HUGO BOSS

HUGO BOSS Analyst Conference Call Q3 2018

Third Quarter Results 2018
Conference Call on November 6, 2018

Transcript – Q&A Session

November 6, 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.

Antoine Belge (HSBC): First, regarding the performance in Q3: I know it's always difficult to isolate the impact of weather, but is it fair to assume that July and August have been up mid-single digit in terms of retail like-for-like, and September was weaker?

My second question relates to your guidance for the full year in terms of top-line, which is unchanged overall. Could you confirm that you have kept each of the regional assumptions unchanged as well and a comment especially on the U.S. wholesale, which is particularly strong? How do you see U.S. wholesale ending up 2018?

Finally, with regards to inventories, which are up 20% at the end of September: what was the quality of the inventories? And how can we be sure that you won't need additional provision or depreciation at the end of December, as you took a relatively conservative approach at the end of September?

Yves Müller (CFO): First, excluding the weather impact, our comp store sales growth would have been in our guidance range of a mid-single-digit percentage increase.

The second question was related to Q4 and the sales expectation. In Q3, we have experienced a negative weather impact and for October we see positive momentum in Europe to make up for the sales decrease of the third quarter. October sales figures for Europe were promising. In addition to this, the U.S. wholesale performance was very good in Q3. We continue our good relationships, especially with Nordstrom and Bloomingdale's and remain positive regarding the U.S. performance for Q4.

Regarding inventory quality, I can confirm that the majority of the inventory increase at the end of September is coming from NOS products, i.e. never-out-of-stock products. We are very confident that we can sell these products. They have high-quality, are predominantly consisting of bodywear, hosiery and similar products and are not too fashionable or seasonable.

Antoine Belge (HSBC): Two follow-ups please. Regarding my second question on the sales by region, I was relating to the FY 2018 guidance by region. Is it the same as it was last time you communicated in August?

On wholesale: the full-year guidance is a low single-digit increase. What is your guidance for the U.S.? I would imagine it to be a bit better than the global average.

Yves Müller (CFO): I can confirm that the full year guidance for the regions is unchanged. So we will pick up especially in Europe.

Regarding wholesale: we won't disclose any specific wholesale outlook for Q4. But it is worth mentioning that, in 2017, we had some delivery shifts from Q4 into Q3. This means, we expect a good wholesale performance in Q4.

Zuzanna Pusz (Berenberg): First, to follow up on Antoine's question. You mentioned that there has been some unfavorable impact of discounting on gross margin. Could you please confirm if this was simply driven by customers choosing to buy products,

which were marked down only because of the weather? Or has there also been a higher level of promotions in stores to attract more traffic?

Secondly, on your like-for-like growth: could you please tell us what is the ASP and volumes within that?

On China, you mentioned that you had a very strong Golden Week, which sounds quite promising, especially given that now there's so much noise in the market around China. Could you please confirm if these strong trends in China are continuing now? Do you believe that this is brand-specific or is it just the repatriation of demand that you are benefitting from?

Yves Müller (CFO): Your first question related to gross margin and markdowns. The higher markdowns in Q3 were related to the fact that we already had the Fall/Winter collection in our stores. But due to the long and hot summer, we were predominantly still selling items from the Spring/Summer collections, which were already in the sales period. This delay led to the effect that the impact from markdowns finally went higher. What we are seeing now, is that the Fall/Winter collection is selling off as the temperatures are coming down, especially in Europe.

Regarding like-for-like performance in Q3: average selling prices were down due to three effects: Firstly, the widening of casual- and athleisurewear offering in our stores. Secondly, global pricing. Thirdly, higher markdowns. However, in the first 9 months of 2018, our like-for-like performance is plus 5%. So we overcompensated the lower ASP by higher volumes and higher conversion rates.

Regarding China: yes, we really had a very good Golden Week, and we do not see any slowdown of our business in China so far. The BOSS brand enjoys very good momentum, also profiting from the fact that we lowered prices over the years. We now have the right global pricing level. In China, we are now 30% to 40% ahead of the European prices. So we are very good positioned. As I pointed out in previous calls, we increased our customer base and we are benefiting from this by selling more BOSS products.

Zuzanna Pusz (Berenberg): One follow up on the like-for-like composition: I remember that, for the first six months, you saw a 5% decline in average selling price. So is there any number you could give for Q3 just to get an idea of the underlying volume growth?

