HUGO BOSS

HUGO BOSS Q2 2019 Analyst Conference Call

Transcript – Q&A Session

August 1, 2019

Please note that the transcript has been edited to enhance comprehensibility. Please also use the webcast replay to listen to the Q&A session on the day of earnings publication.

Antoine Belge (HSBC): First, you mentioned that besides Zalando there are other partners which you are converting to the concession business model. Can you provide some names? In terms of figures, what will be the impact, especially for 2020?

Secondly, on online, which, at 16%, grew a bit slower in Q2. I understand that this is linked to the discounting period having started a bit later and with lower discounts. Is this something that you drove yourself? Do you expect a rebound in H2 for online?

Finally, with regards to your guidance, to what extent are you taking into account that we already had quite a few very warm months? A lot of your guidance is linked to having a strong Q3 this year on a weak Q3 last year.

Yves Müller (CFO): First, in the second quarter, we converted our business with several partners to the concession model, for example, David Jones in Australia, Lamoda in Russia, and Stockmann in Finland and in the Baltics. For the second half of the year, we are planning to convert our business with big department stores from Southern Europe such as Galeries Lafayette and El Corte Inglés. These are the names that I can give you today, others are in the pipeline.

I can confirm your hypothesis that we took the decision to start our online sales period later this year. That was deliberately done by ourselves. The intention was to maximize our online full-price business, which is strategically very crucial for us. Likewise for Q3 and Q4, we will decide on our own, how much marketing and how much discount we want to grant.

Finally, our guidance takes external macroeconomic factors and uncertainties into account. We are confident to achieve our guidance.

Antoine Belge (HSBC): Obviously, July was quite warm, especially in Europe. Did you embed the start to the quarter into your guidance of a rebound in H2?

Yves Müller (CFO): Yes, within our guidance, we took the weather conditions into account. But it's too early to comment on Q3. As you know, we don't comment on current trading in July.

Jürgen Kolb (Kepler Cheuvreux): First, on HUGO, which grew 3% in Q2, representing a slight slowdown compared to Q1. Is this the run rate that you feel comfortable with? In addition, when it comes to HUGO, some parts of the collection development process is already fully digitalized. Could you share with us how this digital part of HUGO's collections is selling through?

Secondly, on womenswear, down 6%, quite weak in Q2. This is now getting to a point where maybe you have to ask yourself if you want to keep that part of your business going. Is womenswear really a core business for you going forward? And what drove the decline in Q2?

Yves Müller (CFO): Regarding HUGO: our mid-term ambition is to grow HUGO sales faster than group sales. And this is what we did with HUGO also in Q2. We are very cautious when it comes to new freestanding stores, growing the HUGO brand very diligently. After having opened several HUGO stores, we are fully focused now on marketing campaigns. As you know, we just started with Liam Payne on Berlin Fashion Week in July. This effect is obviously not yet reflected in our Q2 figures.

Regarding digital, yes, we constantly increase the share of our HUGO collections that are developed digitally, in order to be much closer to digital trends, especially regarding casualwear. By the end of this year, around 10% of the HUGO collection will be developed completely digitally. We are about to continuously increase the share going forward, starting in 2020. And, on the distribution side, the whole HUGO collection is sold via our digital showroom already today.

Regarding womenswear: it's our clear statement that womenswear is and will continue to be an integral part of HUGO BOSS. It's not margin dilutive. It's a EUR 300 million business. Therefore, it scales. It's clearly in the center of our business. On the other hand, as we have already pointed out, in retail, we are very much driven by sales productivity. This means that within our freestanding stores, we sometimes might exchange womenswear by BOSS menswear, e.g. casualwear or athleisurewear, in order to improve sales productivity. This has happened a lot in 2018, and this is the major driver, why we have seen a decrease in womenswear sales in Q2. That has been done deliberately to drive sales productivity. In addition to this, at our fashion show in Milan in September, you will see both BOSS menswear and BOSS womenswear showcasing their collections combined. This is another clear statement that womenswear continues to be an integral part of the BOSS strategy.

