers, who put a larger preference on the themes two and three in our deliveries at the expense of theme one. Without these effects, the wholesale sales would have declined by low- to mid-single-digits in the first quarter, so in line with our full-year guidance. Please keep in mind, at the time when we guided you on our wholesale development for 2017, we had full visibility on the order book. So, it shouldn't come as a surprise that we factored this in and we expect, as I said earlier, still our wholesale business for the full year to perform at these rates.

Regarding your question on gross margin impact, of course, there's a bundle of effects and I think you mentioned them all correctly. Typically, we benefited from channel mix in our business development over the last years. So, given the momentum we just discussed, our channel mix had a slide drag on gross margin development, given that we have higher gross margins in the retail business than in the wholesale business. Also exchange rates played a role, with the British pound having a negative impact on gross margin. The effect from rebates was clearly positive and even stronger than we expected. In Asia, but also in other parts of our business, we have seen an expected positive development from managing rebates tighter than the previous year.

We expected a smaller reoccurrence of inventory write-downs in 2017 compared to 2016. There was a non-reoccurrence of inventory write-downs in Asia, helping to improve our Asian profitability significantly. However, we also had inventory write-downs in the U.S. almost to the same level, which offset the positive impact from Asia. So, overall, we saw a 30 bps improvement in gross margin in the first quarter. We still expect an improvement for the gross margin also for the full year. Hence from today's perspective, we see no reason to revise our gross margin guidance for the full year.

Fred Speirs (UBS): My first question relates to like-for-like. Reuters was quoting you this morning saying that Q2 so far has seen a significant improvement in your in-stores trend. Could you please share, which regions are the main drivers behind that sequential improvement and does that mean that you are positive like-for-like in Q2 to

date? And with the Q1 print, does that change how you think about the likelihood of reaching the high-end of your full-year like-for-like guidance range?

My second question refers to online. We see marketing expenses broadly stable overall in Q1, but there is a shift back towards Menswear within this. Could you give us a sense of how much online marketing spend on Menswear is up year-on-year, and is this going to be a bigger sequential support as we move through the year?

And then lastly, on wholesale, you mentioned what the underlying piece was in Q1. Should we be thinking Q2 down maybe high-single-digit, or is there anything else we should be taking into account for Q2?

Mark Langer (CEO): Let me put everybody on the same page: we are not giving guidance on like-for-like on the second quarter. As it is too early to tell we will neither be commenting on it nor give any guidance on a quarterly basis. Same principle also for the wholesale development in the second quarter.

It is true that the measures that the task force has identified and implemented in the first quarter are, first and foremost, benefiting also our e-commerce business, which was very disappointing in our sales period in January. But for the regular sales of the Spring/Summer collection, still being sold at full-price, we have seen that merchandising is improving, that loading times are better, and that conversion rates improved sequentially during the period.
And also regarding CRM, which has been a drag to our business in the past, we have seen now for February and March, that our measures are activating customers now, bringing them to our website and improving our conversion rate. So, we are seeing a sequential improvement. It is too early to give any commitment or guidance on our e-commerce business for the second quarter. But the second quarter will improve and be significantly better compared to what we recorded in the first quarter. Overall we do expect to return to positive like-for-like in the e-commerce business for the full year.

Marketing spendings have been reallocated according to what we presented at the last Investor Day and what we iterated at the Analyst Conference. We are now more focused on Menswear than we were 12 months ago, that's correct. But especially in print and online advertising, Womenswear continues to benefit with its share of total marketing spendings at around 30%. That is significantly higher than the womenswear’s share of business and is true across all marketing activities, be it print or digital advertising.

On wholesale, we always caution you not to get too excited on above trend developments, like now in the first quarter. You are right to assume that in the remainder of the year we will see a moderation in the wholesale development to bring it in sync with our overall expectations for the full year. As we outperformed full year guidance in the first quarter due to the facts mentioned before, we expect the remaining nine months to be rather dilutive and to deliver for the full-year within our guided range for our wholesale business.

