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Q3 2024 Estee Lauder Companies Inc Earnings Call

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PRESENTATION

Operator
Good day, everyone, and welcome to the Estee Lauder Companies' Fiscal 2024 Third Quarter Conference Call. Today's call is being recorded and webcast.

(Operator Instructions)

For opening remarks and introductions, I'd like to turn the call over to Senior Vice President of Investor Relations, Ms. Rainey Mancini. Ma'am, you may begin.

Laraine A. Mancini ***The Estée Lauder Companies Inc. - SVP of IR***
Hello. 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 results today contain forward-looking statements, let me refer you to our press release and our 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.

Unless otherwise stated, all organic net sales growth also excludes the noncomparable impacts of acquisitions, divestitures, brand closures and the impact of foreign currency translation. You can find reconciliations between GAAP and non-GAAP measures in our press release and on the Investors section of our website. As a reminder, reference to online sales include sales that we make directly to our consumers, through our brand.com sites and through third-party platforms. It also includes estimated sales of our products through our retailers' websites.

(Operator Instructions)

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

Fabrizio Freda ***The Estée Lauder Companies Inc. - President, CEO & Director***
Thank you, Rainey, and hello to everyone. We are pleased to be with you today to review our third quarter results and discuss our strategic initiatives. For the third quarter, we delivered organic sales growth of 6% at the high end of our outlook, exceeded expectations for profitability and continued to significantly improve working capital.

We achieved stronger-than-anticipated performance beginning with gross margin. Results benefited from a greater-than-expected mix of skin care. Moreover, we made great strides in reducing the pressure on excess and obsolescence, driven by our now lower inventory levels and in realizing strategic pricing.

Further contributing to the outperformance, we manage expenses with discipline across multiple areas of the business and have shifted certain advertising spending to the fourth quarter to support our rich innovation pipeline and expanded consumer reach.

Encouragingly, with our third quarter results and fourth quarter outlook, we are confident that the second half of fiscal year 2024 will indeed prove to be an inflection point for the company, representing a renewed sales and profit growth trajectory.

First, momentum in organic sales growth is primed to accelerate in the fourth quarter for a strong second half. Second, we continue to expect operating margin in the second half of fiscal year 2024 to be higher than the first half and to expand from the year ago period.

Third, with a profit recovery plan designed to deliver $1.1 billion to $1.4 billion of incremental operating profit in fiscal year 2025 and 2026, we are well positioned to rebuild our profitability. And with the profit recovery plan also expected to generate savings to reinvest in our brands and consumer-facing initiatives.

We are well positioned to accelerate sustainable sales and profit growth as a faster and leaner organization with stronger leverage from our future growth. During the third quarter, we accomplished much to solidify the inflection point of the second half.

Indeed, we made progress in achieving targeted trade inventory levels in Asia travel retail. We are encouraged by the evolution of our Asia travel retail business this fiscal year as we execute our priority to reduce trade inventory in alignment with retailers and effort by various local authorities to contain a structured market activity.

And retail sales growth in Asia travel retail significantly improved sequentially, returning to growth in the third quarter. This improving retail sales trend in Asia travel retail complemented double-digit retail sales

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growth we continue to see in EMEA and the Americas travel retail.

So far this fiscal year, we also invested in the long-term growth opportunities of traveling consumers, evidenced by our brands having moved within Hainan Sanya International Duty Free Shopping Complex, to the Galleria's new Global Beauty Plaza.

The larger elegant new stores expands upon the high-touch services and experiences that we offered at the previous locations in the complex from Estée Lauder Re-Nutriv new Skin Longevity Institute to La Mer cabin offering bespoke Spa services and KILIAN PARIS juice and cocktail bar featuring fragrance inspire cocktails.

We also made great progress in advancing strategic initiatives and launching exciting innovation to fuel North America, reaccelerate growth in Mainland China and drive momentum in markets that are strong across developed and emerging markets in Asia Pacific, EMEA and Latin America.

Let me begin with Clinique, where we had a robust quarter of progress as the brands double down on its authentic dermatologists brand heritage. Clinique deepened its relationship with the medical community, returning to the American Academy of Dermatology Annual Meeting with high impact engagements. The brand also established the Clinique dermatologist creator council, a collection of doctors who are amplifying the sharing of science and dermatological insights on their own social channels as well as informing Clinique narrative on its social platforms. Impressively, Clinique influence earned media value for skin care in the U.S. showed 80% during the quarter, leaping 33 spots in rank.