Piral Dadhania (RBC): First, on range rationalization. My understanding was that, after the unification of BOSS Black, BOSS Green, and BOSS Orange, there were excess SKUs and option counts, which you would start to reduce with the Spring/Summer 2019 collection. Can you provide an update on the progress that you've made on that front? How much more is lying ahead of you? What type of gross margin benefit can we expect from range rationalization going forward?

Secondly, coming back to your guidance: it feels like the cut was relatively minor. Consensus expectations were already looking for 7% EBIT growth for full year 2019. On Bloomberg, you have mentioned earlier today that EBIT could rise between 7% and 8%. Why didn’t you cut the guidance more in the first place? Also, do you believe that sell-side consensus estimates are too conservative when saying that EBIT will rise in that sort of range?

Yves Müller (CFO): First, on our Capital Markets Day back in November 2018, we said that we want to reduce our SKU range for BOSS Casual- and Athleisurewear by 30% for Spring/Summer 2020 versus 2018. We have now started to sell the Spring/Summer 2020 collection, and I can confirm that we have achieved a reduction close to 30% and we will see the effect in 2020. This initiative is one of the drivers to improve gross margin in the mid-term. As you know, we want to improve our EBIT margin to 15% by 2022. We said that half will be coming from gross margin improvements, and half will be coming via operating leverage. SKU rationalization should deliver around 1/3, i.e. around 50 basis points, of the gross margin improvement.

Regarding the guidance: we reconfirmed our guidance today. At the same time, we now expect to achieve the lower end of the respective sales and EBIT guidance ranges. This is in particular due to the ongoing challenges in the U.S. market, for which we had to adjust our expectations. We now expect FY sales in the U.S. market to decline slightly in FY/19.

Philipp Frey (M.M. Warburg): Can you update us a bit on the non like-for-like part of your retail business and the respective sales growth contribution of renovated stores?

Secondly, what share of your business with Zalando did you already convert to the concession model?

Yves Müller (CFO): First, out of our around 390 BOSS stores globally, there are already now 52 stores with the new store concept. Some of them are brand new, some of them have been remodeled. And, once we have converted a store to the new store concept, we see, on average, double-digit improvements in sales productivity and sales. But be aware of the fact that only 3 stores, i.e. those from 2017, out of those 52 are already included in the like-for-like base. So the renovation impact on LfL is very limited. That's why we are pointing out that non like-for-like is becoming more and more relevant. But the positive news is, once we've remodel a store, we see positive effects. That's actually the reason why we are continuously investing into the store concept. As you've seen, we increased our investments by almost 50% in Q2 as compared to last year.

Regarding Zalando: included in our Q2 online concession sales is the additional BOSS Formalwear concession business that we started on Zalando back in November in the German and Austrian market. In July, however, we started to add new countries. But most importantly, an effect that is much stronger, is that we are about to completely convert our BOSS Casualwear and Athleisurewear business on Zalando into concession business in Q3.

Philipp Frey (M.M. Warburg): Would it be fair to say that probably more than 80% of your business on Zalando is not yet converted?

Yves Müller (CFO): Yes, this is fair to say.

Thomas Chauvet (Citi): Firstly, your FY/19 guidance implies an acceleration in like-for-like sales growth to around 5% in H2. I understand that some of the drivers will be a stronger product pipeline, and a step-up in marketing campaigns. Can you perhaps indicate whether July accelerated towards this level of 5%, especially given the easier comp base?

Secondly, on the admin costs: I think it's the first time ever that they were coming down in absolute terms. What type of costs have you taken out? Will this trend be sustainable in H2 and perhaps also next year?

Thirdly, a follow up on your comment on the LFL in physical stores. How did full-price stores perform compared with outlets in Q2? Are you generally satisfied with the markdown level in your full-price stores, as you were saying that it didn't have a major impact on gross margin in Q2?