John Guy (MainFirst): With regard to the online business, could you please comment a bit more on the exit rate? As January was significantly worse than the 27% decline you had for the full quarter, I appreciate that the task force has come in and did some changes. What was the exit rate in March?

Could you also please comment on the store closures? In terms of the underperforming stores, you have now closed around five out of the roughly 20 stores that you are going to close until the end of this year. Is that going to be an even closure process over the course of the year?

If you could also please comment on France and Benelux, as the comp bases were reasonably soft for both of those two regions. I'm trying to understand why they were pretty weak in Europe? You mentioned that there was a better exit rate?

And finally, on pricing initiatives, you mentioned that there were no pricing adjustments due for 2017. Although, I think for January 2018, you're potentially looking at 10% to 15% price rises in Germany and a 15% price cut in China, I appreciate it's a slightly longer way off. But how should we think about your budgets for Europe and Asia, and great expectations on the back of those price amendments?

Mark Langer (CEO): In the online business, we have seen a measurable and sequential improvement in the course of the first quarter. We finished single month March in positive territory, which is a very promising sign. In March and April we have virtually no rebates offered, so these are the cleanest months. February still had the impact from the later stages of our clearance sales. So this gives me confidence that the measures implemented are effective, becoming visible in better conversion rates and also better activation.
But clearly this is not yet enough to compensate the year-to-date numbers and the very weak start we had in particularly in January. Be cautious to take one month of positive trading and a positive start into the second quarter of the year 2017, as particular in online June- and July will be decisive as we know that consumers are particularly receptive to an intelligent but wide enough offer during the sales period.
So, please take it as a sign of confidence that there are two things in place at HUGO BOSS: we know where we fell short and we know the areas to improve. We have taken decisive measures which and, at least on a quarterly basis, we have seen a quite significant improvement. Our half year results will show how sustainable and sufficient these measures are. Not all of them are implemented yet, there are still areas where we need to get better. But I'm pleased that, against the backdrop of the difficult start, we are heading in the right direction.

The five out of roughly 20 loss-making stores that have already been closed were part of the base last year, but no longer part of the base in the first quarter. This had a small, but measurable positive impact on retail profitability in the first quarter. Please be reminded that we guided you on that a full-year base all 20 stores had about a 70 bps dilutive impact on group profitability. We have not yet finished negotiating the exit for all of them. For some of these stores we are still in negotiation on the final exit terms and timing. But we are confident that the vast majority of these stores will be excluded

from our store base by the end of 2017. This means that the full year effect of the benefits of closing these loss makers will be visible in our 2018 numbers.

With regard to France and Benelux, we are rather flat to slightly declining and not yet at levels as we are in the U.K. and, to a lesser degree, in the German market. In the Benelux market in particular, there is also the impact from some distribution clean-ups as we discontinued a set of concession operations, a factor that we mentioned in previous calls already. And in all other markets it was a weaker market environment - probably affected also by macroeconomic factors - which made these markets not dramatically, but comparably weaker than the two core markets, that is Germany and the U.K.

With regard to pricing, yes, you are correct. With the Spring/Summer 2018 collection, we will implement the principle “same product, same price” within the Eurozone. This will have the effect of price increases or discontinuations of certain price points in Germany. So, be it the suit, be it the jeans, be it the outerwear jacket, “same product same price” across all the Eurozone. Please keep in mind that this implies also price reductions for example in the Swiss market relative to the other European markets.
We have not committed on Spring/Summer 2018 being the implementation date for further price harmonization in Asia. As we mentioned already at the Analyst Conference, we are very pleased with the strong like-for-like improvement in Mainland China. We think that the weakness of Hong Kong and Macau is only to a lesser degree driven by price discrepancies within the region or towards Europe, but has more to do with domestic effects, in particular in Hong Kong.
We will probably give you more details regarding amount and timing of the price adjustment in Asia at our Investor Day in August. We did not yet announce that we will have an X-percent price adjustment in Asia/Pacific with the Spring/Summer 2018 deliveries; this is only true for the price adjustments in Europe.

