Third Quarter Results 2018 Presentation

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- The spoken word shall prevail –

Good afternoon ladies and gentlemen.

My name is Christian Stöhr, I am heading up the Investor Relations activities at HUGO BOSS and I would like to welcome you to our third quarter 2018 financial results presentation.

Thanks Christian and good afternoon ladies and gentlemen. Also from my side, a warm welcome to all of you who join us for our third quarter results conference call. In the next twenty minutes, I will present to you our operational and financial performance before opening the floor to your questions.

From our press release earlier this morning, I am sure you have noticed that our performance during the third quarter was negatively impacted by the challenging market environment, which affected the broader apparel industry. Before we take a closer look at our third quarter financial performance and the outlook for the remainder of the year, let me start by highlighting some operational developments that we have achieved over the course of the last few weeks.

Starting with a major achievement that we have made on the distribution side. To further strengthen our digital services, we agreed with Zalando, our largest online wholesale partner, to intensify our successful partnership going forward.

The focus of the new cooperation model is the use of the Zalando partner program, which enables us to serve customer requirements even better than before. As of October 11, we are now independently managing the presentation and distribution of BOSS Businesswear, which is available at Zalando for the first time.

Importantly, the new partnership with Zalando does not only offer commercial opportunities, it is also an important step forward in taking more control over the distribution of our brands in the online space – from pricing to presentation to fulfillment. We are very excited about this move, and look forward to further strengthening our partnership with Zalando in the years to come, while at the same time increasing our controlled distribution in the online world.

Back in September, BOSS took center stage at the New York Fashion Week, where BOSS Menswear and BOSS Womenswear presented their Spring/Summer 2019 collections under the theme "California Breeze." Taking inspiration from coastal cities and the modern houses overlooking the Pacific Ocean, the seamless overlap of beach and metropolitan life has influenced a fresh new collection, incorporating a relaxed and surf-inspired vibe.

The event was attended by several superstars filling up the front row, including supermodel Barbara Palvin, actor Jamie Dornan, and basketball player Tim Hardaway Junior. At the same time, the event left a strong mark in the digital world, where we reached more than 50 million fans and followers throughout our various social media and brand channels.

On the HUGO side, we continue to make strong progress in strengthening the brand's store network across metropolitan areas. The third quarter has seen a total of five store openings in metropolitan cities, among others London/White City and Paris/Le Marais.

In total, we now have almost 20 HUGO standalone stores across the globe, which speak directly to the fashion-forward customer. Expanding HUGO's store network is an important element in order to further sharpen the brand's unique positioning in the contemporary fashion segment. We will therefore continue to open HUGO freestanding stores in key metropolitan areas over the coming quarters.

To conclude the operational highlights during the third quarter, let me also highlight a major achievement in the area of sustainability, which - as you know - is a firm part of our Group strategy. In September, HUGO BOSS was included into the "Dow Jones Sustainability Indices World" for the second consecutive year. As such, the Group is one of four companies in the textiles, apparel and luxury segment to have qualified for the index this year.

The further inclusion of HUGO BOSS in this index does not only underscore the progress made in implementing and executing our sustainability strategy, it also shows that our guiding principle “acting responsibly” is generating value for the company, its employees, shareholders, customers, business partners, and society alike.

With this, ladies and gentlemen, let me finish my quick review on the operational highlights, by emphasizing that we are encouraged by the further progress we have achieved regarding our strategic priorities, which will shape the future of our company. It is important that we continue to push and proceed with our strategic initiatives independently of short-term developments, as there is no doubt they will all contribute to the long-term success of our company.

With this being said, let’s change perspectives and take a detailed look at what drove the financial performance during the third quarter.

Overall, currency-adjusted Group sales increased 1% in the quarter, as robust growth in the Americas and Asia/Pacific was largely offset by a slight decrease in Europe, where the challenging market environment was a major constraint for the region.

In euro terms, sales remained stable at 710 million euros, as we continued to experience a slight negative translation effect in third quarter following the appreciation of the euro against several currencies compared to the prior-year period.

