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The Estée Lauder Companies, Inc. (EL)

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, everyone, and welcome to The Estée Lauder Companies Fiscal 2020 Third Quarter Conference Call. Today's call is being recorded and webcast. For opening remarks and introductions, I would like to turn the call over to the Senior Vice President of Investor Relations, Ms. Rainey Mancini.

Laraine A. Mancini
Senior Vice President-Investor Relations, The Estée Lauder Companies, Inc.

Thank you. On today's call are Fabrizio Freda, President and Chief Executive Officer; and Tracey Travis, Executive Vice President and Chief Financial Officer. Since many of our remarks today contain forward-looking statements, let me refer you to our press release and other reports filed with the SEC, where you'll find factors that could cause actual results to differ materially from these forward-looking statements.

To facilitate the discussion of our underlying business, the commentary on our financial results and expectations is before restructuring and other charges and adjustments disclosed in our press release. All net sales growth numbers are in constant currency. You can find reconciliations between GAAP and non-GAAP figures on our press release and on the Investors section of our website. During the Q&A session, we ask that you please limit yourself to one question, so we can respond to all of you within the time scheduled for this call.

And now, I'll turn the call over to Fabrizio.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

Thank you, Rainey, and hello everyone. I hope you are in good health during this difficult time as the world confronts COVID-19. My heart goes out to those afflicted and my deep gratitude goes to everyone around the world who is part of the global relief efforts.

Before I discuss results and our strategies to navigate through this challenging environment, I want to first thank our employees at The Estée Lauder Companies. The care and compassion you have shown one another since the outbreak, while also balancing new work routines for yourselves and caring for your families, has been truly inspiring. Your creativity and sense of collaboration have risen to new heights, as we have adapted our business from marketing to sales to manufacturing and more. Our employees have truly exemplified our belief in leadership from every chair.

The Estée Lauder Companies and some of its charitable foundations have made donations to help limit the spread of the virus and ease the related hardship faced by those it affected. To-date, we have made donations and commitments to Doctors Without Borders, The New York City COVID-19 Response and Impact Fund, Red Cross Society of China, Shanghai Charity Foundation, Give2Asia and Community Chest of Korea. This week, we established the ELC Cares Employee Relief Fund, our newest giving initiative, which will be funded through our contributions from the company, the Lauder family and our employees. It will provide immediate and critical financial relief to employees whose lives have been impacted by the pandemic.

Our brands have also found meaningful ways to contribute. The Estée Lauder brand donated 2 million surgical masks for front-line workers in New York, while Clinique donated 50,000 skin care products to doctors and nurses in New York City's hospitals. Aveda launched Aveda Cares, a relief program to benefit independent salons and stylists in the United States. The multi-facet initiative will help salons prepare to recover from COVID-19 related closures.

The M·A·C VIVA GLAM fund is continuing its decades-long giving by allocating $10 million to 250 local organizations all over the world that are providing essential needs and services to people at higher risk during the COVID-19 pandemic. I'm also especially proud of how the company mobilized to manufacture hand sanitizer for front-line workers, high risk individuals and our employees. Thanks to the tremendous work of our global research, development and supply chains teams. Our facilities in the United States, the United Kingdom and Belgium are making over 1 million hand sanitizers.

Now, turning to the quarter's performance, as we discussed with you on our last earning call in early February, we expected third quarter sales to decline. After a strong January globally, we anticipated pressure in February and March in our Asia/Pacific region in our travel retail channel, given the extent of the COVID-19 outbreak at that point in time. However, COVID-19 continued to spread around the world as the quarter progressed and social distancing measures began to impact retail traffic.

As March evolved, travel was significantly curtailed and virtually all stores in The Americas and Europe, the Middle East & Africa temporarily closed, hindering consumer primary access to supply such that the magnitude of the impact on our business was far greater than initially anticipated. In this very complex and challenging environment, reported sales fell 9% in constant currency. Tracey will provide more details about our financial performance in a moment.

In this volatile quarter, there were several bright spots in our business which led to global prestige beauty share expansion. The Estée Lauder brand grew high single-digits, while Darphin and Le Labo also delivered sales growth. Skin care sales grew internationally, including Dr. Jart+. In our Asia/Pacific region, sales in Mainland

China rose mid single-digit after returning to growth in March. Our online sales increased strong double-digits worldwide, with growth accelerating significantly from February to March.

The strength of our global travel retail business in January and February enabled it to deliver low single-digit sales growth for the quarter, excluding Dr. Jart+. Each of our three regions are at different stages of impact from the COVID-19 outbreak as I speak with you today. Furthermore, within regions, the extent of containment and recovery varies. As a result, and given how fluid the situation is, we are continuously fine-tuning our strategies with our brand and regional teams to both manage the present and plan for the future.

Across the regions, a majority of our facilities have continued to manufacture and distribute products, though in a much reduced capacity. Most of our offices globally are operating in a work-from-home scenario. But that too is evolving. Our China headquarters in Shanghai has fully reopened, as all employees began working in the office daily three weeks ago after having been on a staggered schedule for several weeks. As office reopened, however, we are going back to work in a different way. We are employing additional safety measures for health and hygiene. We are also applying the experiences of work-from-home with new ways to collaborate and engage more effectively.