We believe this is just the beginning of the success Clinique will realized by communicating its dermatological education and clinically proven solution for skin care to make up. Moreover, having started with Clinique in March, we are thrilled to be strategically expanding our consumer reach in the U.S. as a select few brands will open dedicated storefronts in Amazon's fast-growing premium beauty store over the coming months.

Clinique's launched capitalized on its renewed dermatologists-guided branding with striking creative assets and elevated storytelling. Impressively, Clinique store has exceeded our retail sales expectations so far and already contributed in March to the brand's share gains in U.S. prestige skin care biggest subcategory of moisturizers among others, as well as in U.S. prestige makeup.

We also successfully accelerated our innovation in the quarter. For the Estée Lauder brand, we brought to market breakthrough innovation across franchises. For its luxury Re-Nutriv franchise, the brand was inspired by its over 15 years of skin longevity research with its new Ultimate Diamond Transformative Brilliance Soft Crème and serum cream foundation. The impact of these launches is powerful, beyond contributing to the brand growth, they firmly established Re-Nutriv as a leader in the science of skin longevity, a visible age reversal.

For Estée Lauder Supreme franchise, the brand leveraged its decades of night repair expertise and

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collagen research with the new revitalizing Supreme night bounce creme first launched to great reviews in Asia Pacific and expanding globally in the coming months. We believe this launch holds great promise serving to strengthen the brand leadership in night-time science and skin care across subcategories.

La Mer extended its winning streak of innovation with the Moisturizing Fresh Cream, which along with its Icon hero products drove the brand to be the strongest contribution to the company growth for the quarter. Beyond these strategic innovations and go-to-market activations across active derma, longevity, night skin care, M·A·C introduced newness in makeup to jump start our rich innovation pipeline in the category for the second half.

M·A·C launched M·A·Cximal silky matte lipstick to greater claim, successfully modernizing its Icon M·A·C lipstick with nourishing ingredients and bolder packaging. From Seoul to Berlin to New York City, M·A·Cximal pop up events drove strong engagement and earned media value.

M·A·C remastered studio fixed fluid foundation came to market in April delivering a new soft matte finish enhanced with new skincare ingredients at even more shades. This high sought innovation and its icon prove the enduring love of M·A·C with consumers and makeup artists alike as the brand celebrates its 40 years in 2024.

Looking at fragrances. Over the last couple of months, we have expanded our consumer reach in the high-potential Asia Pacific region, opening spectacular flagship stores for Jo Malone London and Le Labo each unique with locally relevant features. And we are incredibly excited for the evolution in luxury and artisanal fragrances as together with Valmont we introduced Valmont Beauty this September.

Across our brands and around the world, we are focused on leveraging technology, including AI in support of our enduring strengths and high-touch experiences and high-quality products. We continue to partner with leading technology companies from Microsoft with whom we are collaborating to embed AI to drive faster speed to market and local relevance to Google Cloud as we strive to enhance customized targeting of media at scale.

Turning to the regions. We have spoken about our focus on driving the momentum in markets which are strong. To that end, we have delivered terrific results across many markets, reflecting the desirability of our brands, a compelling innovation, which I described and strong go-to-market execution.

We see this across our developed and emerging markets around the world. Beginning in Asia Pacific, Hong Kong, SAR, Japan have prospered, up double-digit organically in the quarter and year-to-date and we are excited about what's to come, including the launch of The Ordinary in Japan during the fourth quarter.

Moving to EMEA. Germany and Italy have consistently contributed to growth in the markets of the region each quarter. Mexico, Brazil and India strong double-digit growth in the third quarter, fueled excellent performance in our emerging markets year-to-date. For North America, we delivered

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sequentially improved organic sales trends in the third quarter driven by the multi-facet strategic plan we first discussed with you in August. We are pleased with the results we are seeing in our areas of strategic focus.

Skin Care grew organically in North America for the third consecutive quarter driven by Estée Lauder and The Ordinary as hero products, innovation and go-to-market activation excelled. Our luxury and [artisanal] fragrances rose double digits organically one more fueled by Jo Malone London, KILIAN PARIS and Tom Ford. Across our brand portfolio in North America, we are realizing success as we focus on deepening consumer engagement on social platforms where so much discovery in beauty take place.