So let’s go straight into regional performance, starting with Europe, our largest region, where the extraordinarily long and hot summer along with the late start into the Fall/Winter season put a strain on the overall apparel market. In particular, traffic in Continental Europe was below our own and market expectations, with increasing promotional activity putting additional pressure on the region.

Consequently, Germany and France experienced a sales decline of 13% and 8%, respectively. This development was in part due to the aforementioned market conditions, resulting in comp store sales of -4% and +1% respectively. In addition, delivery shifts from the third quarter into the second quarter had a meaningful negative impact on the wholesale business of both markets.

In contrast, Great Britain continued its strong momentum from the previous quarters and was once again the strongest market in Europe, with currency-adjusted sales growth of 11%. Altogether, our own retail business in Europe recorded a low-single-digit sales increase in the third quarter, driven by low-single-digit comp store sales growth. Looking at our wholesale business, sales declined at a mid-single-digit rate in line with our expectations, reflecting the negative impact of delivery shifts compared to the prior year.

In the Americas, our business returned to growth with sales up 5% in the third quarter and all markets contributing to sales growth. While we recorded particularly strong improvements in Latin America, up low-double-digits, our business in the U.S. also grew at a robust 5% on a currency-adjusted basis.

The development in the U.S. was supported by double-digit sales increases in wholesale, where delivery shift effects had a positive impact on our business. Despite an overall promotional market environment, we recorded solid comp store sales improvements in our own retail operations during the third quarter, up low-single-digits versus the prior year. This development was largely driven by strong double-digit growth in our own online business, where we continue to leverage our digital capabilities and the changing customer behavior towards casual- and athleisurewear.

Last, but not least, Asia/Pacific continued its strong performance from previous quarters and recorded a currency-adjusted sales increase of 7%.

While all major markets contributed to this development, the performance in the important Chinese market was once again a particular standout. Double-digit comp store sales increases in Mainland China were a driving force behind the region’s overall performance, signaling ongoing repatriation of local consumption.

Speaking about China, let me also be clear that we do not see any signs of a slowdown in this important market. Instead, we continue to experience strong demand from Chinese customers and we remain absolutely confident about our short- and long-term opportunities in this market.

Looking at Asia/Pacific's other major markets, sales in Japan and South Korea also continued their strong momentum and recorded high-single-digit and low-double-digit currency-adjusted growth, respectively.

Moving over to the performance of our channels, and starting with our own retail operations. Group-wide, own retail sales increased 2% on a currency-adjusted basis in the third quarter.

This development was driven by a 3% increase in comp store sales, with all regions contributing to this improvement. Asia/Pacific, as just mentioned, continued its stellar performance and recorded high-single-digit comp store sales increases. In addition, Europe and the Americas recorded low-single-digit comp store sales improvements.

Unchanged from the pattern witnessed during the first half of the year, a strong increase in conversion rates and higher volumes drove growth in the third quarter. Average selling prices in contrast declined, reflecting strategic measures to strengthen our footprint in casual- and athleisurewear as well as the promotional environment in Europe and the Americas during the third quarter.

By retail format, growth was fairly consistent across directly operated stores and outlets. The online business continued its strong momentum from previous quarters. At 38% currency-adjusted growth, our own online business recorded its fourth consecutive quarter of strong double-digit sales increase. We continue to enjoy strong traffic increases on our hugoboss.com website, following several improvement measures we implemented earlier this year, including the clear differentiation between BOSS and HUGO. In addition, conversion rates have started to improve substantially, reflecting easier navigation and better usability of our website, thus enhancing the overall shopping experience.

Turning to the wholesale channel, where third quarter sales declined 2% on a currency-adjusted basis. Double-digit increases in the Americas and in Asia/Pacific were more than compensated by the expected sales decline in Europe, where delivery shifts from the third quarter into the second quarter had a negative impact on the quarter.

Within our global wholesale business, online continues to clearly outperform the physical channel. While our business with large marketplaces and 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.

