First Quarter Results 2018 Presentation

Metzingen, May 2, 2018
Yves Müller (Chief Financial Officer)

- The spoken word shall prevail –

Good afternoon Ladies and Gentlemen, and welcome to our First Quarter earnings conference call. In the next fifteen to twenty minutes, I will present you our most recent financial performance before opening the floor to your questions.

HUGO BOSS made a strong start to 2018. In the first three months of the year, we confirmed the positive sales trend of the previous quarter despite some significant headwinds in the European apparel market. The Americas and Asia were the engines of growth, recording healthy high single-digit and low double-digit sales increases in currency-adjusted terms, respectively.

First quarter Group sales increased by 5% excluding currency effects. Impacted by the appreciation of the euro against almost all major currencies, revenues remained on the prior year level in reported terms and reached EUR 650 million.

By region, sales in Europe were up 3% on a currency-adjusted basis despite a deterioration of market conditions in the later stages of the quarter. Growth was similar across the own retail and wholesale channels.

Overall, the UK continued to outperform the rest of the region and was up 12% in currency-adjusted terms despite a moderation of tourist demand compared to the prior year. The Benelux markets and France also grew solidly, recording sales increases of 7% and 2%, respectively. The business in Germany was challenged by the overall weakness of the German apparel market. In addition, the renovation of two larger outlet operations had a negative sales impact. Total revenues in Germany declined 5%.

In the Americas, business was up 7% on a currency-adjusted basis. Sales improved in all markets.

In the largest market, the U.S., our business increased 6% on a currency-adjusted basis. Double-digit growth in own retail more than offset a low-single-digit sales decline in the wholesale segment. Wholesale sales were impacted by a distribution change at Macys, where we migrated our business with the former BOSS Green and BOSS Orange lines to a concession model which we account for as own retail.

In our own retail operations we benefitted from changes in the merchandising of our stores as well as from operational improvements. Especially the expansion of our smart casual and athleisurewear offer, to which we have been allocating more retail space over the past twelve months, led to significant volume growth. As a result, U.S. comp store sales improved at a double-digit rate in the quarter, also including increases in the online business of more than 50%.

Sales in Asia were up 12% excluding currency effects.

Performance was positive across the region. Sales in the key Chinese market increased 11%, driven by continued growth in Mainland China but also solid double-digit increases in Hong Kong and Macau. The two latter markets continued the recovery they had already started in the second half of last year.

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. South-East Asia even topped this growth.

Group wide, own retail sales increased 8% on a currency-adjusted basis in the first quarter.

On a comp store basis, the own retail channel was up 7%, in line with performance in the final quarter of 2017. As mentioned in my regional comments, the Americas confirmed the strong trend established over the course of last year and recorded a double-digit increase. Asia grew in the high single-digits and sales in the European own retail business advanced at a mid single-digit rate on a comp store basis.

Unchanged to the pattern in 2017, better conversion rates and higher volumes drove growth. Average selling prices declined in line with our strategy to strengthen our footprint in casualwear and athleisurewear where selling prices are generally lower compared to formalwear.

By retail format, growth was consistent across directly operated stores and outlets. The online business was up 43% in the first quarter. In addition to a weak comparison base, growth benefitted from the improvement measures implemented last year. In mid-March, we also changed the site’s structure and layout to create two distinct brand worlds for BOSS and HUGO, resulting in a clearer differentiation between the two brands, greater visibility of the HUGO brand and better guidance of the user. First indications also point to a steady improvement of conversion rates since the change. As a result, we are confident to generate strong growth in our online business also going forward.

Beyond the further enhancement of our digital presence, we have also progressed with the integration of omnichannel elements in physical stores, a key consideration in the development of our new store concept.

The new concept was used in key stores that we opened and renovated in the first quarter. Our new store in Mexico City was the most prominent new opening in the first quarter. The picture on the slide shows our store front in the King of Prussia Mall in Philadelphia, where we moved to a better, more central location. Renovations in the quarter included our BOSS store in Copley Place in Boston, which reopened in February.

