HUGO BOSS

HUGO BOSS Analyst Conference Call Q2 2018

Second Quarter Results 2018

Conference Call on August 2, 2018

Transcript – Q&A Session
August 2, 2018

Please note that the transcript has been edited to enhance comprehensibility. Please also use the webcast replay to listen to the Q&A session on the day of earnings publication.

Fred Speirs (UBS): My first question is on your gross margin guidance. We have seen gross margin in H1 down 50 basis points and the full year guidance is "largely stable", implying an improvement in H2. Given your inventory position at the end of H1, do you still expect tighter rebates to be a positive tailwind for gross margin in H2?

My second question is about category performance against plan. I'm conscious there are a lot of space allocation changes going on, so I'd be interested if you could talk about which areas are running ahead or behind your plan across the various categories. For example, if we look at athleisure, last year, it was up double-digit. But for Q2, the earnings release mentions sales for athleisurewear were only up slightly quarter-on-quarter.

Yves Müller (CFO): In H1 2018, gross margin decreased by 50 basis points and we stick to our guidance of gross margin developing largely stable in 2018. First of all, we expect a positive channel mix effect in the second half of the year, especially when it comes to a higher retail versus wholesale share. Secondly, we will have an annualization effect of the quality investments. Thirdly, we do not expect currency headwinds in the second half of the year. As a result, we expect gross margin to be largely stable, as we have originally guided.

Regarding space allocation and our strategic integration of former BOSS Orange and BOSS Green into the BOSS brand. We are now focusing especially on casualwear, for which we see a strong underlying double-digit performance. In addition to this, we were pleased that we have seen high single-digit growth for our BOSS businesswear in Q2 - a very positive development from our perspective.
Regarding space reallocations, yes, there have been reallocations for HUGO as expected. HUGO sales were down 4% in Q2, as for certain product categories we reallocated our wholesale business from HUGO to the BOSS brand, as we are convinced that these spaces are a much better fit to the BOSS brand. As we are focusing and targeting two different customer groups, we clearly have to differentiate, also from a distribution point of view, between BOSS and HUGO. In addition to this, we reduced or even eliminated HUGO corners in several of our BOSS stores, to make sure that we focus on two different target customers. So overall, we reduced the selling space for HUGO by these measures.
The underlying performance of HUGO is positive and we are now curious to see how HUGO will perform as we have opened our new HUGO store in Amsterdam in mid-June; and two weeks ago, we opened our new HUGO store in Le Marais, Paris. These new stores will have HUGO in a new, unique store concept.
Also regarding womenswear, we partially reduced selling space in own retail, to clearly focus on sales productivity. In some cases, we reduced womenswear in favor of more casualwear and athleisurewear for BOSS menswear. This reallocation concerns different stores and it will be finalized until the end of 2018. We are satisfied that in our wholesale business, womenswear grew at a low single-digit rate in Q2.

Zuzanna Pusz (Berenberg): My first question is on gross margin. The key drivers of the gross margin decline in Q2 were the channel mix and also the quality investments. Is there any chance you could actually quantify these effects and confirm that there was no significant effect from discounting in Q2? In addition, how much of your

sourcing is denominated in Turkish lira? Because as you have a factory in Izmir, it would be helpful if you could tell us something about hedging.

My second question is on the saving of marketing expenses, given that this quarter saw a bit of that phasing plus the delivery shift of wholesale sales from Q3 into Q2; then, in the second half, you will have the less severe currency headwind. How do you think of profitability in the second half of the year? Do you think you are more likely to end the year at the lower end of your EBITDA guided range (which is -2%) or the higher end (which is +2%)?

Yves Müller (CFO): Regarding gross margin: I can confirm that for Q2, half of the gross margin decline was due to the channel mix effect, while the other big part were the quality investments. Thirdly, there was a currency effect. Discounts had only a minor effect regarding gross margin in Q2.
Regarding Turkish lira and the effect of its decline versus the euro: we source around 15% of our total volume from our own production facility in Izmir, Turkey. High inflation in Turkey translates into wage increases. Since we are hedging this, we have kind of a timing effect for the upcoming quarters and for the upcoming year.

