HUGO BOSS Third Quarter Results 2017

Metzingen, November 2, 2017
Mark Langer (Chief Executive Officer)

- The spoken word shall prevail –

Good afternoon Ladies and Gentlemen, and welcome to our Third Quarter earnings conference call. I will focus my presentation on our most recent financial performance. However, before that, let me tie in with our Investor Day in August and discuss a number of initiatives meant to bring to life the changes to brand strategy.

In the last few months, we highlighted the new BOSS and HUGO collections in a number of high profile events and campaigns in order to build awareness and customer understanding for the refined positioning of the two brands.

Starting with our BOSS Menswear business, we followed up on the statement we made with our presentation at the New York Fashion Week in July with a global social media campaign. Under the headline of "Own Your Journey", Formula One World Champion Lewis Hamilton and actor James Marsden presented their favorite pieces from the current collection.

BOSS Womenswear was in the spotlight at Berlin Fashion Week, where we unveiled our new "Gallery Collection" at the "Berliner Mode Salon". In cooperation with Christiane Arp, editor in chief of Vogue Germany, we curated a spectacular presentation in the former St. Agnes Church, which received a lot of media attention.

Finally, HUGO built on the momentum it had created with its June fashion show in Florence with a visit to Berlin, where the visitors of the "Bread & Butter by Zalando" event had the opportunity to experience the new HUGO first hand. Following the idea of “See Now, Buy Now”, consumers were able to purchase online all styles presented during the fashion show immediately after the event.

In terms of financial performance, we made good progress in the last three months, too. Sales momentum improved further, in particular in own retail. Region Europe and China recorded healthy increases, but also our US own retail business returned to same store sales growth in the quarter.

As a result, third quarter Group sales increased by 3% excluding currency effects. Impacted by the appreciation of the euro against almost all major currencies, revenues were up just 1% in reported terms.

By region, Europe built on the progress made in the second quarter. Third quarter sales were up 4% in euro terms and 5% on a currency-adjusted basis with similar growth across own retail and wholesale.

In own retail, performance in the region improved sequentially compared to second quarter levels. Supported by more favorable industry conditions in August and September, trends in the central and southern markets picked up compared to earlier in the year and also the UK continued to do very well. UK sales were up 9% in currency-adjusted terms, highlighting the strength of our local business as well as good demand from tourists. The latter, however, weakened towards the end of the quarter.

Sales in Germany and the Benelux markets grew by 5% and 4%, respectively. France recovered from the declines in the second quarter and was up slightly despite ongoing challenges in wholesale.

In the Americas, business was down 8% in euro terms and 4% on a currency-adjusted basis. Good growth in Latin America and Canada only partly compensated for lower sales in the US.

In the US, our business declined 9% on a currency-adjusted basis because of double-digit decreases in the wholesale segment. The sales decline in wholesale continues to reflect the strategic reduction of off-price business, a still difficult market environment as well as a shift of demand for cold weather product into the fourth quarter. Nonetheless, we continue to be on track for our guidance of a high-single-digit sales decline in US wholesale in 2017, so we expect performance to be better again already in the fourth quarter.

In US own retail, the positive trend from previous quarters continued. Comp store sales growth was driven by strong double-digit increases in online as well as higher revenues in freestanding stores, which outperformed outlets in the quarter. Improvements in retail management and the expansion of casualwear and athleisure offerings in our stores, even before the launch of our new collections for Spring/Summer 2018, played a key role in this respect.

Sales in Asia were down 2% in euro terms, but 4% above prior year levels in local currencies.

China remained the region's growth engine despite a slight moderation of trends against an increasingly difficult prior year comparison base. Sales in this market were 5% above prior year levels, driven by good growth in Mainland China partially offset by weaker performance in Hong Kong and Macau.

Looking at the other major markets of the region, sales in Japan increased at a double-digit rate in currency-adjusted terms, supported by strong tourist demand in the outlet channel in particular. Australia was flat, impacted by traffic declines in own retail and a weak wholesale business.