We will also start opening the first new HUGO stores in the next few months. Key locations will include Amsterdam, where we will cut off a part of the BOSS store and dedicate it to HUGO, and London.

Turning to the wholesale channel, first quarter sales were up 1% on a currency-adjusted basis. A low single-digit decline in the Americas was more than compensated by a moderate increase in the European wholesale business. Within our global wholesale business, online clearly outperformed the physical channel. While our business with large marketplaces and the online platforms of leading department stores grew at double-digit rates, sales with stationary retailers were down in light of the pressure they are facing from ongoing traffic declines.

Finally, sales in the license business were down 1% in the quarter, reflecting the anniversary of the takeover of our fragrance license by Coty but also timing effects which will reverse in the further course of the year. New product innovations such as the BOSS United fragrance – an extension of the BOSS Bottled family that will launch shortly before the kickoff of the Football World Cup in summer – and the launch of a new campaign for our blockbuster fragrance The Scent will ensure solid growth in this business in the remainder of the year.

Sales in the total BOSS business increased 7% excluding currency effects in the first quarter. Performance was particularly strong in casualwear. This part of the collection has clearly benefitted from the upgrade of the former BOSS Orange offering, which also means that we are giving more space to it in our stores now.

HUGO sales declined 6% in currency-adjusted terms. The brand's casualwear business continued to grow at double-digit rates, above all building on the success of the reversed logo theme that is opening up new customer groups for the brand. However, as expected distribution changes are having an adverse impact on HUGO sales in 2018. These changes relate to some spaces in department stores, which HUGO is giving up in favor of BOSS, because its brand proposition is a better fit with the customer. We are also reducing HUGO's exposure to the outlet channel and are taking it out of BOSS stores to ensure that it is distinctively positioned. We are convinced that this distribution alignment is necessary to sharpen HUGO's fashion-forward, contemporary proposition.

By gender, the 6% growth of our menswear business was driven by improvements in the collection, growing brand desirability and, to a lesser extent, the addition of retail floor space. The latter came at the expense of our womenswear business which declined 3% in currency-adjusted terms. Womenswear sales in the wholesale channel, however, were up, reflecting healthy demand from retail partners in particular in Europe, where BOSS holds a leading position also in this market segment.

Turning below the top line, the gross profit margin declined by 40 basis points to 64.0% in the first quarter. This was due to the quality investments I mentioned earlier. The growing share of own retail in our sales mix only partly mitigated the pressure. All other factors were broadly margin neutral.

We also made further progress in the management of our operating expense base, although exchange rate effects clearly had a positive impact here, too. The lower pace of space expansion, the successful renegotiation of rental contracts and the closure of unprofitable stores completed at the end of 2017 helped keeping own retail costs broadly stable. In addition, some phasing effects in our marketing budget as well as the reclassification of certain costs because of an IFRS change also contributed to the 4% decline of selling and distribution expenses. In contrast, G&A expenses were up 2%, reflecting further investments in the digital transformation of our business model.

As a result of the operating expense decline, first quarter EBITDA before special items increased 1% compared to the prior year quarter, amounting to EUR 99 million. As we had guided at the time of our analyst conference in March, negative currency translation effects held back profit growth. In the first quarter, we incurred around half of the EUR 10 million impact we forecast for the full year. This was in line with our original expectations.

Mainly driven by a lower D&A charge following the decline in investments in 2017, EBIT was up 8% in the first three months of the year. Despite a higher tax rate, net income was still up 3% and amounted to EUR 50 million.

From a regional perspective, the slight sales growth in Europe was not enough to offset operating expense inflation, so that the regional margin declined by 120 basis points to 29.6%. In the Americas, the margin drop to 10.1% was largely caused by negative currency translation effects, which were related to the weakness of the US dollar compared to the prior year period. Exchange rate effects played a role in Asia, too. However, strong sales growth and strict cost discipline more than offset the impact, leading to a margin expansion of 270 basis points. At 28%, profitability in Asia is now close to European levels again.