The Ordinary has long been a pioneer with an outstanding social engine and more of our brands have enhanced their engagement with consumers this year. We are also successfully expanding our consumer reach to better serve new consumers from Clinique's new storefront in the U.S. Amazon Premium Beauty store to expansions early this fiscal year as the Estée Lauder brand entered into more Ulta Beauty stores and KILIAN PARIS entered into additional Sephora stores. For Clinique as the #1 dermatology beauty brand in the U.S. Prestige, we are optimistic for the positive impact its launch on the U.S. Amazon Premium Beauty store will have for the fourth quarter in the initial performance in March.

For Mainland China, we returned to organic sales growth, albeit at a slower pace than expected amid an overall soft prestige beauty industry. Retail sales for prestige beauty were strong in January, but moderated in February and March, due in part to the Chinese New Year coinciding with Valentine Day this year, which limited gifting. This certainly impacted the industry but also many of our brands, which have a strong presence in gifting.

Our focus remains bringing irresistible newness to consumers to best create growth opportunities. Here, our innovation in Estée Lauder Re-Nutriv and Supreme franchise as well as a La Mer and M·A·C were well received across the third quarter, and we have more compelling launches in the fourth quarter.

One in particular from Estée Lauder Perfectionist Pro franchise is especially exciting as it is among the first product created in our China innovation labs and addresses local demand for SPF 50 plus UV protection that is suitable for sensitive and post [derm] procedures skin.

With a 4 quarter innovation pipeline is standing upon the innovation launch throughout the third quarter, and the key shopping moments of 618 are coming, we are increasing our investment in advertising, a go-to-market activation to sustain retail. Since we spoke with you in February, we also made important progress in all work streams across the pillar of the profit recovery plan, of which I'm pleased to share a few examples with you today.

For one, our integrated business planning process, which has now rolled out globally, is contributing to operational inventory improvements. Our enterprise-wide integrated business planning will serve as the foundation to drive better demand planning and reduce excess enable obsolescence.

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It is complemented by advanced planning technologies, including AI, to statistically elevate forecast accuracy, a dynamically positioned and deploy inventories. We have refined and optimized our innovation pipeline for fiscal year 2025 and '26 to best focus on accretive innovation, bringing to market products that both creates and drive trends locally and globally across categories. Innovation in fiscal year 2025 is still expected to be even bigger and stronger than in fiscal year 2024 with more breakthrough innovation and expansion into white space opportunities.

We also announced plans to streamline manufacturing and distribution on a campus through realigning ship schedules, consolidating operations into fewer buildings and shifting powder manufacturing to a trusted third-party partners. This strategic initiative accomplished multiple objectives. As in addition to consolidating capacity and optimizing costs, we also expect greater speed to market by leveraging more external innovation with a global leader in powder.

Before I close, I want to speak to the exciting milestones in our brand portfolio during the fourth quarter. First, a few days ago marked the 1-year anniversary of our Tom Ford acquisition, this transformational deal where we evolved from licensees of Tom Ford Beauty to the owner and licensor of Tom Ford solidified a coveted brand in the company luxury portfolio for the long term and created a new royalty revenue stream.

Moreover, it afforded us strategic synergies which we are now unlocking demonstrated by the recent launch of brand.com in the U.S. and U.K. as just 1 example. And with the Ermenegildo Zegna Group and Marcolin, we are capitalizing on the power of the brand modern luxury glimmer across fashion, eye-wear and beauty, connecting these 3 verticals in compelling new ways to drive growth.

Indeed, in February for Fashion Weeks from Milan to London, Paris and New York, we orchestrated the first-ever 360-degree cross-category campaign and featured a Blockbuster fragrance launch. Later this month, we are thrilled to be further solidifying our brand portfolio in yet another way as we acquired the remaining interest in DECIEM completing the deal we made 3 years ago when we became majority owner.

During these 3 years, DECIEM and its beloved brands, The Ordinary have strode to new heights, ranking top 5 in prestige skin care in many markets, including top 2 in its home markets of Canada and the U.S. Together, we have successfully invested to scale innovation for The Ordinary and have increased The Ordinary innovation as a percentage of sales from 5% to over 25% expected this fiscal year, expanded the brand globally from India to the Middle East to South Africa and improved its profitability by driving operational efficiencies in the supply chain.

With that said, we believe The Ordinary and DECIEM still have bigger opportunities in front of them, and we are excited for what the future holds. Finally, we are pleased to see our initiatives and progress in sustainability recognized. And since we spoke with you in February, we were included in the CDP's Climate A list for 2023.