To conclude on the top-line performance in the third quarter, let's have a look at the development by brand and gender. Sales for the BOSS brand increased 3% excluding currency effects, supported by growth at both BOSS casualwear and BOSS businesswear. We are particularly encouraged by a mid-single-digit growth at BOSS businesswear, as it shows that formalwear is and remains an important part of the premium apparel market and a segment where we can build on the heritage and strength of the BOSS brand.

HUGO sales declined 11% in currency-adjusted terms. While the brand's casualwear business continued to grow at double-digit rates, ongoing distribution changes once again had an adverse impact on HUGO's businesswear in the third quarter of 2018. As already highlighted earlier this year, these changes aim at sharpening HUGO's fashion-forward, contemporary positioning in the marketplace by focusing on those distribution channels, where the brand proposition is a better fit with the HUGO customer.

By gender, our menswear business grew 1% currency-adjusted in the third quarter, driven by high-single-digit increases in casualwear. Our womenswear business saw a currency-adjusted decline of 7% during the quarter, mainly reflecting the further reduction of retail selling space. Womenswear sales in the wholesale channel, however, continue to develop nicely, reflecting ongoing healthy demand from major retail partners in the Americas and Europe, where BOSS holds a leading position in the market.

Turning below the top line, the gross margin saw a decline of 240 basis points to 62.5% in the third quarter, mainly reflecting the challenging market environment, which resulted in greater than expected promotional activity, particularly in the Americas and Europe. Consequently, around half of the gross margin decline is related to a less favorable pricing mix, reflecting inventory valuation effects as well as higher markdowns. The other half is a result of ongoing quality investments as well as negative currency effects. The channel mix was broadly neutral in the quarter.

Moving on to operating expenses, where we continued to have a tight focus on operating cost management. Selling and distribution expenses declined 1% year-on-year, driven by a slowdown in retail expansion and further progress in renegotiating rental contracts. Strict cost management also limited the increase in administration expenses, up only 1% versus the prior year, despite continued investments in the digital transformation of the business model. Altogether, operating expenses declined 1% year-on-year and, as a percentage of sales, were down 30 basis points.

Strict operating cost control, however, was not enough to offset the gross margin decline. As a result, EBITDA before special items declined 12% compared to the prior-year quarter, amounting to 126 million euros. Importantly, and contrary to our initial expectations, currency effects had a negative impact on EBITDA of 5 million euros. EBIT and net income declined 20% and 18%, respectively, also reflecting a swing in the other operating income and expense line.

From a regional perspective, the sales decline in Europe coupled with a slight increase in operating expenses led to an adjusted EBITDA margin decline of 300 basis points to 30.8%. In the Americas, the increase in sales did not result in operating leverage, as the overall market environment continued to be promotional. Consequently, the EBITDA margin of the Americas saw a decline of 660 basis points to 14.7%. Asia/Pacific, however, experienced a significant increase in the adjusted EBITDA margin, up 400 basis points to 17.8%. This development is mainly due to the strong top-line development as well as a slight decline in operating expenses.

While so far, my comments have related to the performance in the third quarter, let me also quickly summarize where we stand after the first nine months.

Group sales were up 4% currency-adjusted and 1% in euro terms, with all regions contributing to this performance. Europe was up 3% and the Americas grew 4%, both in currency-adjusted terms. Asia/Pacific clearly outperformed both regions and recorded strong currency-adjusted sales growth of 9%.

Despite tight operating cost management, resulting in a 60 basis points operating expense leverage, the decrease in the gross margin of 120 basis points led to a 5% decline in EBITDA before special items, amounting to 331 million euros.

Let’s now move on to the balance sheet.

At the end of September, inventories were up 20%, both in euro and currency-adjusted terms. While the majority of the inventory growth aims at further supporting the positive sales momentum, especially in our own retail business, let me also be clear that the like-for-like performance in the third quarter was obviously somewhat weaker than initially expected, reflecting the unusually long and hot summer in Europe. As a result, inventory levels are higher than expected and clearly not at the level I would like them to be.

