First Quarter 2019 Results

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Yves Müller (Chief Financial Officer)
Christian Stöhr (Head of Investor Relations)

- 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 first quarter 2019 financial results presentation.

Today's conference call will be hosted by Yves Müller, CFO of HUGO BOSS. As always, I kindly ask you to limit your questions to a maximum number of two, so everybody gets a chance to ask his or her questions. So let's get started and over to you, Yves.

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

From our press release earlier this morning, I am sure you have noticed that the EBIT development during the first quarter was negatively impacted by a number of factors, among others measures aimed at driving the organizational efficiency, timing of marketing spend, as well as currency effects.

Before we take a closer look at our first quarter bottom-line performance, let me start, however, by quickly reviewing some of the developments we have witnessed from a top-line perspective.

About six months ago, during our Investor Day in London, we presented to you our strategic framework up to 2022, which I am sure you are all familiar with. Back then, we laid out our strategic growth drivers, which will not only help us to outgrow our industry in

the years to come, but more importantly, will also enable us to grow in a sustainable and profitable manner.

Four factors are particularly crucial for our mid-term top-line ambition:
- significant growth in our own online business,
- a gradual improvement in retail productivity,
- exploiting our growth potential in Asia,
- and above-average growth of the HUGO brand.

I am pleased to report, that all our strategic growth drivers – online, retail productivity, Asia, and HUGO – have either enjoyed overproportionate growth in the first quarter or made further progress:
- First and foremost, our own online business recorded its sixth consecutive quarter of strong double-digit growth. Alongside growth in our digital flagship hugoboss.com, the expansion of online concessions also contributed to this development.
- Secondly, we were able to increase retail productivity by 3% on a twelve-month rolling basis in the first quarter, driven by the successful rollout of our new store concept as well as our various initiatives to optimize our store network, including right-sizing or relocating some of our stores. This marks an important step forward towards the targeted mid-term CAGR of 4%.
- Thirdly, Asia/Pacific once again clearly outperformed the two other regions. In particular, in Mainland China, the strong momentum of previous quarters continued, as reflected by double-digit growth on a comparable store basis.
- Finally, HUGO sales grew 4%, supported by double-digit increases in the important casualwear business, reflecting HUGO's growing relevance in the contemporary fashion segment.

Overall, currency-adjusted Group sales increased 1% in the quarter, as growth in Asia/Pacific and Europe was mostly offset by sales decreases in the Americas, which I will come to in a second.

In euro terms, sales grew 2% to 664 million euros, as – similar to year-end 2018 – currency effects provided a slight tailwind to our sales development, mainly reflecting the appreciation of the U.S. dollar versus the euro compared to the prior-year period, resulting in a positive translation effect.

So, let's take a closer look at our regional top-line performance, starting with the Americas, where currency-adjusted sales declined 8% in the first quarter, reflecting sales decreases in both, the U.S., and Canada.

While we had initially anticipated that our business in the U.S. might face a somewhat slower start to the year, considering our difficult comparison base from the prior-year period as well as wholesale delivery shift effects from Q1/2019 into Q4/2018, we also have to acknowledge that the overall market environment was rather unfavorable for premium apparel or consumer discretionary in general in the first quarter of 2019.

In particular, store traffic turned out to be rather muted at the beginning of the year, reflecting softer U.S. consumer sentiment as well as lower tourist purchases. Last but not least, although on a more technical note, please bear in mind that the later Easter holiday in 2019 has also negatively impacted our business in the U.S. during the first quarter – something we expect to reverse as of Q2. The most recent trends witnessed during the month of April have confirmed our expectation of a sequential top-line improvement in our own retail business.

We therefore remain confident that our sales performance in the U.S. will gradually pick-up over the course of 2019. This development will be supported by ongoing momentum in our own online business as well as the further optimization of the merchandise mix in our brick-and-mortar stores, where we continue to see strong potential around our casual- and athleisurewear offering.

To conclude on the Americas, let's take a quick look south of the border: We continue to enjoy robust sales momentum in Latin America, as reflected by mid-single-digit increases in the first quarter, driven by strong improvements in Mexico and Brazil.

Moving over to Europe, our largest region. Sales in Europe were up 2% on a currency-adjusted basis, despite ongoing political uncertainties that continue to weigh on the region. While our own retail business recorded robust growth, up mid-single-digits in Q1, our wholesale business ended the quarter slightly below the prior-year level, reflecting the negative wholesale delivery shift effect from Q1/2019 into Q4/2018.

Consequently, our business in France ended the quarter below the prior year level, despite a positive like-for-like performance in Q1, which is even more impressive considering the ongoing protests in the country and the negative implications they have on tourism in general. Our businesses in Germany and Benelux remained stable compared to the prior year, broadly in line with the overall market development. Last but not least, the UK continued to outperform the rest of the region. With 5% currency-adjusted sales growth, which was driven by double-digit improvements in the own retail channel, our business in the UK was able to withstand the negative implications arising from the ongoing Brexit uncertainty.