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

At the end of March, inventories were up 5% in euro terms and 11% excluding currency effects, reflecting an increase in our own retail buy to make sure we minimize stock outs and exploit additional sales opportunities.

Overall trade net working capital grew 3% on a currency-adjusted basis. Nonetheless, the rolling twelve months average of trade net working capital over sales declined to 18.5% - 130 basis points below the prior year level.

Capital expenditures decreased 23% in the first three months due to a different phasing compared to the prior year. The timing of renovation projects – the main area of investments in 2018 - will focus on the period between April and October. In addition, investments in own retail declined due to fewer store openings. IT investments, however, were up compared to the previous year.

Because of the increase of trade net working capital, free cash flow amounted to a negative EUR 47 million in a quarter that is traditionally small from a free cash flow perspective. Nonetheless, net debt still halved at low absolute levels, reflecting the strong cash generation over the last twelve months.

Ladies and Gentlemen, the results of the First Quarter were in line with our expectations set out in March. As a result, we are confirming our full year expectations today.

Group sales growth is set to accelerate to a low- to mid-single-digit increase excluding currency effects in 2018. All regions are expected to contribute.

By distribution channel, we stick to our forecast of a mid-single-digit comp store sales growth in own retail despite the better performance in the first quarter. This outlook incorporates the effects from an increasingly tougher comparison base in the further course of the year. In the absence of any material net impact from store openings and closures, total own retail sales should increase at the same mid single-digit rate, too. We are also forecasting low-single-digit currency-adjusted growth in the wholesale business. Sales in the license business should increase at a mid single-digit rate.

The Group's gross margin is expected to remain broadly stable in 2018. Positive channel mix effects and lower discounts in own retail should contribute positively. These benefits will be offset by an upgrade of the value proposition of our collections including a double-digit million euro investment in product quality. Considering this investment and some currency translation effects, gross margin development is likely to be negative also in the full first half year before improving in the remainder of 2018.

Considering also tight operating expense management, EBITDA before special items is expected to perform within a range of -2% to +2%, including the aforementioned negative currency impact of around EUR 10 million. Net income growth will be higher, supported by a lower depreciation charge as well as the normalization of the Group's tax rate to levels around 26% in 2018.

Investments will increase to between EUR 170 million and EUR 190 million, largely reflecting the step up in store renovations in 2018. These investments and higher working capital needs will also affect free cash flow generation. In line with our guidance issued in March, we expect free cash flow to amount to between EUR 150 million and EUR 200 million.
Ladies and Gentlemen, HUGO BOSS had a good start to 2018. Sales increased on a broad base, that means across all geographies and in both own retail and wholesale. Where we were still unsure about the acceptance of our collection changes at the same time last year, we can now report back on a strong reception by end consumers as indicated by the current levels of growth in own retail.

I acknowledge that these improvements come with ongoing investments that limit profit growth in 2018. However, the top line momentum that we have generated also proves that the investments in product quality, in the desirability of our brands and the quality of our retail execution online and offline are paying off. We are committed to building on the progress we have made. We will update you on our plans for the return to profitable growth in 2019 and beyond at an Investor Day, which we will be hosting on Thursday, November 15, in London. Please save the date in your calendars, we look forward to welcoming you at the event.

But before looking out too far in the future, let me now answer your questions on today's set of results.

[Q&A session]

Before closing today's call, let me take the opportunity of his last analyst conf call at HUGO BOSS to thank Dennis Weber for his work and dedication to the company in the past eight years. In his role of Head of Investor Relations, he has been your key point of contact and support. Vice versa, he was instrumental in feeding your views, expectations and concerns into the company in order to enable an informed decision-making. On behalf of my Board colleagues as well, I wish him all the best in his new role at Deutsche Lufthansa in Frankfurt.

At the same time, I'm excited that Christian Stöhr will join our Group. Many of you will know Christian from adidas where he has gained excellent industry knowledge. I look forward to having him here in a month from now. Over the course of June, he will work closely with Dennis and the existing team to ensure a smooth transfer of responsibilities.

Many thanks for listening in and good bye for today!