Thomas Chauvet (Citi): My first question concerns the Americas: You said that the discontinuation of the off-price business in wholesale has started supporting sales in your own retail network. By that, do you mean LFL sales development in the U.S. is less negative because of that? And on the U.S. off-price business, are you still on track to reduce the exposure to that business from 20% of wholesale sales to single-digit percent in 2017 as you highlighted at the Investor Day?

Secondly, on HUGO, what was the growth of HUGO in retail in the period? And in wholesale, excluding the timing shift, given you haven't got the new HUGO collection yet, would you say that the performance is a reflection of the good momentum of the broader contemporary segment or the result of some of your specific actions taken on assortment and communication? And do you feel more broadly that the organization is ready and very clear on how to succeed with the Spring/Summer 2018 relaunch of HUGO in that segment?

And finally, as we are all seeing the luxury demand recovering strongly in most markets, in particular Europe and Greater China, are you seeing the share of luxury versus entry level price points perhaps increasing in the period? And do you still have the same view that HUGO BOSS should be staying away from that segment? ,

Mark Langer (CEO): What we do see is that there were no volumes available anymore since summer of HUGO BOSS merchandise in the U.S. multi-brand off-price formats. Price-sensitive consumers have to a significantly larger degree turned towards our factory outlets. Of course, I wished they would come to our full-price stores. But at least on the current trend base, it is a positive sign that these price sensitive customers have now shifted to our own controlled mono-brand off-price formats. There we are in control, we tend to have also better merchandising execution, ultimately also better brand experience and strengthening of our brand equity.
So, we are well on track to achieve the target that you reiterated and that we will reduce our share of off-price wholesale to less than 10% coming from peaks clearly above 20%. And as explained, just to make this clear to everybody, our relationship with Nordstrom and other majors, which are also operating off-price formats on their own, will limit our ability to bring this down to zero. But it is clearly a strong improvement which started to benefit our factory outlet operations in the U.S.

The development of HUGO in the first quarter also benefited from the delivery shifts. Keep in mind that the wholesale share is actually slightly higher for HUGO as compared to BOSS. But it was also driven by a better performance in our HUGO business in own retail. I ask for your understanding that we do not break down sales by brand and channel with regard to the like-for-like development. But it was also due to the fact that the HUGO collection in HUGO-only stores or in our larger stores like on Champs-Elysées, Paris or Sloane Square, London, where we offer both HUGO and BOSS, performed also very positively.
There are two important market segments, which are benefiting right now from change in consumer preference: one is the athleisure segment. The other one is the contemporary avant-garde segment, in which we play HUGO. Both Menswear and Womenswear benefited from that.
It is interesting that also for other luxury players in some markets, there is a reoccurring demand, at least for some brands, also on luxury price points. We have not seen a major discrepancy across our price points. And keep in mind that our new strategy does not include the discontinuation of BOSS Tailored, the upper end of our collection. However, it gives us confidence that there is a huge untapped opportunity that we walked away from for the last two years on the entry price points. This we want to recapture more, independent whether there is a pick up also at the luxury end. And we will strengthen this push even in the second half of the year.
Our core is premium, it's not luxury, as we confirmed. This means that at the upper end of our offering we will still be present, but this will not be decisive for return to profitable growth. The harmonized premium entry price points of our offering will be more decisive.

Antoine Belge (HSBC): Regarding the German market, can you please give your feeling about how things are developing, also compared to the Investor Day, especially with regard to your wholesale partners? What are your expectations for the German market for this year and for the season where prices will be aligned?

My second question relates to cost savings. The first quarter was still impacted by some of the measures started in the second quarter last year. In the previous

conference call you highlighted that you could find more cost savings. So, how should we think about the rate of growth for Operating Expenses for the three remaining quarters of 2017?
And finally, in terms of management, have there been any sort of new hirings?