Regarding phasing effects in marketing: yes, there was a shift from Q1 into Q2. In Q2 marketing was on the prior year level. This shift mainly related to our HUGO Fashion Show and the Formula E sponsoring.
Regarding EBITDA, we are well aware of our guidance for 2018 and we stick to this guidance. Be aware that we said in March that in 2018 we will concentrate on executing our strategic focus areas. We are very much convinced that we are on the right track.
2018 will be a year of accelerated sales growth. This is what we are seeing. We reported 5% sales growth for H1. Secondly, 2018 will be a year of investments, to make sure that we have a sound foundation for returning to sustainable profitable growth in 2019. For 2019 and beyond, we want to make sure, that our EBIT or EBITDA margin respectively will grow faster than our sales.

Warwick Okines (Deutsche Bank): I have a question on the inventory increase of 16% at constant currencies. Can you talk about the reasons for your confidence that levels will normalize by Q4? Does that require higher rebates in the second half?
In addition, I just wonder whether the wholesale delivery shifts had any impact on the end of Q2 inventory level.

Yves Müller (CFO): I do not expect rebates to be higher than last year. We stick to our guidance that the gross margin will remain largely stable in 2018.
One reason I pointed out earlier is that inventory level in 2017 has been very low. Secondly, since we are enjoying very strong sales momentum, especially in online, there is inventory to support this momentum. This is the major driver of the inventory level.

Warwick Okines (Deutsche Bank): But the inventory level was very low in the second half of 2017 as well as the first half of 2017. So I don't see why the year-on-year increase should slow down in the second half.

Yves Müller (CFO): We are managing the inventories to come down to a lower level because we want them to be lower than they currently are. Therefore, we are reducing the inventory inflow for the upcoming months. We have an underlying performance that justifies the high inventory level at the end of June.

Antoine Belge (HSBC): First of all, you've maintained your guidance and listening to everything you say, it seems that you're absolutely on track with your expectation. We analysts had forecasted a bit of a higher profit in Q2. So on the assumption that everything is on track; could you please highlight which areas are actually ahead of expectation and which were maybe a bit disappointing or below your expectation?

My second question is on the Chinese markets, which was up 8% in Q2. Isn't this disappointing, given the current environment in China, which for the broader consumer industry is quite strong? What do you need to do to come back to a double-digit growth rate in China?

Yves Müller (CFO): First of all, regarding top line and bottom line, we are well on track and we are delivering well on our own expectations.
We have been positively surprised by our online development when it comes to the 47% in our own online sales. We are also very satisfied with our online wholesale business, which grew at a nice double-digit rate, too. We see that our internal capabilities that we have built in recent months and years are paying off. We did the right investments to ensure good momentum regarding online growth for the future.

Regarding the Chinese market. Yes, China was up 8% in Q2. We see potential regarding more stores in China going forward. The other big potential is the online business. When it comes to our own online store, but also Tmall, or JD.com. They all offer concession models and we see the tremendous potential to improve our sales in the Chinese markets, especially when it comes to online and the integration of our online and stationary business.

Antoine Belge (HSBC): You did not mention anything that was below your expectations. However, looking at Germany, aren't you encountering a bit more resistance to your higher price points in Germany? My feeling is that initially the price increases were taken relatively well. Now it seems that it is reaching a certain point leading to a bit more pressure on volumes.

Yves Müller (CFO): We did an analysis and compared the performance of our current collections to the outlet performance. Actually, the performance is equal on a like-for-like basis. Based on this, we do not see any tremendous effect from the price increases in Germany. You have to be aware that the German apparel market is very challenging at the moment.

Piral Dadhania (RBC): Earlier you confirmed that you expect profit growth to be ahead of revenue growth next year. Firstly, what gives you that confidence if we expect the revenue growth rates next year to be consistent with what we are seeing at the moment? How much of your operating expenses relate to one-off investments that might kind of

step down, versus how much of your confidence in generating positive operating leverage in 2019 comes from the top line dropping through?

Yves Müller (CFO): I would like to refer to the Capital Markets Day that we will host on November 15. There I will make it very transparent and understandable to everyone regarding operating leverage.
Just to make clear what we have said so far: We have been saying that from a top line perspective from 2019 onwards, we will outgrow the market, which is perceived to grow between 3% to 4%. In addition to this, we are convinced - if I take the cost position we're having - to show operating leverage from 2019 onwards. We will make this transparent at the CMD in mid-November.