In our Asia/Pacific region, our business in Mainland China is further improving as retail stores began to reopen with shortened hours in March. By mid-April, virtually every door had reopened. We are encouraged by China efforts in containing the virus and the initial signs of recovery. We expect to return to double-digit sales growth in Mainland China in the fourth quarter. More recently, sales in Korea had begun to grow and stores have started to reopen. However, Japan, Australia and markets in Southeast Asia are still in the containment phase with most retail stores closed as we speak.

In Europe, the Middle East & Africa, retail stores in most countries had been closed since early March, with the primary exception being in the Balkan Peninsula and the Nordic region. Some countries have recently announced plans to gradually reopen, most notably Germany and Italy, which are promising signs. Prior to these temporary door closures, several countries in Western Europe had been experiencing lower retail traffic as tourism abated in response to COVID-19. We expect these headwinds to persist for some time to come.

In The Americas, most retail stores had been closed since mid-March, although retailers started seeing much lower traffic earlier in the month as social distancing began. More recently, several states in the US have announced guidelines for the recovery, and we are starting to see very limited reopening with curbside pickup. We are closely monitoring the evolution of consumer behavior through this challenging time, and we are developing strategies to address it.

We are using sophisticated social media listening tool, machine learning, and other qualitative and quantitative research techniques. Each day, we are assessing how consumers express their needs and desire from seeking positivity, self-care and wellness to understanding their at-home needs and routines, to hearing their environmental and sustainability concerns. Our successful strategy built on multiple engines of growth is as vital as ever.

Our diversified portfolio of categories, channels, geographies, brands and price points give us many levers to fuel the business and will play a crucial role during recovery when stores reopen and consumers restock at home. Our robust global skin care portfolio, vibrant online business and broad exposure in Asia/Pacific are the primary engines of growth in this moment. These engines had tremendous momentum before COVID-19 and are playing a crucial role during containment while brick & mortar is closed.

Let me first speak on skin care. Emerging trends are increasing the appeal of the category, bolstering already strong category dynamics. Taking care of one's skin has become an expression of self-care, which has risen in importance. Consumers are actively exploring subcategories and expanding their regimens, finding [ph] peace of mind in the ritual of a routine (00:11:39). Our focus on hero products is the right strategy, as consumers seek brands and products they trust.

Consumers are newly discovering and continuing to return to our heroes. Beloved heroes like Estée Lauder's Advanced Night Repair, La Mer's Crème de La Mer treatment lotion and concentrate, and Clinique's Moisture Surge has been seeing strong global demand online since the outbreak, demonstrating the dynamics of big brands. In this unprecedented time, we are staying true to our belief in the power of innovation on our hero franchises.

We launched Estée Lauder Perfectionist Pro Rapid Brightening Treatment, Clinique's Even Better Clinical Radical Dark Spot Corrector + Interrupter, and the NEW Eye Concentrate from La Mer. Consumer demand has been especially compelling. In fact, for the Perfectionist Serum, its March launch on Alibaba Hey Box was one of Estée Lauder's best-ever on the platform. Clinique's Even Better Serum is far exceeding expectation in Mainland China and has been highly sought online in the United States, and La Mer launch contributed to significant share gains in luxury on Tmall.

Among our channels, online is thriving around the world. As we discussed with you at our Investor Day last year, we have long believed in the excellent growth prospects of online and have been investing in this dynamic channel for years. Our presence is global with online sales in over 50 countries. We are highly diversified with over 300 brand.com sites, over 60 brand boutiques on platforms such as Tmall and over 1,700 retail.com doors. Our online brand teams have been actively engaged since the containment measures took hold, optimizing product placement to address consumers' current wants and needs and showcases tools like virtual try-on to ease decision-making.

The Estée Lauder brand expanded its online sales strategy to include a broad array of social selling activities from live shows on Instagram focused on self-care with [ph] global scope models (00:14:15), to live streaming from its brand sites with global and local makeup artists, to live chats with consumers on its brand site, to personalized one-to-one outreach through various communication tools.

M·A·C pivoted its long-awaited April launch for its newness Selena capsule collection to online and social selling to honor the commitment it had made to consumers. The brand employed an exciting digital activation in place and in person events for the global launch to tremendous success [ph] as the order (00:14:54) sold out online in two days. Selena is the biggest collection launched to-date in terms of total sales on maccosmetics.com.

Bobbi Brown began daily lesson with the brand's pro makeup artists across regional channels of topics most requested by consumers. Initial signs are positive, and the brand is welcoming all-new consumers, thanks to this Always-On Artistry initiative. Jo Malone London [ph] has seen (00:15:25) an influx of activity with its digital communities, as consumers have sought to elevate and uplift [ph] their state (00:15:33) with the power of scent. [ph] In China, the brand's (00:15:37) home fragrances and bath and body categories have doubled their mix of business.

[ph] Through our actions like these (00:15:44) in recent weeks, we drove conversion rates sharply higher, and our sales have risen across all demographics. I'm especially encouraged by the online growth we have seen from the ageless consumers. Globally, our brands have seen increases in new consumers of three to four times. Some rates are even higher. For La Mer in the United Kingdom, new consumer acquisition is higher by five times, while

in Thailand across all brands it is higher by eight times. As consumer behaviors evolve during this time, we are [ph] harnessing (00:16:25) more data, leveraging our analytics capability to derive even better consumer insight to provide even better service.