Mark Langer (CEO): Let me start with the German market. I think that it has been the second quarter now with a positive, if not surprising development in Germany.
Remember there was a lot of criticism or nervousness on the capital market after our Q3 numbers in 2016, which were down 10%. The end consumer or maybe our wholesale customers did not accept the price adjustment. Since then we have now delivered two quarters where we were slightly ahead of the overall market segment. This gives the whole HUGO BOSS team and me a lot of confidence that we have a superior good “value for money product offering” for our German consumers. And we treat this ground very carefully. And as I said earlier, we have now used the last 5 months to also clearly look at all elements of our collection in terms of “value for money”. Regarding our offering and the presentation of our Spring/Summer collection 2018 we have a convincing story to our partners on the German wholesale side and our own merchandising function.
With the improved “value for money product offering” and quality on the entry price point, the overall composition of the euro priced collection is sufficiently attractive in design language, but also with regard to value for money for the consumer.
Feedback has been very positive, admitting this is still more conceptually being presented in terms of fabrics and concept stories, because this collection is still in the making. What we have in our showrooms right now is the Pre Spring collection, which is already much closer to the new harmonized collection that we will present in July. But overall, I've seen increased confidence from our wholesale partners and within the HUGO BOSS organization that this is something that will be received around positively, admittedly from the end consumer.
You can be sure that in terms of willingness to invest into the product, listen to demand from the market, and in terms of which price point to start, we will do whatever we can to defend our market leading position. But one principle will be adhered to without any alternative and that is, as of Spring/Summer 2018, “same product same price” in the Eurozone. If we will see that in some product categories, due to competitive moves or demand from the end consumer, entry price points have to be 5 EUR or 10 EUR lower or higher, we will consider this very carefully.
But it is one European price adjustment that we do. The historical differentiation between France and Germany or that between the Benelux and Australia will be things of the past. This will also benefit our capabilities in our e-commerce world, where our consumers anyway expect to be treated equally across all geographies.

With regard to cost savings, our performance year-to-date is a very telling proof to the fact that the company continues to be able to control its operating expenditures in a way to mitigate also the impact from negative like-for-like sales. We expect that the first quarter will mark the low point of our overall like-for-like development for the full year. Remember that we guided for minus 3% to plus 3% of like-for-like sales for the full year. If the market will worsen to what we have seen for the last seven to eight weeks, we will implement contingency measures that we have defined with all cost center owners. This will then be a priority call on which projects, which expenses are

to be postponed or to be reduced in size in order to achieve our EBITDA guidance for the full year.
These plans are in place and aligned, we are flexible enough to adjust our spending pattern, be it hiring, or be it discretionary spending on project scopes to adjust to the level we can afford giving the top-line development.

Antoine Belge (HSBC): And regarding the management team and maybe also the CFO position?

Mark Langer (CEO): We are in a very late phase of the announcement. I am quite confident that we will have an announcement around the AGM. I think we would all agree that this would be perfect timing and a good stage to announce a reputable new CFO for HUGO BOSS. I can only confirm that once we have mutual signatures. But we are in a very advanced stage to fill this position.

Piral Dadhania (RBC): Regarding your gross margin guidance: as you begin to widen the entry price offer in the second half of the year with your Fall/Winter 2017 deliveries, and the potential impact of negative price mix we can expect there, should we expect gross margin development for the first and second half of 2017 to look slightly uneven? I.e., will gross margin for the second half be lower than for the first half as you get some negative price mix effects coming through?

And regarding your North American retail business: you have said that there were significant footfall declines in your full-price retail network, but the outlet business has done much better stabilizing in the first quarter. Could you just confirm the share of outlet in North America as a proportion of your total retail sales and whether you see that development as structural versus cyclical? And if it is structural, then what actions can you take to prevent further deleverage as we progress through 2017 and into 2018?