Group wide, own retail sales increased 3% in euro terms and 6% in local currencies in the third quarter.

On a comp store basis, the own retail channel was up almost 5%, a further improvement compared to second quarter levels despite a slightly more difficult comparison base. As mentioned in my regional comments, Europe and the Americas made good progress compared to earlier in the year and recorded mid-single-digit comp store sales increases in the quarter. The growth rate in Asia was slightly below the other two regions.

In all three regions, better conversion rates and higher volumes drove growth. Average selling prices declined slightly. This pattern is very much in line with the expectations underlying the changes in brand strategy. We are convinced that a stronger focus on casualwear and athleisure and a better-balanced offer - ranging from upper premium to luxury price points - will drive volume growth and more than offset lower average selling prices following the mix changes I just highlighted.

By retail format, directly operated stores were the best performing channel on a comp store basis. Growth rates in online and the outlet channel were slightly lower.

The online business was up 6% in the third quarter, further benefitting from the improvement measures we had started applying earlier in the year. The offer is better geared to the specific needs of our online customers now and we have made good progress in search engine optimization. In addition, enhanced CRM capabilities allow us to reach out to consumer in an increasingly targeted way.

Looking ahead, we are working on further improvements of the hugoboss.com site that will go live in the first quarter of next year. While the overall look and feel is not going to change much, we will adjust navigation and site structure to improve usability and to create two separate brand worlds for BOSS and HUGO. Over the next few weeks, we will also implement a simplified check out process as well as launch an Android version of our mobile app, complementing the existing iOS offer.

Beyond growing our eCom business, we have also progressed with the integration of omnichannel elements in physical stores, a key consideration in the development of our new store concept. We have now started renovating the first few stores with the design we presented you during the Investor Day in August. Over the course of the last few weeks, we reopened our stores in Geneva and Birmingham, both now outfitted with the new store concept. Next on the list will be Dubai, where we will complete the refurbishment of the former franchise store in Dubai Mall shortly. Based on a detailed analysis of the performance of these remodeled stores, we will deploy the new concept in all openings and refurbishments planned in 2018.

In the third quarter, we opened three new freestanding stores, all located in Asia. Year-to-date, however, the number of freestanding stores declined by a net 7 to 435 at the end of September. Most of the closures were decided when we reviewed our network in summer 2016. By the end of this year, we will have discontinued operations in 15 of the 20 stores we had designated for closure in total. For the remaining five stores, we successfully negotiated more attractive rent terms and decided on far-reaching changes to the operating model. In two flagship stores in Greater China, for example, we reduce our floor space by more than half by giving up an entire selling floor. Contrary to what he had originally planned, we hence decided to continue operations in these locations. Initial results confirm that profitability of these stores has improved visibly compared to prior levels.

Turning to the wholesale channel, third quarter sales were down 3% in euro terms and 1% currency-adjusted, largely due to the aforementioned declines in the US whereas the European wholesale business was up at a mid-single-digit rate. Unavoidable differences in the timing of deliveries compared to the prior year were a negative in the Americas and a positive in Europe this quarter, but the net effect was small.

Looking out into next year, we have just started the order season for our Pre-Fall 2018 collection, the second collection designed under the new brand strategy. Given that we are only half way through the process and in light of the relatively small size of this collection, I ask for your understanding that we will not disclose any quantitative feedback today.

Similar to what we reported in August, the feedback of our partners on the changes in our collections and brand strategy continues to be clearly positive. However, they also remain very cautious when it comes to the overall industry outlook, irrespective of some better data reported for Germany and other European markets over summer. Based on our conversations, the majority of department store representatives expects challenging market conditions to continue, so we forecast buying budgets to remain tight also heading into 2018.
On a brighter note, the license business continues to go from strength to strength and had a stellar performance again in the third quarter. Sales were up 24% due to strong double-digit growth in the fragrance business in particular. Similar to previous quarters, strength was broad based across the product portfolio, including BOSS and HUGO as well as our Men's and Women's fragrances.