When retail stores reopen, we will be in a stronger position to further unlock the potential of omni-channel. We are also focusing on the areas of most immediate opportunity in Asia/Pacific with Mainland China as of March and Korea as of April moving from containment to recovery. We told you on our last earning call that we stood ready to facilitate recovery as soon as the market supported it, and we are doing just that. In Mainland China, we successfully piloted emerging business model for online and department stores to adapt to the changing landscape.

For La Mer, personalized service across channels with curated and targeted communication drove both online sales and department store sales significantly higher in the month of March. The strength of the La Mer repeat business model has been a key factor for its strong recovery and contributed to the brand's outstanding prestige beauty share gains in Mainland China in the quarter. As countries in Asia/Pacific move into recovery, we are mindful of the consumer in these markets who traditionally purchase our products in travel retail, but not able to do so with air travel largely curtailed.

Our regional brand leads are working to meet this consumer demand in markets, be it in department stores, specialty-multi, freestanding stores or online. Our travel retail team is also actively engaged as destinations in the channel reopen, already driving positive trends in Hainan or Macau. We remain focused on meeting the needs of Chinese and Asia consumers with local relevancy and local trends. Since we last talked in February, we have advanced our work toward our new investment in a state-of-art innovation center which will open in Shanghai.

In closing, in this unprecedented time, I'm moved by how deeply we are living our company values and how are intent on becoming an even better company through this challenging moment. With our extraordinary people and our successful strategy built on the multiple engines of growth, we stand ready to emerge strongly when the global recovery begins.

Now, I will turn the call over to Tracey.

Tracey Thomas Travis

Executive Vice President-Finance & Chief Financial Officer, The Estée Lauder Companies, Inc.

Thank you, Fabrizio, and hello everyone. COVID-19 is certainly proving to be the most significant challenge we have faced as a public company, as much of our brick & mortar distribution globally has been deemed nonessential during the quarter by several jurisdictions and remains closed today. We continue to do our best to support our communities and our employees while also working to mitigate the business impact during this time. As a reminder, my commentary today is adjusted for the items that Rainey mentioned at the beginning of the call and net sales growth numbers are in constant currency.

So, looking at our third quarter results, net sales fell 10%, driven by the rapidly evolving impacts from COVID-19 that occurred throughout the quarter. As the majority of our brick & mortar distribution throughout the world was closed as the quarter progressed, we quickly pivoted to drive sales online. Our online growth accelerated sharply at the end of March and continued to rise in April. Sales grew in travel retail from a strong January and February before travel restrictions were enacted, and skin care remained our most resilient category. The Americas region and the makeup category suffered the biggest shortfalls. The December acquisition of Dr. Jart+ added approximately 2 points of net sales growth.

Our gross margin decreased 320 basis points compared to the third quarter last year due to a combination of factors. In the first seven months of our fiscal year, we saw outstanding growth in our skin care category, much of it in Asia and in travel retail. To meet what has now been our third year of double-digit demand for our products, we supplemented our internal manufacturing capacity with additional third-party suppliers and we incurred increased airfreight to support sales growth in areas distant from our manufacturing facilities. This resulted in higher supply chain cost in our third quarter. The impact of increased tariffs, higher obsolescence and promotional activity also contributed, as well as the inventory step-up related to Dr. Jart+.

Previous initiatives like Leading Beauty Forward, which is still projected to contribute approximately $425 million to $475 million in net savings by fiscal 2021, have put us on much stronger footing to weather normal economic downturns. However, the impact of COVID-19 has not been a normal downturn. The sudden and dramatic change in sales growth from the beginning of the third quarter to the end created a deleverage effect that could not be offset quickly enough by the significant cost actions we took, which totaled approximately $250 million. Therefore, operating expenses as a percentage of sales rose 250 basis points.

As we told you last quarter, we expect to see a greater impact from our third quarter cost actions, including advertising and promotion reductions more aligned to sales performance, a hiring curtailment and the benefits of work-from-home, which yielded sharply reduced travel and meeting expense as well as consulting expenses, in our fourth quarter.

As it became apparent that store closures and social distancing measures would move beyond China to be adopted around the world, we implemented even more cost actions that will have a more meaningful impact on curtailment of expenses beginning in May. These primarily include furloughs and other leaves of absence, as well as temporary reduction in compensation for management and board members. The capabilities we have built and the actions we are taking now enable us to manage through the situation today, while funding targeted strategic investments going forward, which will position us well to emerge strongly when the recovery is more apparent.

Our interest expense rose by $11 million to $28 million during the quarter, reflecting higher debt levels to finance the acquisition of Dr. Jart+. Our effective tax rate increased to 30.5% from 22.1% in last year's third quarter, primarily attributable to a higher effective rate on the company's foreign operations due to the mix of earnings. Adjusted diluted EPS of $0.85 fell 45% compared to the prior year. Currency diluted EPS by $0.01 and the acquisition of Dr. Jart+ diluted EPS by approximately $0.03.

During the quarter, we recorded $346 million of impairment charges related to four brands and certain freestanding retail stores that have been further challenged by the impact of COVID-19 on consumer demand. We believe that our strong balance sheet and ample liquidity provide core competitive advantages for our company, demonstrating the importance of scale. These position us to not only manage through a crisis, but to emerge from it stronger.