And finally on CapEx: your full-year guidance is for €150 million to €170 million, but your first quarter spend is significantly lower than that on a run rate basis. Could you just explain the phasing of CapEx, whether there is potential that the full-year number could be lower than that and hence free up some further free cash flow generation?

Mark Langer (CEO): Let us start with the gross margin impact. With the Fall/Winter deliveries the company will place bigger focus on entry price points. We explained it also when we gave the gross margin drivers for the full year at the Analyst Conference in March. Actually, regarding the mix by product category, whether we sell more clothing versus casualwear, or athleisure, or even within groups, the HUGO BOSS product range has a very comparable gross margin across multiple product categories. Except for ties which is the most margin accretive product category. However we will not have a push on ties, but we will have a push on the important entry price points. These will hopefully increase footfall ultimately. Because customers that are looking more for these price points did not find this offer in our full-price stores in the last three to four seasons. We elevated the brand at price points, which did not find the acceptance from these costumers. So, we would like to reactivate these customers. By the way, one of the elements that has helped us now to improve our e-commerce

business, also in the later stage of the first quarter, is that entry price suits are far more visibly placed on our website than ever before.
A higher expected sales share of entry price points will not affect gross margin. But it could cause cash margin to decline: it clearly makes a difference whether we sell two suits at €600 versus €800. It is important that we compensate this cash margin impact by better conversion rates and higher traffic rates. This applies for all price adjustments, be it also lowering prices like we did in Asia. You have seen that we were able to overcompensate price adjustments or shift some more to entry price points if the market mix is right.

In terms of the U.S. retail footfall, its development is beneficial to our factory outlets. It is partially attributable to the discontinuation of the off-price business in the multi-brand environment. This has led also to the situation that our factory outlet business has grown stronger than our full-price business in the U.S. Outlet business in the U.S. is already above group average, as it accounts for more than 30% on retail sales in the U.S. We do not give the specific split between full-price and off-price by markets or region. But we still consider this a positive development considering the point of departure. Keep in mind that 20% of our wholesale sales were within multi-brand off-price formats, which we consider far more brand equity dilutive than our own factory outlet operations.

Regarding CapEx, we can assure you that we will not cut corners in terms of renovating our store network or postponing openings on store projects that we believe into. We have pretty good visibility also historically on our pipeline on renovations and openings. So, this is purely timing.
Also we are in the late stages of implementing a new store format. That we will also present to you at the Investor Day. Also in terms of in-store execution this will have a much stronger impact on consumer perception, but also functionality than our current BOSS store concept. This has led to the fact that we have postponed some of our openings later. Our flagship store in Geneva, with opening date around September/October 2017, will be our first European store that follows the new B7+ evolution concept. This will also be a showcase to the new in-store execution, not only in terms of merchandising, but also then in terms of store design. We will share with you on site in August more details to the new store concept.

Piral Dadhania (RBC): So, you expect to spend the full €150 million for the full year?

Mark Langer (CEO): Yes, no change to our guidance.

Piral Dadhania (RBC): Let me follow-up quickly on your price volume mix equation please, I am talking about the gross margin. I guess that your response suggests that you are expecting a full volume response to the change in the prices. Does that tend to come through immediately or does it tend to be lagged?

Mark Langer (CEO): We had examples that we will build on where price adjustment have been very well received by our wholesale partners and end consumers. And we know what marketing and communication is the important part of that. But ultimately, the product just has to be delivered in terms of fashion statement, in terms of quality,

in terms of fit. That is why we have said there is a lot of focus on the development and the preparation with our wholesale partners, but also our own buying teams to ensure that in particular, as we will see harmonized entry price points for the BOSS brand for Spring/Summer 2018, these prerequisites are met.
There will be an important data point to be shared with you at the Investor Day of the first initial buying reaction from our wholesale partners. We will provide you with more details at the Investor Day. And regarding the first sellout performance, we will report in 12 months from now, when we report on the first quarter 2018 performance. So, in terms of lessons learned from previous successes, but also cases where have fallen short, I feel confident that we have incorporated that.
But as we said earlier at the Investor Day and at the Analyst Conference, with the delivery of this collection and bringing all pieces into play of the new strategy, we expect the year 2018 to be the year of return to growth. And this requires a convincing offer, also with the new collections.