Piral Dadhania (RBC): Just a follow-up for 2018 OpEx then: obviously, there was a phasing effect in marketing expenses in H1. Could you give us an indication of what you expect to spend on a full year basis? Would it be comparable, in relative terms, to last year or potentially a little bit lower?

Yves Müller (CFO): The maximum is same to last year. It could also be a little bit lower as we already see some marketing efficiencies within the marketing budget.

Jürgen Kolb (Kepler Cheuvreux): Firsty, I saw the number of average employees increased by about 400 in H1. Given that not too many new stores have been opened, I was just wondering where you've been adding the employees and what you expect for the full year?

Then, on the wholesale delivery shift from Q3 to Q2: can you give us an indication whether this was just a technical issue? Or did wholesalers just simply want to have the merchandise earlier than last year?

Yves Müller (CFO): Regarding the increase in employees, there were two reasons: Although the retail space remained stable, we have more retail staff on our sales floor, which drives higher conversion. It also relates to omnichannel services and it supports the improvement in our comp store sales. This is one reason.
The other reason is that we have invested into our digital capabilities. We hired people in various countries, but especially here in our headquarters, in order to have the digital capabilities in terms of content marketing, CRM or general IT. But we are more or less done now with hiring when it comes to digitization.

Secondly, regarding the delivery shift: We were happy that our replenishment business grew at a double-digit rate. This means that our wholesale partners ordered more than they have expected originally. Delivery shifts were more due to technical than due to economic reasons.

Thomas Chauvet (Citi): First, on retail LFL. If we strip out online from both Q1 and Q2, the growth was more or less the same. It looks like your brick-and-mortar LFL slowed down from 5%-6% in Q1 to 3%-4% in Q2. Could you confirm that the slowdown was largely due to the U.S.? And if so, what kind of store base LFL are you seeing in July in your key market, is it reaccelerating?

Secondly, on the retail channel, full-price stores have been outperforming outlets for several quarters now. Can you please indicate the share of retail sales derived from outlet in H1 at Group level? But also for the U.S.? I think it used to be in the U.S. around 50% a couple of years ago.

Moreover, just a follow-up on category management and the HUGO strategy. I have not visited the HUGO store in Amsterdam. From the photo in your presentation, it doesn't look like it carries a lot of formalwear. So are these HUGO freestanding stores largely casualwear, low ASP driven, while the formalwear will be found in BOSS stores? Or are you planning to gradually downside or discontinue the formalwear of HUGO to leave BOSS your main formalwear offering?

Yves Müller (CFO): First, regarding HUGO. Be aware that within the HUGO brand, the formalwear part is still higher than the casualwear part. The picture of our Amsterdam store was taken from a point of view that it only shows the casual part of the collection. We stick to our strategy that HUGO targets a different customer. However, we are both offering formalwear and casualwear for HUGO, that's for sure.

Regarding the outlet business: In H1, both our freestanding stores, i.e. the full-price business, and the online business, have outperformed our outlet business. From a qualitative perspective this is good news. Regarding the U.S.: yes, since our full-price business is performing pretty well, the outlet share is decreasing. The outlet share should decrease further in the coming years, well in line with our strategy to have a high-quality business in the U.S.

Thomas Chauvet (Citi): What was the share of outlet sales in total U.S. retail sales in H1?

Yves Müller (CFO): In H1, I would call it in the 40s. And regarding the comp store sales increases coming only from online, this is not the case.

Thomas Chauvet (Citi): I didn't say that. But it looks like it slowed down by a couple of percentage points quarter-on-quarter, because of the U.S. business. Therefore, I was wondering whether this was just due to a bit of weakness throughout Q2 in the U.S., with maybe a reacceleration in July?

Yves Müller (CFO): No. It is important, if you compare performance in Q1 versus that in Q2, to do a 2-year comparison. In Q1 2018, we saw comp store sales growth of 7%, whereas Q1 2017 was minus 3%. Therefore, the 2-year comparison adds up to plus 4%. Now, if you take the 2-year comparison for Q2, we had plus 3% in Q2 2017 and plus 5% in Q2 2018. Therefore, the 2-year comparison is plus 8%. Hence, I don't see any reasons to assume a deceleration regarding comp store sales growth.