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Overall, we received our best-ever collective scores in 2023 from CDP as along with these excellent climate results, we scored A- in each of the water security, forest timbers and forest palm oil.

In closing, we are at an inflection point in our company performance, primed for a strong second half of organic sales growth and improved profitability. And with our profit recovery plan, we are well positioned to meaningful rebuild our profitability in fiscal year 2025 and '26 while also generating savings to reinvest in our brands and consumer-facing initiatives.

We are confident in our strategy to realize the promising growth opportunities of global prestige beauty, leveraging the strengths of our diversified brand portfolio rich innovation pipeline and the superior quality of our products. I extend my gratitude to our employees for the significant contribution you have made in bringing us to this inflection point of a renewed sales and profit growth trajectory.

I will now turn the call over to Tracey.

Tracey Thomas Travis ***The Estée Lauder Companies Inc. - Executive VP & CFO***
Thank you, Fabrizio, and hello, everyone.

Our third quarter organic net sales increased 6% at the higher end of our expectations. As Fabrizio mentioned, we are pleased with the progress we've made thus far in Asia travel retail with reducing retailer inventory and the corresponding return to net sales growth. These achievements in the quarter were a bit earlier than expected and led to a partial shift in the expected timing of the resumption of replenishment orders from the fourth quarter to the third. Partially offsetting this growth was lower-than-expected net sales in Mainland China, reflecting the impact of ongoing softness in overall prestige beauty, in part due to subdued consumer confidence and softness during holiday and key shopping moments.

Our earnings per share of $0.97 exceeded our outlook for the quarter due to the acceleration of skin care, the return to net sales growth in our Asia travel retail business, tighter expense management and a lower tax rate. The reduction in our tax rate was largely driven by the shift in our geographical mix of business. Regarding our regions, organic net sales in our Europe, the Middle East and Africa region increased 12% driven largely by the growth in our Travel retail business.

Our Travel retail net sales increased strong double digits returning to growth after 7 consecutive quarters of decline, given the sequential acceleration of retail sales and shipments as well as the anniversary of lower shipments last year, which were pressured by transitory headwinds in Hainan in Korea as well as limited international flights, visas and group tours from China to other markets last year.

Elsewhere in EMEA, organic net sales in our priority emerging markets increased strong double digits where we drove growth from most brands and in most channels of distribution, given our strategic initiative to expand consumer reach, in particular, for our fragrance and skincare brands. Our results in mature markets were mixed, resulting in overall flat growth.

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Organic net sales in our Asia Pacific region increased 3% led by Hong Kong SAR, Mainland China and Japan, reflecting mid-single-digit net sales growth in skin care and high single-digit growth in fragrance. Organic net sales in the Americas increased 1% largely due to Latin America, where continued growth in Mexico and Brazil led by makeup, drove double-digit increases in department stores and freestanding stores.

Organic net sales in North America were flat in the quarter as growth in fragrance and skin care was offset by declines in makeup and hair care. The double-digit growth in specialty multi, driven by Estée Lauder and M·A·C was offset by softer performance in department stores and direct-to-consumer channels.

From a category standpoint, organic net sales in skin care rose 9% largely driven by our Asia travel retail business as well as from Hong Kong SAR and Mainland China. Organic net sales from La Mer and Estée Lauder propelled the category's growth led by strong campaigns behind our hero product franchises with new product innovation and increased in-store activations.

Organic net sales in makeup increased 4% largely driven by our Asia travel retail business and by Latin America. Net sales from Estée Lauder and Clinique led the category's growth fueled by ongoing activations behind our hero product franchises. This was partially offset by a prior year benefit from changes made to M·A·C's take-back loyalty program. Excluding the impact from the prior year benefit, M·A·C net sales increased mid-single digits with growth across all regions, mainly driven by new product innovation.

Organic net sales in fragrance increased 1% and in hair care declined 4%. In fragrance, net sales growth was driven by our luxury and artisanal brands led by Jo Malone London and Le Labo. Jo Malone London grew double digits in Travel retail and specialty multi. Le Labo saw double-digit growth in our direct-to-consumer channels, particularly in freestanding stores, driven by both same-store growth and targeted expanded consumer reach.

