Second Quarter Results 2018 Presentation

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Christian Stöhr (Head of Investor Relations)

- The spoken word shall prevail –

Good afternoon ladies and gentlemen.
My name is Christian Stöhr, I am the new Head of Investor Relations here at HUGO BOSS and I would like to welcome you to our second quarter 2018 financial results presentation. Today's conference call will be hosted by Yves Müller, CFO of HUGO BOSS. So without further ado, let's get started and over to you, Yves.

Thanks Christian and good afternoon ladies and gentlemen. Also from my side, I would like to welcome all of you to our second quarter results conference call. In the next twenty minutes, I will present to you our second quarter operational and financial performance before opening the floor to your questions.

I am very pleased to report that the strong momentum HUGO BOSS saw in the first quarter of 2018 continued in the second quarter. Currency-adjusted sales increased 6%, driven by high-single-digit sales improvements in Europe and Asia/Pacific. In euro terms, sales grew 3% to 653 million euro, as we continued to experience a negative translation effect in Q2, following the appreciation of the euro against most major currencies compared to the prior-year period.

The robust top-line performance in the second quarter is proof positive that the implementation and execution of our strategic fields of action drive growth across the entire Group.

- It demonstrates that implementing and executing our two brand strategy based on two unique brand identities and targeting two distinct target customers, is clearly paying off. There is no doubt that both BOSS and HUGO resonate well with our customers, across all wearing occasions.

- It also shows that we are improving our execution across our most important distribution channels. The strengthening of our operational KPIs in own retail and the strong growth of our online business are particular standouts in this respect.

I am particularly encouraged to see that our own retail business recorded another quarter of strong growth, with revenues up 5% on a currency-adjusted basis.

Despite a more difficult comparison base, comparable store sales also increased 5%, emphasizing the strong underlying momentum our brands enjoy globally. Consequently, all regions recorded comp store sales increases in the second quarter. In particular, Asia/Pacific continued the positive trend from previous quarters, with comp store sales up in the high-single-digits. While comp store sales in the European markets improved at a mid-single-digit rate, the Americas grew at a low-single-digit rate.

Similar to previous quarters, comp store sales growth was mainly driven by better conversion rates as well as higher volumes. Average selling prices saw a decline compared to the prior year, mainly reflecting strategic measures to strengthen our footprint in casual- and athleisurewear, where average selling prices are generally lower compared to formalwear.

By retail format, growth was fairly consistent across directly operated stores and outlets.

The online business, however, saw a further acceleration versus Q1, and was up 47% in the second quarter. This development clearly reflects the many structural changes we have made to our website's overall usability, our increased Customer Relationship Management activities as well as the consistent alignment of BOSS and HUGO, leading to an improvement in conversion rates. At the same time, we

are also seeing a steady increase in the number of registered customers, who have identified our website as their preferred go-to destination. We are confident that the overall favorable trends in the online business will persist, despite a more difficult comparison base in the second half of the year.
Beyond the further enhancement of our digital presence, we continue to gradually upgrade our store network by rolling out digital elements as part of our new physical store concept. In this context, during the second quarter, we opened three new BOSS stores and remodeled another four stores. These stores do not only create a new environment for our customers as they incorporate fresh and modern architectural design elements, more importantly, they all offer a variety of digital services among others, the so-called experience table that allows customers to browse through the entire BOSS collection.

In this context, a particular highlight of the quarter was the reopening of the newly designed BOSS stores in Singapore and Munich. The stores feature the latest BOSS Mens- and Womenswear collections and convey a homey feel due to a more generous and comfortable seating area, integrated skylights as well as granite flooring. Their innovative interior concept inspires customers in various ways through interactive features. For example, digital mirrors can be transformed into touchscreens through contact, thus providing the opportunity to discover and shop the newest collections virtually.

Another milestone during the second quarter was the opening of the first HUGO store with its unique store concept. The store opened its doors in early June on Leidsestraat, in Amsterdam, one of Europe’s most visited high streets.