During the quarter, we borrowed $1.3 billion under our $1.5 billion revolving credit facility and had $200 million of commercial paper outstanding, ending the quarter with nearly $5 billion in cash and cash equivalents. In April, we issued $700 million of 2.6% 10-year senior notes in order to further enhance our financial flexibility and liquidity and repaid the commercial paper with the remaining capacity under the revolving credit facility. We were able to do all of this while maintaining our strong single A credit rating.

For the nine months, we generated $1.95 billion in net cash flows from operating activities, an increase of 11% from the prior year. We invested $468 million in capital expenditures and $1.04 billion to acquire the remaining interest in Dr. Jart+. We also used $883 million to repurchase shares and $502 million to pay dividends. To further enhance near-term liquidity, we are focusing our capital investment on areas necessary for future growth and paring back in areas such as retail renovations and office improvements.

We cut our planned capital expenditures by one-third and now expect to spend between $600 million and $650 million for the full-year. Additionally, we have suspended share repurchases for the balance of this fiscal year and our quarterly dividend that would have been paid in June of 2020. All of these activities greatly enhance our ability to manage through the shutdown in brick & mortar for an extended period of time, while we focus on stimulating greater consumption online.

History has not provided any truly comparable recent events we can use as guidance concerning the effects of the global pandemic. The disruption to our business caused by COVID-19 has clearly been more widespread and more pronounced than we had expected it would be when we last spoke with you just a few months ago in February. We delivered remarkably strong double-digit growth in sales and adjusted EPS through January, but that was followed by the dramatic spread of the pandemic and the related door closings and curtailment of travel that we spoke about.

Due to the fluidity of the situation, it is both complex and difficult to predict the duration or the timing and trajectory of the recovery and the corresponding impact on our business. At this point in the fourth quarter, the majority of our distribution with the exception of China and a few other markets remains closed. And while we are encouraged by the weekly acceleration of our global online business, we do not have enough visibility into the progression of the rest of the business until more retail doors open in the coming months. And we do believe traffic could initially return at a slower pace, as some consumers remain tentative until a treatment is developed.

Therefore, given the level of uncertainty, we are not providing explicit sales and EPS guidance for the year. That said, there are a few guideposts that we can provide to you. The inclusion of six months of sales from the acquisition of Dr. Jart+ should add about 1 percentage point to sales growth for the year. It is expected to dilute EPS by about $0.14 due to purchase accounting. Currency translation is expected to negatively affect reported sales growth by 1 percentage point, reflecting weighted average rates of $1.11 for the euro, $1.26 for the pound and CNY 7.03 for the yuan for the fiscal year. The related EPS dilution should be approximately $0.05.

We are very encouraged as we see the beginnings of recovery in China and markets around the world begin to discuss gradually lifting retail and travel restrictions as the virus abates. We expect strong online acceleration to continue, as underlying consumer demand is driving both replenishment and new customers online. However, unlike the third quarter, where many of our global doors were open until the last month of the quarter, we expect that most of our retail distribution will remain closed for much of the fourth quarter and consumer traffic will likely recover slowly in brick & mortar.

We expect greater sales and margin declines in the fourth quarter as a result. We estimate that global prestige beauty will decline double-digits in the second half of our fiscal year. We are also mindful of the risk of a global recession and a slow recovery in employment impacting consumer sentiment and discretionary spending. Our gross margin in the fourth quarter will reflect the adverse conditions we have been experiencing in March and April. The sudden and dramatic change to our volume forecast is expected to trigger an accounting rule requiring us to recognize the impact of reduced manufacturing volumes on our standard cost.

Our plants have been running at meaningfully reduced capacity, reflecting some temporary plant closure as well as reduced efficiencies to accommodate social distancing requirements, staggered shift changes and other changes necessary in this environment. We are also required to recognize expenses related to manufacturing employees who are not working. These expenses are now recognized in the current period instead of when the product is sold.

The inclusion of Dr. Jart+ with the impact of the inventory step-up will also pressure our gross margin. We expect our belt-tightening efforts to have a more pronounced impact in the fourth quarter to partially offset the negative impacts I've discussed. We are implementing some of the additional actions in May and expect to deliver fourth quarter savings of between $500 million and $600 million. Our full-year effective tax rate is expected to be approximately 24%.

So, those are some of the guideposts that we can provide to you for the year. We are committed to continue to take the appropriate actions to rationalize our cost base relative to the new normal and return as quickly as possible to both sales growth and margin expansion as the COVID-19 situation stabilizes during the course of fiscal 2021. We delivered tremendous sales and profit growth through the first half of the year, as our business continued to benefit from the strategic actions we took over the past several years to position our company for sustainable profitable growth.

And while the unfortunate temporary shock of COVID-19 has made our outlook for the balance of this year uncertain, we have taken appropriate action to mitigate the effects of the pandemic, while continuing to protect our business to be able to be well-positioned for both the near-term recovery and the long-term opportunities inherent in global prestige beauty. On behalf of Fabrizio and The Estée Lauder Companies leadership team, we extend our immense gratitude to all of our employees around the world for their extraordinary efforts to manage during this unprecedented period.

And that concludes our prepared remarks. We'll be happy to take your questions at this time.

QUESTION AND ANSWER SECTION

Operator: The floor is now open for your questions. [Operator Instructions] And our first question comes from Lauren Lieberman from Barclays. Your line is now open.