Partially offsetting these increases was a decline from Estée Lauder due to retail softness during holiday and key shopping moments. Our gross margin increased 280 basis points compared to last year. This reflects positive impacts from changes in category mix driven by the acceleration of skin care, lower obsolescence charges given the reduction in excess inventory compared to last year and stronger strategic price realization through lower levels of promotion.

These improvements were partially offset as expected by the impact of the previous pull down of production that triggered a requirement to recognize the related manufacturing costs in the current period instead of when products are sold. This resulted in a 215 basis point headwind to gross margin.

Foreign currency also pressured gross margin in the quarter. Operating expenses decreased 290 basis points as a percent of sales during the quarter, driven by the sales growth leverage and expense

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management, including advertising and promotional expense, which decreased approximately 240 basis points compared to last year.

This reduction reflects the anticipated shift in certain spending from the third quarter to the fourth to support innovation launches in key holiday moments in the fourth quarter.

Operating income increased 75% to $554 million, and our operating margin expanded 570 basis points to 14.1% compared to 8.4% last year. Our effective tax rate for the quarter was 30.5% compared to the elevated rate of 43.1% last year. The decrease in the effective tax rate was primarily driven by a lower effective tax rate on our foreign operations, due to the difference in timing of the estimated change in our full year geographical mix of earnings in the current and prior year periods. This was partially offset by the unfavorable impact associated with previously issued stock-based compensation.

Diluted EPS was $0.97 compared to $0.47 last year, largely due to the increase in sales, improvement in gross profit margin and a lower tax rate. The impact from the business disruptions in Israel and other parts of the Middle East was $0.01 dilutive to EPS in the quarter. The acquisition of the Tom Ford brand was neutral to EPS as interest expense related to our debt financing was offset by the combined benefits derived as the licensor of the brand from royalty revenue this year and savings from no longer having to pay royalties on the beauty business.

For the 9 months, we generated $1.5 billion in net cash flows from operating activities compared to $1 billion last year. The increase from last year reflects lower working capital, which was largely due to the actions we have taken to reduce in-house inventory levels, primarily finished goods and semi-finished goods that resulted in a significant improvement in our days to sell.

We invested $702 million in capital expenditures, and we returned $710 million in cash to stockholders through dividends. As Fabrizio mentioned, our plans under the profit recovery plan are progressing and are on track. This quarter, we began taking charges under the restructuring program and expect approval to accelerate in the fourth quarter of this year and throughout fiscal 2025 with meaningful benefits beginning to flow into our fiscal year 2025 results.

Turning now to our outlook for the remainder of fiscal 2024. We are pleased with our progress thus far in reducing inventory levels resuming replenishment shipments in Asia travel retail, accelerating innovation and selectively expanding our consumer reach. These efforts have led to sequential improvements in both net sales and operating margin from the first half of the year, culminating in our return to profitable net sales growth this quarter. With these results and our outlook for the fourth quarter, we continue to expect a stronger second half compared to last year, underscoring that we believe we are at a sales and profitability inflection point.

While we delivered on the high end of our third quarter expectations, we are lowering our fiscal '24 organic net sales outlook range to reflect continued risks from evolving macroeconomic volatility, including continued softness in Mainland China and geopolitical tensions in certain areas around the

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world.

In Asia travel retail, we are also mindful of potential short-term volatility in retail sales related to actions certain retailers are taking to increase their profitability. With the recalibration between our third and fourth quarters, we discussed earlier, we are maintaining our full year operating margin expectation and are increasing our EPS outlook slightly to reflect disciplined expense management year-to-date, somewhat offset by our plans to strategically invest in key areas of our business in the fourth quarter to continue to drive profitable growth and reflecting incremental headwinds from foreign currency translation.

The combination of our third quarter performance and outlook for the fourth quarter results in a strong second half compared to the first half with improvements in net sales and operating margin. Excluding the in-period charge we recognized in the third quarter, gross margin is also expected to improve in the second half. We believe our assumptions for the second half mark a meaningful turning point for the company, demonstrating the signs of our recovery and better position us along with our profit recovery plan initiatives to drive sales growth and profitability further in fiscal 2025 and beyond.

Using March 29 spot rates of 1.079 for the euro, 1.262 for the pound, 7.227 for the Chinese yuan and [13.50] for the Korean yuan, currency translation is anticipated to negatively impact reported sales and diluted EPS for both the fourth quarter and the full year.