Sales in the total BOSS business increased 3% excluding currency effects in the third quarter. Performance was particularly strong in athleisure, which still retails under the name of BOSS Green in 2017. Here, sales grew at strong double-digit rates. Businesswear and casualwear revenues were up, too, albeit at more moderate levels.

HUGO sales grew 4%. Good growth in Europe was partly offset by declines in the US, where we have started to change our distribution in wholesale. In the process, BOSS is taking over spaces from HUGO in the wholesale channel, where the BOSS brand proposition is a better fit with the account's target customer. Expect this effect to weigh on HUGO sales also in 2018 as we consistently align the brand's distribution with its fashion-forward, contemporary proposition.

By gender, the 4% growth of our menswear business was driven by improvements in the collection as well as the shift of marketing expenditures and, to a lesser extent, retail floor space. The latter came at the expense of our womenswear business where sales declined 1%. Rest assured though that we will not stand still to also grow this part of our business as part of our commitment to bring HUGO BOSS back to profitable and sustainable growth.

Turning below the top line, gross margin was up slightly in the third quarter. This was largely due to channel mix, that means the outperformance of the own retail business over wholesale. However, the positive effect was largely offset by currency translation effects related to the strong euro, which we generally do not hedge.

All other factors were broadly margin neutral. This includes rebate management, where gains in Asia were balanced by slightly higher markdowns in Europe and the Americas.

Operating expense growth was moderate also in the third quarter. Nonetheless, increases exceeded reported sales growth. Own retail only played a minor role in this respect given the benefits from rent renegotiations, the closure of unprofitable stores and limited expansion. Instead, marketing investments in the context of the brand repositioning and the expansion of digital teams and systems are exerting structural cost pressures whose mitigation will remain an ongoing challenge also in 2018.

As a result, third quarter EBITDA before special items declined 1% compared to the prior year quarter, amounting to EUR 143 million. Currency effects had a more severe negative impact on operating profit in the third quarter compared to earlier in the year as a result of the euro appreciation versus major currencies over the last six months.

While the D&A charge and the financial result remained largely unchanged, we released EUR 5 million of provisions made in connection with the store closure program initiated in 2016. The release was recorded as income in the special items line. On the one hand, we negotiated lower than expected early termination payments in some locations that we exited. On the other hand, and as I had outlined earlier, we decided against closing a handful of stores where the operational and financial outlook has improved materially since summer last year.

Offsetting this positive factor, we booked a higher tax rate this quarter in anticipation of a higher charge also in the full year. We now expect the Group's tax rate to reach around 26% in 2017, compared to 24% in 2016. This outlook reflects changes in German tax law that came into effect this year and will lead to a higher taxation of the Group's license income in 2017 and beyond.

Net of these two effects, Group profit remained virtually unchanged compared to prior year levels and amounted to EUR 80 million in the third quarter.

From a regional perspective, profitability in Europe benefitted from the good sales performance in both distribution channels and disciplined cost management. In the Americas, margin performance suffered from the sharp sales decline in wholesale. And in Asia, segment profitability was affected by negative currency effects and rising selling and distribution expenses. These factors more than offset gross margin benefits from a reduction of rebates in own retail.

Ladies and Gentlemen, I focused my comments on the third quarter in order to give you a good understanding of most recent trends. Let me also summarize where we stand after the first nine months of the year.

Group sales were up 2% in euro terms and on a currency-adjusted basis. Europe performed broadly in line. Sales in the Americas declined 3%, sales in Asia/Pacific were 5% ahead of the prior year, both in currency-adjusted terms.

EBITDA before special items was up 1%, slightly below sales growth. A better gross margin was offset by higher operating expenses in relation to sales, so that operating margin declined by 20 basis points to 17.4%. Net profit was up 43%

following the non-recurrence and even partial reversal of prior year one-time expenses.

Let me also give you some more color on key balance sheet items and cash flow performance.

At the end of September, inventories continued to be well controlled. Group inventories were down 3% in euro terms and stable in local currencies with a similar performance across the three regions.