Lauren R. Lieberman
Analyst, Barclays Capital, Inc.
Q

Great. Thanks. Good morning. I wanted first to talk about – I have so many questions. So, I wanted first to talk about travel retail and just what your data and analytics have told you over time about the sales historically through that channel, how much of it is sort of impulse, how much of it is new consumers discovering your brands, how much of it is sales that would have or could happen elsewhere like a replenishment-type sale when someone travels, because that could inform thinking about your ability to recapture some of that sales or what degree of that sales even assuming global travel remains depressed for a good amount of time. Thanks.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.
A

Yes. I think first of all, your assumption is correct. Our data confirms that those are consumers that while traveling are buying, discovering or replenishing their products. So, then there is business travel, where people that travel for business bring back some gifts, and obviously, this creates consumption. But in travel retail, the most successful products all over the world tend to be what we call our hero products, so the products which have high loyalty, a high repurchase rate, because both as a gift and as personal consumption, which are the two drivers of travel retail, people really want to buy products that they are pretty sure will either replenish their habits or create exciting gifts. In that sense, there is the possibility to recover at least part of the travel retail sales in the country of origins, and we are working on this in every country, mainly emerging markets, in China, in US, in Europe. And so, there is a project to do this as much as possible.

However, in this moment, to be very clear, travel retail in Europe and US is basically closed. And so, in the quarter four, there is a very big issue of closures that is in the middle of the travel retail sales which are possible in the short-term. In Asia, we started seeing already amazing results when there are openings. In this moment, the travel retail within China, particularly in the Hainan Island or the travel retail in Korea and the travel retail in [ph] Hong Kong, Macau (00:34:51), this started already coming back and is delivering good growth. We are focusing in this case very much more on conversion, and it's working. So, again, it's a world of two tales. But the real travel retail recovery will start happening in fiscal year 2021 with the gradual reopening of travel and will be probably one of the most gradual reopening in the recovery from our expectation and from our data.

Operator: Thank you. And our next question comes from Steve Powers from Deutsche Bank. Your line is now open.

Steve Powers
Analyst, Deutsche Bank Securities, Inc.

Q

Great. Thanks, Fabrizio and Tracey. Hope you're well. I guess is it...

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Yeah. Thank you.

Steve Powers
Analyst, Deutsche Bank Securities, Inc.

Q

Is it possible that you could talk a little bit more about what you saw in March relative to January-February and what you've been seeing in April across your key categories, geographies and channels? Because I think that too would help inform at least the near-term visibility. And I guess relatedly, if you're able – it sounds like you have line of sight to some belt-tightening initiatives in the fourth quarter. But I'm trying to juxtapose that against some of the near-term manufacturing and other COVID-related headwinds that you spoke to, Tracey. So, just a little bit more color about what you've seen and are seeing in the moment while things are shut down. Thank you.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Yeah. I'll start from what are we seeing on the sales side, and then I'll let Tracey cover all the financial implications and the financial aspects. So, the recovery first of all is very different by region, because the COVID-19 issue has a different speed and a different level of depth in different markets, and some markets are already, as you know, in recovery. Other markets are still in the middle of the issue. So, we are managing things in a very differentiated way by region, by country. So, what we see in this moment is that in – still the closures are – in Europe and US are [ph] 90% (00:37:02).

If you have seen some of the data that are emerging on the situation in United States in the last week of March or the first week of April, the market was minus 70% and the brick & mortar closure has a very big impact. So, this, we see the month of March, the month of April and part of month of May where closures are very big in EMEA and in North America, has been probably the worst moments for that regions. And then, we see a gradual recovery as the brick & mortar will open in these regions, meaning Europe and America, and also in Europe and America, we see already an extraordinary progress of the online. That's the key important point.

On the other side, in April, in places like China, Korea, Taiwan, we see already double-digit growth. We already see the recovery being very active. And that for us is very encouraging, because it shows that as soon as there is a recovery from the consumer point of view, so when the consumers are back with the spirit of really going back to their normal habits like it's starting, as I said, in China, Korea and Taiwan, the double-digit growth comes back fast and – because we see both an increased consumption, we see a restocking in consumer homes and we see a restocking in trade which happen at the same time.

So, the recovery is strong. But the recovery is, for the moment, only in these areas, and as I said, is in global online. In global online, there are – most of the areas of the world is double-digit, but there are areas which are triple-digit. And then the recovery, as I said, started in very few travel retail doors which are open, as I said, mainly in China and Korea. But the rest of the world for the moment is still closed. And so, in fiscal year 2021, we expect to see all the engines, meaning including the European and US brick & mortar, gradually coming back. But as Tracey has clarified in her prepared remarks, we believe the comeback of brick & mortar will be gradual.

We have signs of this already in Asia, where the recovery really starts online and starts gradually in brick & mortar, and brick & mortar acceleration takes much more time, because it takes not only the technical reopening, but takes that the consumer confidence to buy in brick & mortar comes back. And this will only come back more gradually. So, that's what we see. In summary, we see faster recovery in Asia for the moment, a lot of closures still in Europe and US, very fast recovery online globally, and a more gradual recovery in travel retail.

Tracey Thomas Travis
Executive Vice President-Finance & Chief Financial Officer, The Estée Lauder Companies, Inc.

A

And Steve, to your question on the cost savings and the manufacturing variance, the way I would think about that, in the fourth quarter, the $500 million to $600 million of cost savings, about a third of it is related to employee actions and the other two-thirds related to other expense areas that we stepped up in terms of our cost savings, advertising, consulting, travel, et cetera. So, that's generally the split in the fourth quarter.