We now expect organic net sales for our fourth quarter to increase 6% to 10% with increased consumer-facing investments, including shifts from the third quarter and aligned to support innovation in key shopping moments in the fourth quarter. This growth also reflects the anniversary of some business disruptions we experienced last year, primarily in Hainan.

In Mainland China, we expect the ongoing softness of overall prestige beauty to continue to pressure net sales. Currency translation is expected to be dilutive to reported net sales by 1 point. We expect fourth quarter adjusted EPS of $0.18 to $0.28, an increase of over 100%. Currency translation is expected to dilute EPS by $0.01 and potential risks of business disruptions in the Middle East are expected to be dilutive by $0.03. Adjusted EPS in constant currency is expected to range between $0.19 to $0.29.

For the full year, we expect organic net sales to range between a 1% to 2% decline. Currency translation is expected to be dilutive to reported net sales by 1 point. Our full year operating margin outlook remains unchanged and is expected to be between 9% and 9.5%, a contraction from 11.4% last year.

We continue to expect our full year effective tax rate to be approximately 35% compared to 26.5% last year. Diluted EPS is expected to range between $2.14 and $2.24 before restructuring and other charges. Currency translation and potential risks of business disruptions in Israel and other parts of the Middle East are expected to dilute earnings per share by $0.09 and $0.06, respectively. In constant currency, we expect EPS to decrease between 33% to 36%.

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Our fiscal 2024 outlook also assumes the purchase of the remaining outstanding equity interest in DECIEM anticipated to be completed in May of 2024. In closing, our expected second half results starting with our strong third quarter performance demonstrate our progressive return to sales growth and profitability. We have navigated through numerous challenges over this past year with resilience and determination to take meaningful actions to begin to improve the trajectory of our business.

Our results show we have made great strides, and we have immense gratitude for the resolve and hard work of our teams globally. And while we are pleased with our progress and results this quarter, we remain keenly aware of the additional work that lies ahead to continue down the path of restoring stronger profit margins. We are intensely focused on doing the necessary work to return to long-term sustainable growth and profitability, supported by the profit recovery plan initiatives and executed by our dedicated employees.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today comes from Bryan Spillane from Bank of America.

Bryan Douglass Spillane ***BofA Securities, Research Division - MD of Equity Research***

So Tracey, I just wanted to ask, I guess, a question about the 4Q guide and what's implied. So I guess the implied margin in 4Q steps down from 3Q, yet the revenue will be roughly the same. It just implies maybe there's not as much leverage. But so if you can just give us some perspective on the margin step down quarter-to-quarter. And then as we think about the run rate into '25, is there anything that we should read into the fourth quarter guide that would sort of inform exit rate for '24 into '25, both in terms of organic sales and margins.

Tracey Thomas Travis ***The Estée Lauder Companies Inc. - Executive VP & CFO***

Thanks, Bryan. When you think about the fourth quarter and what I said in my prepared remarks, I talked about some shifts that are occurring in the fourth quarter. So we did shift some advertising expense out of the third quarter and into the fourth quarter and that was to support some of the timing of the activity that we had in the fourth quarter, both innovation as well as some of the holidays in the fourth quarter.

I also talked about the fact that travel retail -- Asia travel retail, we resumed shipments earlier than what we had expected in the third quarter. So there are -- it's hard to look at Q3, Q4, you really need to look at the second half together because of some of those shifts.

What's impacting our fourth quarter performance is -- and the change in our guidance is softer growth of prestige beauty in Mainland China. The continued macro uncertainty that retailers are cautious in many

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markets have.

We also have higher currency than what we had expected. So that is pressuring our EPS a bit as well. But when you look at the second half compared to prior guidance, what you will see is some of the expense savings that we realized and that I again talked about in my prepared remarks, we are actually flowing through. So we are offsetting some of the currency downside that we had, and we're also offsetting some of the sales softness that is embedded in our updated guidance range.

Operator
Our next question comes from Olivia Tong from Raymond James.

Olivia Tong Cheang ***Raymond James & Associates, Inc., Research Division - MD & Research Analyst***
You mentioned several times that you've seen improvement towards targeted retail inventory levels in travel retail, but not quite there yet. So can you talk about exit rate on the quarter, more recent performance in Asia travel retail, particularly in Hainan and Korea, and then also China, both on and offline. And just what consumption looks like more recently, your views on the 618 festival upcoming. It sounds like you're going to spend a bit more money on that than you had previously anticipated and just your outlook there.