Yves Müller (CFO): Firstly, yes, you're right. We are indicating that we expect like-for-like sales growth in H2 within the mid-single-digit percentage range. However, as I said to Antoine, we won't be commenting on July performance. This is our general rule and that applies also today.

Regarding the administration costs: the improvements are coming from both personnel cost and lower depreciation. Regarding the former, this is also a result of the reorganizations that we did in Q1. As you remember, we had some one-off costs in Q1 and we now see the benefits in Q2.

Finally, in Q2, we recorded an outperformance of the outlet business versus the full-price business. One reason was that we renovated a couple of our big outlets, for which, since then, we see a tremendous performance, especially when it comes to Bicester in U.K., Woodbury Common in New York, and also two German outlets, which are all in the base now. However, despite this kind of outperformance in the outlet channel, overall markdowns remained stable in comparison to the prior year, which indicates that in the full-price business we really kept the markdowns under control.

Thomas Chauvet (Citi): If it's personnel cost and D&A, that effect should continue in the next 2 or 3 quarters – so can we expect a decline in admin costs until maybe Q1 next year?

Yves Müller (CFO): Yes. This is because of the efficiency program that we initiated back in November.

Volker Bosse (Baader Bank): First, on your online business. Thanks for all the details on what is to come in the second half. However, I missed the Asian names. So perhaps you give us an update where you stand with Tmall, for example? How is the underlying momentum progressing here?

Secondly, on gross margin: you're 100 basis points down in Q2. To be honest, I'm still struggling with the bridge. You spoke about inventory valuation. It would be helpful to understand how much of the 100 basis points is coming from the different gross margin components.

Thirdly, on H2, for which you expect a strong acceleration. However, we also see cost inflation, e.g. regarding freight costs, personnel costs, all over the place, at least when listening to competitors. How does that play into your projections?

Yves Müller (CFO): First, regarding our Asian online business, which is mainly with Tmall and JD. As we said in May, we have changed our partner and are now working with a new marketing agency which is running our website on Tmall and JD. We are very satisfied with the first results. We were able to double our sales on these platforms. However, our online business is still like a "small start-up" in Asia, so please don't overestimate this doubling. But it's clearly going in the right direction, and we are developing this business nicely. In addition to this, with our upcoming

BOSS fashion show in Shanghai, of course, we also want to further expand our customer base on these platforms.

Regarding gross margin and the inventory valuation effect in Q2: please be aware that this is an effect related to 2018, not 2019. It was a positive effect in Q2 2018, which was reversed in Q3 2018. So in total, it was neutral in FY 2018. For FY 2019, we are confirming today our gross margin to increase by up to 50 basis points. In the first half of the year, we have been down 60 basis points. But we are convinced that we can achieve the FY target, especially, when it comes to Q3. Finally, the majority of the decline in Q2, in terms of the 80-20 rule, was related to this inventory valuation effect.

Regarding cost inflation, I see tremendous potential in utilizing our purchasing department to mitigate this effect. Also, when looking at raw material prices such as those for wool and cotton, you see some deflation tendencies as well. So overall, for the time being, it's not an issue for us.

John Guy (MainFirst): First, on your EBIT guidance of an increase in the high single-digit percentage range as compared to the expected negative IFRS 16 impact on EBIT in the low single-digit million euro range. Does this imply that in total you're looking for an IFRS 16 impact of around EUR 25 million to EUR 30 million for the full year? Because looking at H1/19, the IFRS 16 impact on EBIT was basically flat. Within your interim financial report you mention a EUR 66 million IFRS 16 impact related to straight-lining. Can you talk a bit about that straight-lining impact? Does this mean that you didn't book enough rental expenses in the past, or have there been some deferred tax charges that you're now having to roll through?

Secondly, on inventory. As a percentage of sales, it's still up around 20 basis points. Within the context of the confidence that you flagged around gross margin increasing by up to 50 basis points in FY/19, how much of that is already factored in, based on the weaker performance that you're seeing in the North American market, which doesn't look like it's going to change?