John Guy (Main First): My first question is on inventory. Could you please highlight if there has been any sort of concentration of inventory in any particular market, or is it relatively balanced across your geographies? You mentioned that the aging and the quality of the stock is actually pretty good. Maybe you could just give us a little bit more color around that.

My second question is going back to the gross margin and your expectations of a stronger gross margin in the second half of this year. If I'm rolling back into Q2 FX, maybe around 10 basis points up, product quality down 40, rebates minus 10 and then, minus 40 basis points on the channel mix. You mentioned that the channel mix would effectively annualize, so we are going to see a much stronger performance within retail. Where else are we going to see the benefits? I think product quality investments may continue into the third quarter at least. So if you could just clarify where you see the additional upside?

Yves Müller (CFO): Regarding the inventory concentration, I can clearly say it is very balanced. The dominant part is more or less in the central warehouse. Actually, there was kind of a product group investment into jerseys, polos, T-shirts and jeans. These are all product groups, which you can sell during the whole year. So this is well balanced.

Secondly, regarding gross margin, I think your analysis is pretty good when it comes to Q2. So firstly, since we had a wholesale delivery shift, there will be a swing effect into Q3. Given the current retail performance, we expect the negative channel mix effect of H1 to reverse itself in H2.
Regarding quality investments: you are right, we will see these also in Q3. But from Q4 on, we will see first signs of an annualization of the quality investments.
In addition, we do not see any currency headwinds for H2, which makes us confident that we will achieve our gross margin target for the full year.

John Guy (Main First): Just one follow-up on your European wholesale business: You said it was up 17% in the second quarter. What are your expectations for your European wholesale business in H2?

Yves Müller (CFO): The increase of 17% was largely coming from the delivery shifts as well as the good performance of our replenishment business. We stick to our guidance to grow our wholesale business by a low single digit rate for the full year.

Edouard Aubin (Morgan Stanley): My question is on your online business. If you could please update us on the profitability of the business? When do you expect it to have any material impact on the Group's profitability?

Yves Müller (CFO): The profitability of our online store is very high. It is actually the highest that we are having in terms of channel mix. Since the share of online is comparably low, any incremental increase will drive the margin of our business.
Secondly, we are aware that this is not a fixed cost business, but rather a variable cost business. Therefore, in terms of risk/return, we highly value the online business and we will keep focusing on it's growth.

Volker Bosse (Baader Bank): My first question is on the wholesale business, which grew 10% in Q2. You have already mentioned the delivery shifts. What would have been the channel's sales growth excluding the shift from Q3 to Q2?

My second question is on your omnichannel capabilities. How are you progressing with the group-wide implementation of omnichannel functionalities? What is still missing? What are the next steps? How do you make sure to get access to customer traffic on the leading online fashion portals?

Yves Müller (CFO): First, excluding the delivery shift effect, the underlying growth of our wholesale business was in the low single-digits in Q2.

Regarding omnichannel functionalities: we already offer them in 12 different countries, we offer click & collect and order-from-store, and we are expanding this to the U.S. until the end of this year. Also next year, we are expecting to roll these services out to additional countries, such as the Nordics, Ireland, Canada, Mexico and Australia.
The next promising functionality will be ship-from-store, which enables delivery from selected stores to the customer in a very fast way.
Moreover, we are nicely present on various platforms like Zalando, ASOS or Next. They are currently growing at a double-digit rate and we are very satisfied with this development.

Philipp Frey (Warburg): First, regarding your investments in digitalization. If you would split the increase in administration expenses into areas where you see an immediate payback, like CRM investments, and areas with a payback only later: are these predominately investments into the future that are going to help achieving margin leverage in 2019?

Secondly, on selling and distribution expenses and their split between Q1 and Q2; the decline of 4% in Q1, and the 1% increase in the second quarter: what is your expectation in terms of underlying growth rate for H2? Are you continuing to see an underlying decline of your rental expenses?

Yves Müller (CFO): First, the reported 7% increase in administration expense in Q2 is mainly linked to investments that pay off directly. This means, about 5%-points relate to investments which will have a direct payback, that is in between one year.

Regarding rental negotiations, I still see upside in the upcoming months and years for reducing our rental costs and improving our rental expense to sales ratio. Regarding selling and distribution expenses, in Q1 the predominant part of the decrease related to marketing. We expect the underlying performance of operating expenses in relation to sales to slowly decline in the upcoming quarters.