Warwick Okines (Deutsche Bank): I have got one question on each of your three regional retail businesses. Listening to what you said about Europe, I am surprised as I get the impression that you are a bit more confident than maybe the numbers look to me. What reassurance can you give us that the European performance has not just been boosted by very soft comp of March 2016, which you referred to last year? And how worried are you that the performance in Germany is being driven more by wholesale than retail which has been the pattern for some time?

On the U.S., specifically the mainline retail stores: again, that is a negative against a very negative comp from the prior year. Are you seeing any positive signs in your mainline retail business?

And thirdly, looking at the Chinese retail business, this time last year, you cut prices 20% during the Q1 period. Could you talk about the performance of the Chinese business this Q1 before and after that price cut?

Mark Langer (CEO): I think it was clear from my opening statement that we are still operating in a market environment that in almost every part of the world is not supportive and we would be surprised if there is a significant improvement in the underlying market. When compared to what is the support we get from the market, I'm pleased in particular with the performance in most European markets and also with the Mainland Chinese development.
Let's go through it by region. As I said, we have seen now for the first time - well our fourth quarter was similar, but the impact in the first quarter was much bigger - that overall, already quite resilient or robust physical retail business was dragged down by the performance of our online business. And with all the fair criticism that this needs to be addressed, we have taken measures and we are pleased with the results, although, the e-commerce was down 27%. Our e-commerce business this is predominately a EMEA business, which has dragged down our European retail performance overall. So, with now remedy measures in place for the European e-commerce business, and a healthy above market average development we see both in the full-price and outlet in most European markets, I am confident that there is a self-help with the better assortments and the better buying, as we move later into the year.

With what we have done in terms of collection, in terms of our buying decision, and by the decision to strengthen athleisure and casual wear offering in our stores, I am confident that we will see quarter after quarter, in particular in the European business, an improvement compared to where we started. The first quarter Q1 was in particular driven by the e-commerce business, with the difficult start to the year. But we expect continuous improvement to it. And I cautioned you that March and April are two not so crucial months in annual performance. But they gave us a trend development over the last eight to nine weeks, which indicates a sequential improvement in line to achieve and meet our full-year targets.

In the U.S., it will take at least 12 months to annualize on the wholesale off-price distribution. And even on the full-price: as you know many of our wholesale partners are experiencing still a difficult market environment. I cannot see any sign of a quick return to growth, in particularly in the full-price business. We need to serve these customers across the sales channels they prefer, be it e-commerce, be it factory outlet. As I said, our factory outlets started to benefit from our decision that we have taken on the wholesale side. But overall, I expect the U.S. market - and this is the lighthouse for the Americas development - to be the one which will remain continuously more challenging than the other two markets, despite sequential improvements.

Regarding Asia/Pacific and the impact on pricing: there is not sufficient data yet to what degree the annualization of the price adjustment in China will now - as we start to compete against stronger comps from last year - dampen the effect in 2017. Please keep in mind that in our numbers, the full impact from the price adjustment only started to kick in at the later stage of the second quarter 2016, and in particular, then in the third and the fourth quarter of 2016. So, it is still too early to comment to the fact how strong the annualization impact will be. With a better merchandising decision and a better in-store execution we try to supplement to that.
But the performance, in particular regarding structural profitability in Asia/Pacific, is off to a very good start as we demonstrated in the first quarter and this will be accretive also for the remainder of the year.

2017 will be a year of transition and stabilization where we implement important measures. But it will not be a year where we, based on Q1 figures, can already announce a return to growth for the year 2017. That was not our intention and our numbers for the first quarter, if adjusted for the wholesale delivery effect, will confirm the view that the company has always given for the full-year 2017.