Yves Müller (CFO): Regarding IFRS 16: First, just to be clear, we made the decision to exclude any potential impact of IFRS 16 from our guidance. This is very crucial because IFRS 16 is still a big project that all the large retailers have to deal with. In our case, we talk about more than 1,000 rental contracts that have to be analyzed in detail. It's a very complicated topic when it comes to rents, as we talk about stores, shop-in-shops and outlets. We talk about variable rents, rent-free periods, indexations and all these things that need to be factored in. We are also closely aligning this with our auditors. At this stage, the impact from IFRS 16 that we are guiding today, is the best of our knowledge. However, I cannot exclude that there might be some changes going forward. But we will clearly let you know once it becomes more transparent.

Regarding the inventories, yes, we've reduced inventory growth by another six percentage points in Q2 to 3% currency-adjusted growth. Looking at our conversion cycle, for the first time since four quarters, we are now also seeing an improvement. Regarding the weak U.S. market: this is factored in within our numbers and our guidance. So we clearly reconfirm our guidance regarding gross margin to improve it by up to 50 basis points in FY/19.

John Guy (MainFirst): Regarding IFRS 16, it looks like you possibly didn't account for high enough rental expenses in the past? And that within the transition to IFRS 16, there could be some messaging here in terms of basically raising some of those rental costs? That's the way that I see it because it's not D&A, and I don't know if it's deferred tax assets.

Yves Müller (CFO): No. I cannot confirm this. Actually, to be precise, it's the opposite. The impact refers to straight-lining. And I think we have been too conservative in the past. We are still in discussion with our auditors to solve these issues, but it's nothing to worry about.

Elena Mariani (Morgan Stanley): First, on your mid-term targets. Back in November you have provided us with the guidance for fiscal year 2022, and an outlook of an average 5%-7% organic sales growth and a 15% EBIT margin target for 2022. Can you just confirm whether, as of today, you're still comfortable with his guidance? And if so, what do you think will deliver this acceleration in the coming years towards like the mid-point of the range for sales growth and towards the 15% EBIT margin target?

Secondly, a clarification on gross margin. You're talking about an unchanged guidance of an increase of up to 50 basis points for the full year. Will this be more like close to 50 basis points? Or could this also mean 10 basis points, given that you've tweaked the EBIT guidance slightly towards the lower end of the range. Also, how should we think about phasing in Q3 and Q4, given that the big chunk of conversions is going to come in the third quarter?

Also, one final clarification on the e-concession business: last time, you told us that this was representing approximately 10% of online sales in 2018, and that it should come to around 20% of online sales in full year 2019. Is it correct to assume that you're going to have online sales of around EUR 35 million related to e-concessions by the end of 2019?

Yves Müller (CFO): Regarding the mid-term guidance, I can clearly reconfirm today that we stick to our mid-term guidance of a sales CAGR of 5%-7% and an EBIT margin target of 15% by 2022. Clearly, for the months and quarters to come, we are expecting an acceleration especially coming from the online concession part of our business. This will be one major driver. The second major driver will be our store optimization initiatives as we are heavily investing into our store network. You will see positive effects coming from the modernization of our store network, right-sizings and making the whole network even more efficient. We are progressing according to our plan and I can therefore clearly confirm our mid-term guidance.

Secondly, on gross margin. We are guiding gross margin to increase by up to 50 basis points in FY/19. So this means up to 50 basis points, with the major driver being Q3. It will be more Q3-loaded than Q4-loaded, in particular, as the inventory valuation effect is expected to reverse in Q3.

Thirdly, regarding our online concession business, which is progressing very well: already today, the online concession part accounts for more than 20% of our online business. We are well on track and are performing better than initially expected.

Elena Mariani (Morgan Stanley): One small follow-up, please, on the benefits we're going to see from the online conversions: is it fair to assume that they will then annualize in the third quarter of next year, so you're going to have a tailwind also in the first half of 2020?

Yves Müller (CFO): Yes, that’s true.