Fabrizio Freda ***The Estée Lauder Companies Inc. - President, CEO & Director***
So global travel retail return to growth also driven by, frankly, growth and retail growth across all the regions. So the first important point is retail sales growth. And this was very, very strong in EMEA, Americas, in many parts of APAC and was single digit in the China [TAR] part. But this is a very important progress versus the past. And this is for Estée Companies brands, is great news also for the future.

The second thing that we are seeing is a very robust traffic recovery across the travel retail channel, which is driving the sales to travelers there is work to be done still on conversion, which is the areas of improvement that we are still working on, but we had a lot of work and progress in this by activations and retail division, activating particularly in Hainan with a lot of activity, and this activation are working. And so we see progress also in this area.

And then as it was part of your question, because of all these elements, strong improvement in the inventories in our retailers and so reaching the targets in several retailers and in several SKUs ahead of our original communicated target.

So at the end, this created a very good growth, which is based on retail growth and sell into replenishment because of the decreased inventory levels versus the past. This combination is very solid. We expect this to continue and to progress in line with our goals.

Operator
Our next question comes from Lauren Lieberman from Barclays.

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Lauren Rae Lieberman ***Barclays Bank PLC, Research Division - MD & Senior Research Analyst***
I just had a question about spending levels. It was great. Tracey, thanks for being so specific on the advertising and the reinvestment this quarter and then shipped into 4Q. But if I remember in 3Q, there was also some timing shift on spend. So I wanted to talk a little bit about maybe the decision tree of like when to put that spending in?

Is it -- because if it's shifting, is it about pace of getting innovation ready and launched? Is it about the consumer environment, maybe avoid putting money in play that would be like pushing on a string if the consumer isn't there. But it does feel like some of those spending plans are shifting gently quarter-to-quarter. And so I was curious if you could just comment on that.

Tracey Thomas Travis ***The Estée Lauder Companies Inc. - Executive VP & CFO***
Yes. Well, you outlined a few of the reasons that we would make a decision to shift some of the spending. So one of the things that we saw early in the quarter, towards the middle of the quarter is that some of the holidays, particularly in China, were not performing as we had anticipated.

I think we mentioned in our prepared remarks, 2 holidays that are important for us, Chinese New Year and Valentine's Day. We're closer this year actually overlapped a bit than in prior years. Valentine's Day is actually a pretty strong gifting moment for us in China. Our team does a fantastic job of supporting Valentine's Day, both Chinese New Year and Valentine's Day are less promotional holidays than some of the other holidays.

But we didn't see the lift that we would normally see out of those holidays and trending into other holidays in the quarter, we made the decision -- or the China team made the decision that it was best to shift some of that advertising to the fourth quarter and support some of the holidays that are upcoming in May and then obviously the big 618 holiday in June.

So 1 of the things that we've talked about for a long time is the agility that we have created, particularly in our advertising spend that allows us to take some of those decisions so that we can better match our advertising spend and when we think consumers will be reacting and responding whether it's to our gifting programs or our innovation programs. So that is what you saw in, Lauren, in the Q3, Q4 shift.

Operator
Our next question comes from Dara Mohsenian from Morgan Stanley.

Dara Warren Mohsenian ***Morgan Stanley, Research Division - MD***
Tracey, I wanted to stick with that question, but perhaps look out more longer term. Obviously, you mentioned higher investment in fiscal Q4 and the shift from Q3 and also you had better-than-expected expense management in Q3. So can you just take a step back and discuss the pace of reinvestment you expect behind the business over the next few years? How much of that is captured in the difference between gross and net savings and the profit recovery program? and then how the pace of that reinvestment fits with the savings from the profit recovery program and how you think about the

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savings. So really, the cadence annually looking at reinvestment versus savings as you look out over the next few years. And how they interrelate with each other.

Tracey Thomas Travis ***The Estée Lauder Companies Inc. - Executive VP & CFO***
Great. No, thank you for the question. So yes, let me take the opportunity to talk as you asked about the profit recovery plan. We're always focused on profitable growth, let me start there. The actions that we're taking both within the profit recovery plan as well as outside of the profit recovery plan are focused on profitable growth.

The profit recovery plan is an accelerator of our growth, and in particular, an accelerator of our margins. And let me just try to simplify it a bit. I know we've said that we will share, which we will more with you in August once our plans are complete, and we provide guidance for the next year, but the profit recovery plan is, first and foremost, focused on restoration of our gross margin.