Yves Müller (CFO): The ASP decrease was in the high single-digit range, the conversion rate was up low double-digit, the frequency was up low single-digit and sales per transaction were up low single-digit. This finally ended up into 4% like-for-like sales growth in freestanding stores, which is the best indication for the current collection.

Piral Dadhania (RBC): Starting with weather: can you please explain your learnings from this summer and your Q3 performance? What is being done to make the supply

chain and inventory delivery more flexible as you transition from the Spring/Summer to the Fall/Winter collection?

Secondly, could you provide an indication of the HUGO freestanding store performance relative to average? I think some of your pilot stores have been open for over 12 months now. You have 20 HUGO stores in total. So any initial indications as to how the stores are doing would be very helpful.

Finally, on rental contract renegotiation. You flagged it in Q3 and for some previous quarters as well. Given you have lowered your gross margin guidance but left your EBITDA growth guidance unchanged, could you perhaps give an indication of the magnitude of the savings you're seeing there and other potential OpEx offsets to be able to maintain the EBITDA guidance?

Yves Müller (CFO): Regarding the weather issue and our learnings: First, we will outline this during the Capital Market Day next weeks, especially when it comes to speed. However, to give you an indication, the learning must be to make the switch. The sizing of collections is one issue: how big are the in-between collections, i.e. the pre-spring and pre-fall collections, which are sold especially in February/March and July/August. Secondly, it's about the role of the online channel when it comes to unsold merchandise at the end of the season. Our omnichannel capabilities offer a lot of possibilities going forward to mitigate the risks of weather.

On HUGO and its freestanding store performance: be aware that we currently have two different store concepts for HUGO in place. In total, we have almost 20 HUGO freestanding stores. For those still running under the old store concept, we see a positive like-for-like sales performance. The six new ones just opened recently, so it's too early to give you a realistic indication at this point in time.

Regarding cost savings: yes, rental negotiations will go on. We will further optimize the pay-to-sales ratio. These are cost items for which we see further potential to have them reduced in Q4 and going forward in 2019.

Thomas Chauvet (Citi): First, on profitability in the Americas: can you come back, Yves, on the significant margin pressure? For the first nine months of 2018, EBITDA margin for the Americas is at 14.1%, which is more than half as compared to Europe, despite healthy sales growth in the Americas. I know there are structural reasons for the lower profitability in general. But are there initiatives to ensure return to a more acceptable margin level in this important market next year?

Secondly, on HUGO, which was down 11% in Q3. I understand it's largely self-inflicted. Can you reconfirm that the reduction of HUGO's presence in wholesale and some of your freestanding stores and in outlets will be over by year-end? You say that you want to sharpen HUGO’s brand positioning. Have you engaged in discussions with different types of wholesale partners to sell HUGO where the brand should belong, i.e. the contemporary fashion segment?

Yves Müller (CFO): Starting with your second question on HUGO. You're right. We pointed out that there have been a lot of distribution changes regarding HUGO in the first nine months of 2018, which were necessary in order to sharpen the brand's positioning in the contemporary fashion segment. First of all, we reduced HUGO's presence in the outlet channel. Secondly, we took HUGO corners out of our BOSS stores to clearly differentiate between the BOSS and the HUGO customer. Finally, and this was a big part as well, in wholesale, we shifted back from HUGO to BOSS at several partners. Especially, for one of our important wholesale partners in Germany, BOSS represents a much better fit than HUGO. These distribution changes are now executed and will largely be over by the end of 2018. Therefore, from 2019 onwards, HUGO is supposed to grow again. In addition to these changes, we have lots of very good cooperations for HUGO, e.g. in the online world with Zalando, where we distribute HUGO in the wholesale format. Or with Galeries Lafayette, where we've moved HUGO towards the fashion-forward floors in September.

On profitability in the Americas: yes, in general, you are right. We are not satisfied with our profitability in the Americas, especially when it comes to the U.S. We have initiated several measures to improve the profitability. However, this will take some time, but we are well aware that we have to improve the profitability in the U.S.

Melanie Flouquet (JP Morgan Chase): My first question is on gross margin guidance for the full year in comparison to the 9-month trend. If I'm not mistaken, then depending where Q4 cost will end up, you're guiding for between minus 50 bps and plus 130 bps improvement in gross margin, so quite a wide range. In Q3, the markdown and the inventory valuations represented half of the gross margin decline, i.e. they represented 120 bps of the margin decrease. Why are you expecting to have a lower impact in Q4 than you had in Q3? Is this because the excess inventory is going to be rotated over several quarters and we should not expect higher markdown activity in Q4?