As it relates to our gross profit margin, and you saw the impact in the third quarter, we expect that we will continue to see in the fourth quarter the impact obviously of the tariffs and of the higher third-party sourcing cost that will impact us in the fourth quarter. In addition to that, I spoke about the under-absorption of some of our overhead and labor cost that we need to expense in the fourth quarter. So, the bigger impact will be in the fourth quarter on that. So, our gross profit margins will decline further in the fourth quarter related to those one-time issues related to the lower production volumes. As we increase production volumes as we emerge out of COVID-19, that will correct itself.

Operator: Thank you. And our next question comes from Olivia Tong from Bank of America. Your line is now open.

Olivia Tong
Analyst, Bank of America Merrill Lynch

Q

Great. Thank you. Good morning, and hope you guys are well.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Good morning.

Tracey Thomas Travis
Executive Vice President-Finance & Chief Financial Officer, The Estée Lauder Companies, Inc.
A

Good morning, Olivia.

Olivia Tong
Analyst, Bank of America Merrill Lynch
Q

Wanted to ask you about just your sales, and I think fairly impressive that China was only down for the month of February and that travel retail was still up in the quarter. But the US decline was pretty staggering. So, as we start thinking about when Western markets start to reopen, can you talk about differences not only in underlying demand in these key markets, but obviously your infrastructure, because clearly e-commerce penetration is significantly higher in Asia than in the US? So, can you talk about just your infrastructure? Is e-commerce better developed just in China overall and how do you compare for that? And then, just thinking later in the year, I know it's still pretty far away, but what's guiding how you plan for holiday, Singles Day and things down the road as we think about the future? Thank you.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.
A

So, I'll start and then Tracey will add perspective. So, the penetration online actually is very strong in the United States, in the UK and in China. Those are the three markets where we have the stronger penetration online, where the market is very well developed online. So, in terms of how we see the situation in the US, obviously, our stabilization plan in the US has been postponed by the COVID issue that emerged. So, it will take a bit more time than what we originally were hoping when we had an encouraging last quarter in calendar year 2019.

So, that is because of the closures of the brick & mortar. In the United States, the online acceleration is outstanding as we speak. And so, actually it's very reassuring to us that the percent of the business online will dramatically increase. Now, this was already planned for the long-term, but this issue has accelerated it. And as I explained in my prepared remarks, what we are seeing in the UK, in the US and in China, that the – particularly the ageless consumers, so the consumers above 50, 55, that – as you know, the online was mainly for millennials and the new generations. But frankly, all these other consumers now are extra consumers that are using e-commerce much more in all its aspects. And we believe that this change is here to stay.

And so, the increase of the percentage of business online, including retail.com – so, it's not only brand.com, it's retail.com, it's platforms in China and in other parts of the world, it's pure plays in the UK. So, in all the online channels, there is an increase of percentage of sales that goes online. To be clear, for the long-term, this is positive to us. It's very positive. Online has always been one of our key drivers, one of our profitable drivers, and most importantly, make a stronger platform for the future of omni-channel, which is the way – also particularly in luxury – the distribution models will evolve on all fronts. So, good development, and we believe this is positive. Tracey, do you want to add perspective?

Tracey Thomas Travis
Executive Vice President-Finance & Chief Financial Officer, The Estée Lauder Companies, Inc.
A

Then, on our infrastructure as well as our plans for holiday, clearly, we are mindful of and watching very closely in terms of, as doors open, the productivity of those doors. So, certainly both with our retail partners as well as our own freestanding stores, just making sure as doors open that they are productive, that they are profitable. And we will, as we have over the last few years, take appropriate actions if we find that we do emerge out of this with brick & mortar doors that are less profitable than we would like for them to be.

As it relates to holiday, at the same time, one of the things that Fabrizio – when he was speaking about online, the inference there is we are very much focused on the fact that demand remains strong, and it's really the access to our products that has become challenging in markets like in Europe as well as in The Americas. So, lots of activity, our programs shifting to online really to make sure that people can access our products. We also are focused on for holiday what we think holiday will be like. We actually are hoping that by holiday, things stabilize a bit. As I mentioned in my prepared remarks, we are mindful that there could be a recession certainly impact, but hoping that by holiday, people are ready to shop again. So, our holiday programs remain intact. The quantities may be adjusted a bit given how much demand has come back by that time.

Operator: Thank you. And our next question comes from Erinn Murphy from Piper Sandler. Your line is now open.

Erinn E. Murphy
Analyst, Piper Sandler & Co.

Q

Great. Thank you. Good morning, and I hope you both are well as well. I guess a follow-up just to The Americas, Tracey, for you. When you think about sales down 23%, it was worse than we thought. Could you just quantify how much was truly the decline from store closures in the last two to three weeks of the quarter versus maybe pulling back on wholesale sell-in? And then bigger picture, as you think about the mix of business in The Americas, I guess, Fabrizio, you already addressed online clearly accelerating. But I'm more curious on kind of how you think about the reliance or the toggles between the department store, the specialty multi-channel, as well as the freestanding stores on the other side of this crisis. Thank you.

Tracey Thomas Travis
Executive Vice President-Finance & Chief Financial Officer, The Estée Lauder Companies, Inc.