With its unconventional fittings and firmly integrated social media offers, the concept speaks directly to HUGO’s fashion-forward customers. Further HUGO stores will be opened in selected European cities, including Paris and London, in the second half of the year.

Moving on to the wholesale channel, where revenues grew 10% in the second quarter. While our replenishment business was quite favorable overall during the quarter, and thus provides evidence for the success of our new collections, it is important to highlight that the performance during the second quarter was also supported by delivery shifts.

In particular, Europe benefited from these shifts and consequently recorded a 17% currency-adjusted growth during the second quarter. Asia/Pacific increased 2% currency-adjusted and the Americas ended the quarter below the prior-year level, indicating that the market environment remains challenging in some regions. Ongoing traffic declines continue to put pressure on certain stationary retailers and larger department stores in particular. Against this development, online marketplaces continue to strongly outgrow physical retail, with double-digit currency-neutral growth during the second quarter.

To finish on our distribution channels, currency-neutral revenues in the license business were down 6% in the quarter. Similar to the first quarter, this decline mainly reflects the anniversary of the takeover of our fragrance business by Coty at the beginning of 2017 as well as timing effects related to our license income. As we expect these timing effects to reverse in the second half of 2018, we are confident that our license business will return to growth.

From a brand perspective, currency-adjusted sales for our BOSS brand saw a slight acceleration, up 8% in the second quarter. While this performance was driven by double-digit growth in casualwear, also reflecting the quality investments we have made, I am particularly pleased to see that our formalwear business grew at a high-single-digit rate. This is proof positive that our formalwear business continues to enjoy strong relevance for BOSS customers, who want to be dressed in a classic yet modern and highly sophisticated way.

Moving over to HUGO, where sales declined 4% in currency-adjusted terms - in line with our expectations. While the brand's casualwear continued to grow at double-digit rates, its formalwear business recorded sales declines in Q2. Strategic distribution changes, aimed at fostering HUGO's clear fashion statement in the market, resulted in a further reduction in space at both wholesale and own retail. While these initiatives had already left their mark during the first quarter, they continued to weigh on HUGO's performance in Q2.

By gender, our menswear business was up 7% in currency-neutral terms, whereas our womenswear business ended the quarter below the prior year level. The reallocation of retail floor space from womenswear to menswear was the main contributor to this development and is likely to impact the performance during the remainder of the year. Womenswear sales in the wholesale channel, however, continued to grow, reflecting healthy demand from wholesale partners in particular in Europe. This makes us confident that our women's business will return to growth once the distribution clean-up has been finalized.

Coming back to HUGO. At the beginning of July, the brand celebrated a bold return to Berlin to present its Spring/Summer 2019 men's and women's collection at the Berlin Fashion Week. HUGO's Spring/Summer 2019 collection is inspired by those who mix and match styles of different decades to create their own aesthetic. The collection promotes the idea of customization and self-expression. In this context, the venue at Motorwerk Berlin was transformed into a techno club for the fashion show. Various models and influencers, among others Winnie Harlow and Lottie Moss attended the event, while rapper Wiz Khalifa performed live on stage after the show.

While we are excited about the powerful messages that HUGO has provided during the Fashion Show, we are already looking forward to the upcoming BOSS Fashion Show, taking place in New York City next month. Stay tuned for the next impactful brand event of HUGO BOSS in 2018!

From a regional perspective, currency-neutral sales in Europe were up a strong 9%, driven by double-digit growth in wholesale, where the delivery shift effects played a major role. Our own-retail business increased 5% currency-neutral, with comp stores sales growing at a similar pace.

Overall, the UK continued to outperform the rest of the region and was up 12% in currency-adjusted terms despite a further moderation of tourism. While Benelux also increased at a double-digit rate, France recorded a somewhat more moderate growth, up 11% and 5%, respectively. Our business in Germany returned to growth with revenues up 2%, despite the persisting overall weakness of the German apparel market.