To ensure that inventory levels come down towards year-end, we have taken immediate action and implemented short-term as well as structural measures. In this context, we have not only adjusted the merchandise buying for the remainder of the year, but also realigned our internal processes to further optimize demand planning going forward. Based on the measures taken and the expected acceleration in top-line growth in the fourth quarter, which I will speak about in a moment, I remain confident that inventory levels will see a normalization towards the end of 2018.

Despite the increase in inventories, trade net working capital saw a modest increase at the end of September, up 11% compared to the prior year. This development reflects our strict discipline in trade terms management as well as concerted collection efforts. As a percentage of sales, average trade net working capital was up 10 basis points to a level of 19.4%.

Looking at our investment activity, capital expenditure increased 12% in the first nine months, largely driven by the anticipated step-up in store renovations. This continues to be a strong focus area of investments, not only in 2018 but also beyond.

The increase in capital expenditure, together with higher cash outflow from inventory changes, resulted in a decline in free cash flow, down to 13 million euros at the end of September. Nevertheless, we continue to forecast free cash flow for the full year to reach the initially targeted range of between 150 million and 200 million euros, as we forecast a significant increase in free cash flow in the fourth quarter. This will be driven by the anticipated earnings increase and cash inflow following the reduction in inventories.

Now, ladies and gentlemen, after reviewing the financial performance of the third quarter and the first nine months, let me spend a few minutes on our outlook for the remainder of the year.

Despite the challenging market conditions in the third quarter, we remain confident of reaching our full-year top- and bottom-line guidance as reconfirmed this morning. We continue to expect currency-adjusted sales to grow at a low- to mid-single-digit rate in 2018, supported by mid-single-digit comp store sales increases. The gross margin, which we had initially forecast to remain broadly stable year-on-year, is now expected to decline between 50 and 100 basis points, as we account for the gross margin decline during the third quarter. Lastly, we continue to forecast EBITDA before special items to be within our guided range of -2% and +2% compared to the prior year, as we expect operating expense leverage to compensate for the gross margin shortfall, reflecting our strict cost management.

Importantly, the confirmation of our full-year top- and bottom-line outlook stems from our conviction that the fourth quarter of 2018, which traditionally is the strongest in terms of sales, will see a significant improvement in sales and earnings.
We expect the top-line momentum to accelerate in the fourth quarter, driven by robust comp store sales improvements in our own retail business. This assumption is supported by a positive business development in our own retail operations in October. We are particularly encouraged by the strong performance of our Chinese business during Golden Week, which was not only well above last year, but also represented one of the most successful Golden Week's in our history in China. In addition, we forecast our wholesale business to improve relative to the performance seen during the first nine months.

Our gross margin is expected to improve during the fourth quarter compared to our first nine months performance, as we forecast a reduction in markdowns. In addition, we will annualize quality investments, which had started back in the fourth quarter of 2017, and which will provide a further tailwind to the development of the gross margin.

Lastly, we will continue to strictly manage our cost base during the fourth quarter, to ensure that we continue to generate operating expense leverage as we approach year-end. In this context, the third quarter has already shown our high level of cost discipline. Together with my Board colleagues, I will ensure that this discipline will be lived and acted upon each and every quarter from here on.

And while I have every confidence that we will reach our full-year 2018 guidance, more importantly I also remain convinced that we will return to sustainable profitable growth as of 2019. As we consistently pursue our strategic initiatives, we see plenty of opportunities for our business that will enable us to grow in a sustainable and profitable manner in the years to come. On that front, my Board colleagues and I will give you a detailed update during our upcoming Capital Markets Day next week.

And with that, ladies and gentlemen, I am now happy to take your questions.

(Q&A)
OK, ladies and gentlemen, that completes our conference call for today. As you know, on November 15, we will be hosting our 2018 Investor Day in London, and I would like to invite all of you to join us on that day.

If you have any questions with regards to the registration process, 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 again next week. Bye-bye.