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Sure. So, in January, as Fabrizio mentioned, we actually saw positive growth in all of our markets, including in The Americas. We actually started to see some softness towards the end of February. And to your point, the doors were not closed, but certainly it was apparent by that time that COVID-19 was starting to spread and consumers were starting to get a bit nervous about shopping in store and really focusing on stocking up on more essentials. And then in March, we saw the biggest impact obviously with the doors closed, half of March, but really the early part of March, a tremendous decline in shopping because of the tentativeness of the consumer and really the consumer focus understandably so on health and essentials for their homes and their families.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Yeah. And the other thing I want to add is, obviously, our job is also to protect our profitability. And when we saw this evolving, we started spending less already in February, and then in March, also our spending was reduced in order to mitigate the impact of the thing. So, to be clear, we are anticipating the events. And so, the spending was reduced already starting gradually in February. The consumer sentiment started going down already in February.

And then in March, when the closures started in the United States, sales went to zero, because basically the brick & mortar completely closed and the consumer was shocked. The retailers stopped ordering. So, you need to see the month of March like a very big dip moment, and that's why the overall number of the quarter was negative. But to be clear, till January included, and it already was true in the last quarter of calendar 2019, we were stabilizing the business and this was going on the positive trends. And again, we plan when the market will be back to go back to our stabilization program.

In terms of what will happen – to your question on what will happen to the other part of the business which is not online, obviously, the percentage of online business will increase. The rest will be reduced. And so, in our opinion, there will be closures, there will be a reduction of brick & mortar stores overall, and this will make the brick & mortar stores more productive and the ability to deliver experience better. So, we don't see this necessarily as negatively in the long-term. It will be obviously a negative in the short-term. And we see the future of freestanding stores and brand.com being an omni-channel future. In this period, it's fascinating to see how consumers are learning different ways to use the online, the concept of last-mile, the role of small convenience stores, meaning freestanding stores [ph] versus brand.com (00:50:48), how the two combined can create new experiences.

So, there's going to be some interesting, frankly in our opinion, promising evolution of the ability to serve the consumer in a luxury environment in the future. But the transition is going to be complex, difficult. And in the transition, the biggest opportunity is the strong growth of online. And again, for us, this is also positive because we have a great infrastructure. We are very strong in brand.com, in retail.com, in platform, in pure plays, depending on which part of the world [ph] this channel had a (00:51:25) different percentage of the online business. But we are well-covered in each one of them. And so, driving this across the globe and in the United States is going to be in the transition out of COVID, the strongest opportunity.

Erinn E. Murphy
Analyst, Piper Sandler & Co.

Q

Thank you.

Operator: Thank you. And our next question comes from Michael Binetti from Credit Suisse. Your line is now open.

Michael Binetti
Analyst, Credit Suisse Securities (USA) LLC

Q

Hey, guys. Thanks for taking our questions here. I guess, Fabrizio, just to follow that question, in The Americas, I guess you said January is positive and February a bit slower, so March deeply negative. I guess still to average out to negative 23%, it seems like you held some inventories that were probably ordered by the retailers in the US when you saw this coming. Maybe you could comment on, as we look to reopening, what kind of inventory levels out in the channel you see that we're going to be working with as we reopen in the US, I guess?

And then, I guess just going back to travel for a minute, to get to the positive number – and we just look at some of the passenger data in China, it looks like it was down maybe 70% or 80% through February. So, to get to your number to be positive in travel – I think you've commented to us that Chinese consumer is about half of that business before – it speaks to very big growth rates in Europe and in the US for your entire business to land at positive in the quarter. I'm just wondering – I know you said it could be into fiscal 2021 till we'd really see a bona fide recovery in travel. But it seems like you've done some things in that channel that are driving a pretty meaningful share gain in the travel locations that were open heading into this. I wondered if you could comment on any of the strategy there that you think stands out recently.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Yeah. I'll start to answer your travel question, and then Tracey will go on the inventory question. So, basically, you're right. I think what you were describing is what happened. But let me summarize it. January was another extraordinary month for travel. So, that's also what is in the mix. So, in January – remember, January is the Chinese New Year. So – and Chinese New Year, yes, started being impacted, but still some of it happened. And so, we gained market share. We were planning to do that. We had an amazing program in all the areas that were open [indiscernible] (00:53:51). So, travel was strong in the October-December period and continued to be very strong in January.

Then, in February, there was a slowdown obviously, but travel remained open in other parts of the world. And then, in March, travel really was closing. So, yes, in travel, the month of March was the worst month. So, the mix of the three months explains our strong market share performance in the quarter. I believe, however, our market share performance in travel will continue, but the market in quarter four will be probably the worst in travel retail, because the Europe and US are really closed, and in Asia, as I said, there is many Asia stores which are closed. There are three really active areas, which is within China, the domestic travel with Hainan [indiscernible] (00:54:45), which has been reactivated at a percentage, not fully, but with much higher conversion from travelers to purchasers.

So, the key point here, remember that about 10% of travel buys something. The moment travel gets reduced, but is open, and 30%, 40% of travel buys something for several reasons because of good marketing, because there is less people, because it's easier, because it's less crowded, because there are good activities, this changes. And so, in this moment, we are really seeing active few doors, but very important ones with very high conversion rates. [ph] And that's what's the impact (00:55:26). Then, one – the other thing which is encouraging in our travel retail reading in this moment is that, in the moment, most of the world is closed. But when we see openings, the consumer is back very fast, because the traffic will only be back gradually, but the conversion rates can be much better.