Despite strict inventory management, overall trade net working capital grew 5% on a currency-adjusted basis. This was due to an increase of trade receivables solely related to a different timing in the collection of cash from some larger partners. At the time of our reporting, the receivables position has almost normalized again, so we do not expect this effect to recur going forward. Irrespective of it, the rolling twelve months average of trade net working capital over sales declined to 19.3% - 40 basis points below the prior year level.

Investments decreased 29% in the first nine months. The decline was primarily due to own retail, reflecting fewer new store openings but also phasing effects related to the renovation of existing stores. As we had communicated in August, we shifted a number of renovation projects to 2018 to allow incorporating the learnings from the first rollouts of the new BOSS store concept.

Primarily because of better earnings and lower capex, free cash flow increased 29%, even including cash outflows of around EUR 25 million related to the store closures. As a result, net debt declined strongly compared to the prior year period.

Based on a better than expected year-to-date sales performance in own retail, we are upgrading our top line outlook today.

We up the outlook for all three regions: Sales in Europe should increase at a low-single-digit rate while the Americas should deliver a broadly stable performance. Asian revenues are projected to grow at a low- to mid-single-digit rate, all on a currency-adjusted basis.

We now expect the own retail business to grow at a mid-single-digit rate on a currency-adjusted basis. On a comp store basis, sales should increase at a low-single-digit rate, in line with the year-to-date performance. Unchanged to earlier in the year, wholesale revenues are forecasted to decline at a low- to mid-single-digit rate. License sales will be up double-digits.

In sum, this will result in a low-single-digit increase of Group sales on a currency-adjusted basis. Previously, we had anticipated a stable performance.

The Group's gross margin should increase slightly year-over-year. A positive channel mix effect and the non-recurrence of prior year inventory write-downs will compensate for negative currency effects. We now expect EBITDA before special items to remain stable year-over-year, reflecting the midpoint of the previous guidance of a performance between -3% and +3%. This guidance includes a negative impact from exchange rate movements, which will have a greater effect on earnings than we had originally forecasted. Net income is expected to increase at a double-digit percentage rate, although growth will be slightly lower in the full year compared to the first nine months.

Last but not least, our balance sheet and cash flow outlook remains unchanged: capital expenditures will amount to between EUR 130 million and EUR 150 million. Free cash flow will exceed prior year levels and reach around EUR 250 million.

Ladies and Gentlemen, our financial results and outlook demonstrate that we are on track to achieve the goals we set ourselves or in some parts to even exceed them. I am pleased with the momentum we have built in own retail in particular, but I also acknowledge that some market-related tailwinds contributed positively to performance in the last three months.

We will not be able to influence overall market trends. Instead, we focus on what is in our own hands. With a view to the next few months, this is above all building further momentum around our brands. The first deliveries of our Spring/Summer collections will become available in our stores at the end of this month. This collection is the first one fully reflecting the refined positioning of BOSS and HUGO as well as the quality investments we are making to upgrade their value proposition. We are also busy preparing for the opening of the first HUGO stores in key European cities such as Amsterdam, London, Paris and Berlin from Spring 2018 onwards.

In addition, and as discussed, enhancing our digital presence is a key priority. Beyond the optimization of hugoboss.com, digital transformation also includes the further rollout of omnichannel services, which is in full swing, as well as the digitization of key operational processes – see the digital HUGO showroom through which we are taking orders for the first time right now. Finally, we innovate the way we operate with a number of initiatives meant to drive customer-centricity and organizational agility.

With so many activities requiring the full attention of management, I am pleased to be able to pass on my CFO responsibilities shortly.

As of the beginning of December, the current team – consisting of Bernd Hake, our Chief Sales Officer, Ingo Wilts, our Chief Brand Officer, and myself as the CEO – will be complemented by Yves Müller as our new CFO. As announced a few months ago, Yves will join us from Tchibo, the German coffee and non-food retailing company, where he has held the CFO position for the last eleven years. I look forward to having him on board.

Yves is going to play a key role in our financial communication going forward, of course. In the meantime, however, let me answer your questions on today’s set of results.