Secondly, for the full year, you are clearly guiding for compensating higher than expected gross margin pressure in Q3 with cost control in Q3 and in Q4. What are the pockets of costs that you identified and that enabled you to compensate this gross margin pressure? Are they sustainable?

Yves Müller (CFO): Relating gross margin and markdowns in Q3: Yes, half of the gross margin decrease in Q3 was due to inventory devaluations and markdowns. For Q4, we don't expect this to reoccur. Be aware that in Q4 2017, we had high markdowns. That is why we expect a markdown improvement for Q4 2018. And that's the reason why we expect an improvement in our gross margin for Q4 in comparison to the first 9 months of 2018.

Regarding the cost items: there are a lot of sustainable cost measures. First of all, it's the slowdown of retail expansion, as we are now focusing more on remodeling our stores with less CapEx. Secondly, it's about the renegotiation of rental contracts, which represents a big part. Thirdly, it's about optimizing our retail excellence, especially injecting more retail experience to have a tighter control in the pay-to-sales ratio. Fourthly, it's about overhead costs, which can be reduced further going forward. There

is one issue regarding marketing. We are now in Formula E instead of Formula 1, so there's a shift from marketing expenditure into 2019. Overall, the marketing expenses are stable in comparison to last year.

Melanie Flouquet (JP Morgan Chase): One follow-up, on your comment on gross margin, please: so you are not expecting higher markdown pressure in Q4, but the inventories are up 20%. Does this mean you are expecting inventories to not require significant markdown and to tail off over time rather than at the end of this year?

Also a follow up on the cost line: the cost savings you are identifying seem to be quite long-term initiatives. I'm just wondering what came in, in Q3 and in Q4 that enabled you to compensate the gross margin pressure, but that you did not expect in your cost line?

Yves Müller (CFO): In the first 9 months of 2018, we already experienced an operating leverage of 60 basis points when it comes to costs. So these measures are already contributing, the effect is increasing quarter-over-quarter and that's the reason why they will be coming in, also in Q4.

On inventory: yes, we saw an increase of 20% at the end of Q3. But as I already pointed out, these are predominantly NOS products, and they will turn rather quickly. We will come to an acceptable level at year-end, and there will be no further markdowns necessary to sell off the inventories.

John Guy (Main First): My first question is relates to your intensified cooperation agreement with Zalando. Could you please quantify where you think the sales and margin opportunities might be? From a channel mix perspective, you said that the impact was neutral in Q3. I would have thought that, given the wholesale decline and a very strong online, we would have seen a slightly more positive contribution from channel mix. So can you talk about the opportunities of the intensified cooperation with Zalando?

Secondly, on your unchanged free cash flow guidance for 2018 of between EUR 150 million to EUR 200 million. You are expecting an improvement in inventory, you slightly lowered your CapEx guidance, and you're probably looking for an increase in earnings to get you there. But, with regards to the inventory issue, even if we adjust for the shifts in wholesale in Q3, inventory would have still been up 17% in Q3. I appreciate that you've got seasonal sales of just around 60%, 20% are fashion items and 20% is never-out-of-stock. But I still don't understand how you're going to be able to phase down the inventory that quickly in order to see less than 120 basis points of gross margin impact in the fourth quarter.

Yves Müller (CFO): Regarding Zalando: yes, in the last nine months, we talked a lot about the opportunities of a concession model. I'm happy to announce today that we finally signed the contract. Please understand that I won't be too specific today, but we will be very explicit next week in London. But just to give you an indication: for the BOSS brand, we changed the model from wholesale to retail with Zalando. This implies higher sales as we account for the full retail sales and no longer only for the wholesale

sales. So the new cooperation model will be gross margin accretive going forward from a channel mix perspective.

On free cash flow, yes, you're right: higher earnings, lower CapEx and lower inventories. They will come in, in order to make sure that we reach our guidance of a free cash flow of between EUR 150 million and EUR 200 million. In July we noticed that we were suffering from a retail like-for-like performance below our expectations. That was the reason why we decided to lower our merchandise buy, i.e. the inflow of inventory, in order to decrease the total inventory position. This means we took immediate action to bring inventories down. This action is one major driver for inventories to go down at year-end and this will, as a consequence, lead to a free cash flow within the guided range.