And last thing I want to say, the other thing which is the positive expectation for the long-term in travel retail [indiscernible] (00:55:53) also in travel retail, the percentage of business in pretail, meaning the ability to pre-book online when travel is increasing. And as you can imagine, we have great capabilities in that. We have a good structure. We have invested in that. So, we are ready. And you can imagine that in this area, particularly in the period of transition where [ph] sales retail (00:56:15) will still be important also while traveling, you can expect a continuous increase of the online part also in travel retail. So, very [ph] tough quarter (00:56:26) for travel retail, but still I believe that the long-term of travel retail will remain extraordinarily strong and extraordinarily promising.

Tracey Thomas Travis
Executive Vice President-Finance & Chief Financial Officer, The Estée Lauder Companies, Inc.
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And as far as the inventory in the trade with our wholesale customers, clearly, with stores closed six to seven weeks, I would say the early part of the door closures, we started to see a slow pick-up in online, and as we indicated, it has really progressed. So, certainly our retailers, those that can share inventory between their brick & mortar and their online sites, have been drawing down on some of the store inventory planned for stores on their retailer.com sites. And we've seen those progress quite nicely and sales really picking up strongly in the last two to three weeks in particular. So, as doors open, we expect that from a shipment standpoint, we'll see a slow reorder from a replenishment standpoint certainly from some of the fast-movers that have moved quickly on retailer.com sites. But as the quarter progresses, we would expect shipments to gradually strengthen throughout the quarter and by June really be much stronger.

Michael Binetti
Analyst, Credit Suisse Securities (USA) LLC
Q

Thank you.

Operator: Thank you. And we have time for one more question. Our final question comes from the line of Dana Telsey from Telsey Advisory Group. Your line is now open.

Dana Lauren Telsey
Analyst, Telsey Advisory Group LLC

Q

Good morning, and glad to hear everyone is healthy and safe.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

A

Good morning.

Dana Lauren Telsey
Analyst, Telsey Advisory Group LLC

Q

With the expense reductions that you've put in place, how much of it do you think could be permanent versus transitory? And lastly, with the innovation plans underway, any shifts in timing and launches given the current situation? Thank you.

Tracey Thomas Travis
Executive Vice President-Finance & Chief Financial Officer, The Estée Lauder Companies, Inc.

A

So, as you know, Dana, as we've announced, we have taken some short-term cost actions to improve the liquidity situation, and we announced those in the middle of April. And so, those are some of the employee actions that we've taken. And then, some of the other actions are also short-term as it relates to advertising, really right-sizing more our advertising to the current sales trends, which will obviously pick up as our sales trends pick up. There are other areas like travel. I think we're all getting used to the ability to work from home and communicate online. And so, there are other areas that are more discretionary that we certainly are looking at more permanently having cost reductions in some of those other cost areas. But it's something that – as you know, we have ongoing cost management programs in addition to the program for Leading Beauty Forward. We have other cost actions, and we take advantage of the opportunities that we see to lock in savings whenever we can.

Fabrizio Freda
President, Chief Executive Officer & Director, The Estée Lauder Companies, Inc.

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Yeah. And just want to add to this that for the long-term also, what were the most – the best drivers for our growth before the crisis are the ones which are coming back the stronger – that seems to be the one that will come out stronger out of the crisis. If you think that online channels globally is coming out stronger; the Chinese consumers is recovering first and stronger; skin care is recovering first and stronger than any other part; and within makeup, face makeup; within fragrance, artisanal fragrances; and within travel retail, the very efficient travel retail doors of Asia are recovering faster. So, our key drivers of growth are recovering first and stronger for the long-term. So, said in other words, I see all the signs that the key drivers of growth will come out of this crisis stronger for the long-term. And even if in the short-term we are going to be hit hard by the closures, particularly by the very understandable consumer shock in this moment, in the medium, long-term, we will be a strong organization with our key long-term drivers further validated.

And one of the drivers will remain innovation, to answer your last question, is on innovation, we are continuing to innovate. As I said in my prepared remarks, we are reinforcing – or investing in a Shanghai center to make sure that our innovation becomes even more relevant to Asia and to the Asian consumers and to the Chinese consumers particularly. And we, however, are focusing our innovations much more than before in this period, in this period of transition. We are focusing our [ph] innovation (01:01:43) on fewer and bigger innovation. We are focusing our innovation on what works better online in this transition or trying to pivot online where possible because of the closures. And we are focusing our innovation on hero franchises, meaning on the franchises which are – that have high consumer loyalty and high consumer awareness. Because in this moment of transition, in the middle of the crisis and out of the COVID crisis, we clearly see the consumers are interested in the brands they trust, in the products they know. They go back first to loyalty even before very new adventures. And so, we are reflecting this in our innovation plan that in this moment, I believe, is one of the strongest we ever had.

Dana Lauren Telsey
Analyst, Telsey Advisory Group LLC

Q

Thank you.

Operator: Thank you. And that concludes today's question-and-answer session. If you were unable to join for the entire call, a playback will be available at 1:00 PM Eastern Time today through May 15. To hear a recording of the call, please dial 855-859-2056, passcode 4138908. That concludes today's Estée Lauder conference call. I would like to thank you all for your participation and wish you all a good day.