In the Americas, our business remained stable compared to the prior-year period. In the U.S., by far the region's largest market, our business declined 1% on a currency-adjusted basis. While our own retail business recorded further growth in the second quarter, up at a low-single-digit rate, our wholesale business continued to be negatively impacted by an overall decrease in consumer demand for formalwear. In addition, strategic distribution changes continue to weigh on our US wholesale business, as we had converted parts of our casualwear and athleisure business into a concession model in the first quarter of 2018, which we account for as own retail.

Speaking about own retail, trends continue to be very solid in the U.S, supported by changes in the merchandising of our stores as well as operational improvements. As we continue to invest more into casualwear and athleisure, we leveraged favorable market trends, which in turn drove low-single-digit comp store sales growth in the second quarter.

Importantly, this comp store sales growth was achieved in a high-quality manner: Following the strong start to the year in the U.S., we took the decision to run the Spring/Summer Sale period even more diligently and carefully than we have done in the past, reducing the depth and length of the sale period. Therefore, Q2 is certainly not about a deceleration in momentum in the U.S.! It is about driving quality growth in one of our key markets and we are well on track to reach our full-year targets.

Last, but certainly not least, sales in Asia/Pacific were up 7% excluding currency effects, with growth across all major markets.

Sales in Greater China increased 8%, driven by continued growth in mainland China as well as 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, with healthy underlying demand.

Looking at the other major markets of the region, sales in Japan and South Korea increased at a double-digit rate in currency-adjusted terms, supported by robust tourist demand. In addition, currency-neutral revenues in Australia increased at a low-single-digit rate.

Now, moving away from the top line, let's have a closer look at the remaining P&L items, starting with the gross margin, which decreased 80 basis points in the second quarter to 66.9%. This development was mainly due to a less favorable channel mix, reflecting double-digit growth in our wholesale business as I have previously mentioned. This effect, however, is of a temporary nature and is expected to reverse in the second half of 2018, as we anticipate an overall positive channel mix effect in 2018. In addition, quality investments had a meaningful impact on our gross margin in Q2.

As the CFO, I am particularly pleased to see that we continue to diligently manage our operating expenses. A generally lower pace of retail expansion together with the successful renegotiation of rental contracts helped limit the increase in own retail costs during the second quarter. Our marketing expenses, which due to some phasing effects saw an acceleration versus Q1, ended the second quarter broadly stable compared to the prior-year level. And while general administration expenses saw an increase of 7%, let me point out that this increase largely reflects further investments in the digital transformation of our business model, which as you know is an important element of our strategy. Alltogether, operating expenses increased a very moderate 2% in the second quarter. As a percentage of sales, operating expenses declined 50 basis points in Q2.

As a result, EBITDA before special items remained fairly unchanged at 106 million euro. Similar to the first quarter, and as expected, currency-translation effects had a negative impact of around 5 million euro in the second quarter.

EBIT was down 8% in the second quarter. This development mainly reflects the release of accruals in the second quarter of 2017. The tax rate amounted to 26% in Q2. Overall, these effects resulted in a net income decline of 7% to 54 million euro, translating into earnings per share of 77 cents.

From a geographical perspective, European margins improved by 280 basis points to 31.4% as a result of strong sales growth, which more than offset the slight increase in operating expenses. In the Americas, the margin dropped to 17.0%, largely due to the weakness of the U.S. dollar compared to the prior-year period. Margins in Asia/Pacific ended the quarter at 22.2%, down 110 basis points versus the prior year. This development reflects negative exchange rate effects as well as an increase in selling and distribution expenses.

Now, this brings me to our performance for the first six months of 2018. Group revenues increased 5% currency-neutral and 1% in reported terms to 1.3 billion euro. The sales development was driven by a strong 6% comp store sales increase, with improvements across all store formats, led by our online business, which grew at a strong double-digit rate. From a regional perspective, all regions contributed to the robust sales growth during the first half of 2018, with Europe and Asia/Pacific performing particularly strong, as revenues grew 6% and 9% respectively.

EBITDA before special items remained stable compared to the prior year at 205 million euro, as the increase in gross profit helped to offset higher operating expenses. We ended the first six months of 2018 with a net income of 103 million euro, which is slightly below the prior-year level.