John Guy (Main First): Inventories were up 16% at constant FX in the first half of the year, 20% unadjusted for the timing of wholesale in Q3. You took action back in July, and I appreciate that there is a timing effect, but we have not seen any decrease yet. Where do you think inventory as a percentage of sales gets to by the end of the year?

Yves Müller (CFO): At year-end, we will see an inventory level that is slightly above the low last year level. Be aware that not all inventory is equal. Here we talk about a lot of NOS articles, which turn very fast. In connection with the decreased merchandise buy, these are the factors, which will bring down the inventory level. But be aware that the inventory quality is sustainable as of the end of Q3.

Jürgen Kolb (Kepler Cheuvreux): First, you mentioned, that October started very promising. If I'm not mistaken, last year, October was particularly weak. So the momentum was obviously stronger in October. Could you please fill us in how November and December developed last year? Was that also a rather weak month for you so that you are coming off from a relatively low comp base?

Secondly, you mentioned that you are working on a better forecasting model. Could you please give us some idea as to what that means? Is that something that kicks in already in the short term? Or is that just a mid- to longer-term project? What exactly do you do there?

Yves Müller (CFO): On your first question: usually, we do not disclose information on monthly sales developments. However, it is important to mention that we had a very good October as compared to last year. This underlines our guidance for Q4. November and December comp bases are a little bit tougher, but we are confident that we can make it. The first days of November are promising as well.

Secondly, regarding inventory levels and forecasting, we took immediate action with regard to the approval process: once the merchandise planning is done, it has to be approved. This means, the buy has to be approved by controlling via four-eye-principle. This action is intended to have immediate impact on future inventory development.

Elena Mariani (Morgan Stanley): A couple of follow-ups from me. Again, on your inventory level. As part of your short-term and structural measures, are you also

planning a different usage of outlets? In particular, with regards to Q4 and the measures you're going to take, are you planning to move some of these items to outlet in a more massive way? I still do not understand how you can talk about these items being high quality, because I would imagine that they are leftovers that are not going to be sellable in the coming quarters. If you could further clarify, that would be great.

My second question is on your like-for-like trajectory. If we exclude the weather in Q3, you said that you were on track to have a mid-single-digit like-for-like. Thinking about next year – and I appreciate you are going to give further details next week – is it fair to assume that with like-for-like growth in the low to mid-single-digit range, you're going to definitely achieve operating leverage and margin expansion? Given all the initiatives that are going to annualize by the end of this year, and the cost savings that you have talked about?

Yves Müller (CFO): On your second question, regarding like-for-like and operating leverage: this will be one of the big topics next week at the Capital Markets Day. However, like we always said, we envisage to have low to mid-single-digit like-for-like growth to be enough for operating leverage and return to sustainable profitable growth in 2019. This will be enough, because there is still more to come from the cost side. Just to give you an indication: we will not give any guidance for 2019 next week. We will talk about mid-term guidance next week.

Elena Mariani (Morgan Stanley): Does mid-term mean a 3-year guidance?

Yves Müller (CFO): More than this, but we will talk about this next week.

Regarding the inventory level, your question was whether we want to put some of these items into outlet. A clear no because these are not fashionable items. As I pointed out, they are predominantly NOS items that can be sold in wholesale, for example. This means, there are a lot of items that can either be sold to wholesale partners, or that can be sold in our own retail freestanding stores at full price. So there is no indication that these items go into the outlet, meaning that we will not shift them to the outlets in Q4.

Philipp Frey (Warburg): Firstly, can you please update us on the number of BOSS stores that you converted to the new store format? How are those stores performing right now?

Secondly, regarding the double-digit increase of your wholesale replenishment business: do you consider the increase to be more a function of the quarter's ordering of wholesalers, or is it due to a substantially better performance of your collection as compared to the collection of peers?

Yves Müller (CFO): Regarding your first question, I have to refer to the Capital Markets Day. We will be explicit on this topic next week, as this measure is long-lasting and does not only refer to Q3.

Regarding replenishment, there are three major effects. First, we see a structural effect relating to wholesale pre-orders, as wholesalers get more prudent in their pre-orders. Secondly, yes, we see a better performance of our collection relative to our peers. Thirdly, we are having good momentum in our bodywear and hosiery business, which is growing at double-digit rates.

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