This brings me to Asia/Pacific, where sales for the region increased 4% excluding currency effects. We continue to be encouraged by the strong performance in Mainland China, which, as I have already mentioned, recorded double-digit comp store sales growth in the first quarter of 2019. Unsurprisingly, and no different to 2018, Mainland China was thus once again a driving force behind the region's overall performance.

While this development is supported by the frequently discussed repatriation of local consumption, it also reflects the broadening of our local customer base as a result of our highly attractive price-value proposition. Beyond these effects, we have implemented many initiatives – from marketing to distribution – all aimed at further strengthening our brands' awareness in the market.

Our performance in Hong Kong and Macau was – as expected – somewhat weaker in the first quarter of 2019. While this development is partly related to the aforementioned repatriation of the Chinese spend, it is also attributable to the fact that both markets have seen a number of important store renovations and closures over the last quarters, aimed at optimizing our store network, which has left its mark on the first quarter sales performance.

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

Moving over to the performance of our channels, and starting with our own retail operations. Group-wide, own retail sales increased 3% on a currency-adjusted basis in the first quarter.

This development was driven by a 4% increase in comp store sales, on top of a 7% increase in the prior-year period. While comp store sales in the Americas declined slightly, reflecting the aforementioned challenging market environment, Asia/Pacific and Europe recorded strong comp store sales improvements, up high single digits and mid single digits, respectively. The like-for-like performance was driven by a slight increase in visitors and conversion rates. The average selling price instead recorded a slight decline, reflecting the higher share of casual- and athleisurewear in our product mix.

Moving over to our own online business, which grew 26% on a currency-adjusted basis. This development was supported by a very healthy low double-digit sales increase on a comparable basis. In addition to sales increases on our digital flagship hugoboss.com, the expansion of the concession model over the course of the last year also contributed to sales growth.

Turning to the wholesale channel, where first quarter sales declined 4% on a currency-adjusted basis. This development, however, does not come as a surprise, as it is largely driven by the delivery shift effect from Q1/2019 into Q4/2018, something we had already flagged with the publication of our full year 2018 results back in March.

Within our global wholesale business, and no different to previous quarters, online continues to clearly outperform the brick-and-mortar business. 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 arising from ongoing traffic declines.

Finally, sales in the license business were up 8% in the quarter, reflecting healthy growth in all product categories, including eyewear, watches and fragrances, with the latter returning to growth following a rather difficult performance in 2018.

Speaking of fragrances, it is our clear ambition to return to a product launch cadence in 2019 and beyond, which does not only characterize the BOSS and HUGO brands as clear innovators in the space, but also enables us to grow sustainably. In this context, our fragrance business in 2019 has already seen two important product launches, with positive feedback received by our customers. Only a few weeks ago, shortly before Easter, we launched “BOSS Bottled Infinite” – an extension of the BOSS Bottled family, with

Hollywood actor Chris Hemsworth acting as the face of the global advertising campaign. Earlier this year in Q1, we launched "HUGO Reversed", a new fragrance for our HUGO brand.

To conclude on our top-line performance of the first quarter, let's have a look at the development by brand. Sales of the BOSS brand were stable on a currency-adjusted basis. Increases in casual- and athleisurewear – driven by the ongoing trend towards casualization – were compensated by the slight sales decline in businesswear.

HUGO sales, in turn, increased 4% on a currency-adjusted basis in the first quarter. While casualwear continued to grow at a strong double-digit rate, sales in businesswear declined, reflecting strategic distribution changes in the prior year aimed at strengthening the positioning of HUGO in the contemporary fashion segment.

Let's now take a closer look below the top line. Please bear in mind that the following comments exclude the impact of IFRS 16. We have laid out in detail the exact implications following the first-time adoption of IFRS 16 in our quarterly statement.

Starting with the gross margin, which declined by 20 basis points to 63.8% in the first quarter, as the positive channel mix effect – reflecting overproportionate growth in our own retail business – was more than offset by negative currency effects. The latter is a direct consequence of the appreciation of the U.S. dollar versus the euro compared to the prior-year period and reflects our U.S. dollar denominated sourcing activity, which as you know accounts for a good third of our total sourcing activity. All other effects that have been visible in 2018 – be it markdown management, inventory valuation, or quality investments – were broadly neutral in Q1.

Moving on to operating expenses, which increased 7% in the quarter, resulting in a decline in EBIT and net income of 22% and 21%, respectively. To give you more granularity on the bottom-line development, let's take a closer look at what impacted EBIT in the first quarter.