Now, let me refer to our balance sheet and cash flow development at the end of June 2018. Starting with inventories, which showed a currency-neutral increase of 16% at the end of June. There are a few things on inventories that I would like to highlight:

- Firstly, let me remind you that inventory levels in 2017 were particularly low, hence a more normalized stock level and thus an increase in inventories was to be expected.
- Secondly, the increase in inventories will also support the strong momentum that our own-retail business enjoys, in particular when it comes to online.
- Last but not least, inventory aging looks healthy and I am quite confident that we will see inventory levels come down as we approach year-end.

As a result of the higher inventory levels at quarter-end, average trade net working capital increased 12% currency-adjusted. As a percentage of sales, however, average trade net working capital decreased 40 basis points to a strong level of 18.8%.

Looking at capital expenditure, capex was down 10% in the first six months of 2018, mainly reflecting a different phasing of spending compared to the prior year. As already mentioned back in May, this year’s investments will largely be linked to the renovation of stores and shop-in-shops, and mainly affect the second half of 2018. Consequently, we expect capital expenditure to increase over the coming months, getting us to the forecasted range that we have given for the full year.

In terms of cash flow development, free cash flow amounted to 32 million euro. The decline compared to the prior year reflects the increase in trade net working capital. Now, keep in mind that the first half of the year is traditionally less cash-generative.

We have every confidence that the second half of 2018 will show much stronger cash generation and continue to feel comfortable with the free cash flow guidance we have provided for the full year 2018.

To finish on the cash flow discussion, net debt came down to a level of 158 million euro at the end of June, reflecting the strong cash generation over the last twelve months.

The robust performance during the first half of 2018 illustrates the strong underlying momentum of BOSS and HUGO. This, as well as the positive feedback we have received from our customers with regards to the upcoming Fall/Winter 2018 collection, reinforces our confidence in the aspirations we have set ourselves for the year. We therefore reconfirm our full year outlook and continue to expect currency-neutral revenues to increase at a low- to mid-single-digit rate.

Moving down to the bottom line, we continue to forecast EBITDA before special items to come in at a range between -2% and +2%. While we expect gross margins to improve during the second half of the year, mainly supported by a more favorable channel mix and the annualisation of quality investments, this improvement will be largely offset by higher operating expenses, as we will continue to invest into our brands, our organization, and the digitization of our business model.

To conclude, ladies and gentlemen, the second quarter results have fully met our expectations and we are well on track to reach our targets for the full year. The robust top-line performance is proof positive that the momentum has not only returned to our business, but is also strong enough to compete against more difficult comparisons. This speaks to the accelerated dynamic our brands enjoy, the strong perception of our collections, and improvements in execution.

It is also speaks to the investments we make, be it from an organizational, brand, or distribution perspective. They form the foundation that helps us to approach our customers in the most impactful way, faster and with an higher service level than ever before. Ultimately, they will also be the foundation to drive sustainable and profitable growth in 2019 and beyond.

Our relentless focus therefore remains on further investing into the quality of our business, while at the same time executing on our strategic priorities.

On the latter, my Board colleagues and I will update you later this year, as we want to make sure you perfectly understand where we stand today and what our ambitions are for the future. Therefore, on November 15, we are inviting all of you to join us for the HUGO BOSS Investor Day 2018, which will take place in London. We will send out the official invitation, including registration form, after the summer break in mid-September. I kindly ask you to save the date and mark November 15 on your calendars.

With this, ladies and gentlemen, let me thank you for your attention, and now I am happy to take your questions. As we have a long list of participants in the queue, and in order to be fair to all of you, I kindly ask you to limit the number of questions to two. So two questions per person, please!

OK, ladies and gentlemen, that completes our conference call for today.

Our next reporting date will be November 6. If you have any questions, please feel free to contact any member of the IR team.

And with that, I would like to thank you for your participation and wish you a very good day. Talk to you soon. Bye bye.