In total, there are three main elements that weighed on EBIT in Q1:

Firstly, selling and distribution expenses grew 6% mainly reflecting the negative phasing effect of marketing spend compared to the prior year. As a reminder, marketing

investments were particularly low in the first quarter of 2018 because of a shift of expenses from Q1 2018 into Q2 2018. This year, in contrast, our marketing spending is more weighted towards the first quarter, reflecting the launch of our Porsche collection as well as the global campaign shoot for the BOSS brand's upcoming fall/winter collection. In addition, we stepped up the spending in performance marketing to further support the growth of our own online business. In total, the timing of marketing spend had a mid-single-digit million euro impact on EBIT in Q1.

Secondly, administration expenses increased 10% in the quarter, mainly due to further digital investments aimed at driving the digitization of our business model. To give you just two prominent examples: during the first quarter, we started to work with our new online marketing agency in China to fully leverage our digital capabilities and to accelerate growth in the marketplace. In addition, in the U.S., we have completed the roll-out of omni-channel services across the entire market and upgraded the back end system to our European standards. Administration expenses were also impacted by costs related to organizational changes, which will help us to speed up operational processes and drive efficiencies in the years to come. Let me be clear that those costs were rather one-off in nature, hence Q2 should not be affected by these one-time costs, which altogether amounted to a mid-single-digit million euro amount.

Last, but not least, currency movements were also a drag on operating income, reflecting the depreciation of the euro against several major currencies. In total, currency movements had a low single-digit million euro impact on EBIT.

Coming now to the balance sheet.

As promised at the beginning of the year, we continue to make progress in bringing inventories down to more normalized levels without diluting our gross margin development. At the end of Q1, inventory growth saw a further decline, as we ended the quarter with an increase of 9% on a currency-adjusted basis compared to an increase of 14% at the end of 2018. While we are encouraged by this development, we will clearly continue to focus tightly on inventory management and expect a further reduction over the coming quarters. As a result, trade net working capital increased in line with inventories, up 8% currency-adjusted at the end of March.

Looking at our investment activity, capital expenditure increased by 13 million euros in the first quarter, reflecting the anticipated step up in store renovations and the further expansion of our IT infrastructure. Consequently, our free cash flow development was negatively impacted by a similar magnitude.

With this, ladies and gentlemen, let’s change perspectives and look ahead at our expectations for the full year. We remain confident of achieving our full-year top- and bottom-line guidance as communicated in early March and reconfirmed today.

We continue to forecast Group sales to grow at a mid-single-digit rate in currency-adjusted terms, as we expect top-line momentum to accelerate over the next quarters. We are confident that the robust momentum in our own retail business will continue and therefore forecast comp store sales to also grow at a mid-single-digit percentage rate in the remaining quarters of 2019. Besides the robust growth of our like-for-like business, we project a strong acceleration in our non-like-for-like retail business.

Regarding the latter, two factors will be decisive:

- Firstly, we expect important growth stimuli from the further expansion of the concession model in our online business, especially in the second half of the year. New e-concessions, and those we initiated in 2018, will clearly contribute to strong double-digit growth that we forecast to continue for our own online business also in the coming quarters.
- Secondly, we expect store optimizations that are either already underway or planned for the coming months, as well as major renovations, to drive our top-line performance. Let me give you some examples: we will soon be renovating our strategically important store in Chicago, with its reopening planned for Q3, and also our biggest flagship store worldwide, Champs-Élysées – which is currently under renovation – will be converted to the new BOSS store concept just after summer. Adding to this, only a few days back, in April, we have re-opened our big outlet stores in Woodbury, near New York City, and Bicester, near London, as well as our flagship store in Tokyo Roppongi Hills.

From a bottom-line perspective, we forecast a strong acceleration in our earnings development over the next quarters. Let me walk you through a couple of factors that will contribute to double-digit EBIT growth in the remaining nine months of 2019:

- Firstly, compared to Q1, we expect an improvement in the gross margin in the remaining quarters, supported by easing currency headwinds, improved markdowns as well as ongoing positive effects from a more favorable channel mix. Q3 will most likely represent a peak in this regard, simply due to the relatively low comp base.
- Secondly, the quarterly shifts that led to higher marketing expenses in Q1 are expected to balance out over the next quarters. For the year as a whole, we continue to expect our marketing budget to develop more or less in line with our top line.
- Thirdly, we expect the reorganizational measures that I outlined previously to take effect in the coming months. The measures have been completed in Q1 and will contribute to EBIT growth over the course of the year. Our efficiency program, initiated back in November of last year, is also expected to deliver its first positive results in the coming quarters.

These three factors will contribute to strong bottom-line improvements in the coming quarters, with Q2 expected to return to EBIT growth. For the year as a whole, we continue to forecast EBIT to grow at a high single-digit percentage rate and thus faster than sales.

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

OK, ladies and gentlemen, that completes our conference call for today. If you have further questions please feel free to contact any member of the IR team.

And with that, I would like to thank you for your participation and wish you a very good day. I'll talk to you at the latest on August, 1 when we will report our second quarter results. Bye-bye.