Now we're mindful of shifts in category mix and channel mix relative to history. Obviously, we had growth in fragrance in our artisanal and luxury fragrance portfolio, and that's very important. We're also focused on restoration of our makeup growth. But certainly, as you saw in this past quarter, we are also experiencing the acceleration of our very important skin care category, and we expect that, that will continue.

The biggest drain on our margin has been our gross margin. And it's in the aftermath of the pandemic. It has been the biggest focus of our recovery, and we are focused on price realization. Part of that will be driven by the actions that we are taking in terms of inventory management to control discounts in excess and obsolescence.

You saw a bit of the results of that in Q3. And you will see certainly more of that in fiscal '25. So that is a very big focus of our profit recovery plan, the focus on restoration of our gross margins. We're also focused on supply chain efficiencies that will help our gross margins and accretive innovation. And we talked about some of the processes in Fabrizio's prepared remarks that we are deploying and strengthening in order to be able to do that.

The second area of focus is greater leverage of our expense base. We have efforts in indirect procurement in terms of accelerating some of the savings there. And we have -- are taking some difficult decisions as it relates to rightsizing and streamlining parts of our organization, and that's the restructuring program that we spoke to you about before.

That is really -- the combination of that should drive the $1.1 billion to $1.4 billion of incremental operating profit over 2 years. And again, we said that slightly more of that will happen in fiscal '25 [then] in '26. And again, in terms of the mix of where that recovery is expected more in gross profit margin, but also in our operating expenses. But I want to take the opportunity to talk about a couple of other benefits as it relates to the profit recovery plan.

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So in addition to the margin recovery, the program is expected to fund additional investment to your point, for growth, namely in consumer activation, more consumer activation for our brand. So the expectation is we are going to save more than the $1.1 billion to $1.4 billion that we are committing to in terms of operating profit improvement in order to also increase some of our advertising spend, very targeted and selectively against the momentum that we see in our business.

And last but not least, we expect to streamline and reduce some of the complexity in the organization that is built up over time in our processes and that's expected to increase our speed, agility and effectiveness in our markets. And I know our organization, in particular, very much looks forward to this benefit. So it's a powerful program. I'm glad you asked about it. When we deliver on all elements of it, and we will share more in terms of helping with the modeling of it in August.

Operator

Our next question comes from Filippo Falorni from Citi.

Filippo Falorni ***Citigroup Inc., Research Division - VP & Equity Research Analyst***

I had a question on the Mainland China business. You clearly mentioned strong start in January, but then a deceleration. You mentioned that the exit rate has been soft in the country. So maybe you can comment particularly like what you've seen more recently from a category growth standpoint, promotional activity levels and maybe market share?

And then maybe longer term, if you take a step back, based on your analysis on the market, what do you think has been the main driver of the weakness? Is it mainly macro related? Is it more trade down in the category? Or are competitors doing better? Any sense of what the drivers of this slowdown are, will be helpful.

Tracey Thomas Travis ***The Estée Lauder Companies Inc. - Executive VP & CFO***

Yes, sure. On the -- in this moment, the slowdown, the softness is the overall prestige market. And that's what is softer than what we originally expected and that's what is stuck in Mainland China.

What I want to clarify is that we need to look at the -- we do look at the Chinese consumers in total and not only the segmentation the market does. So there is a mainland China's consumers, there is Hong Kong SAR. There is the [TAR] China, which includes Hainan, for example, in other parts and there are the international traveling consumers, the people which for tourism or business travel from China to Tokyo, Paris, et cetera.

So we see actually progress in the total Chinese consumer consumption on our brands, and they are very solid. And when you took Mainland plus the progress in Hong Kong SAR plus the TAR China retail progress that I was speaking about in the previous question, plus the success we see of our brands internationally, the Chinese travelers now are growing more, for example, in Japan, for example, in Paris.

And so when you put all these numbers and frankly, they are all solid numbers except the international

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travelers in other cities, which is an estimate in our model, but we see clear progress and there is progress between quarter 2 and quarter 3 despite the softness in Mainland, and there is actually their turn positive, very interestingly positive in quarter 4 estimates for the future.

So the trends are also depend by channel. And the drivers, first of all, at different consumers, the consumers that travel both for vacation and internationally tend to have [beat] the high end. In this moment, the softness is more in the middle -- in the consumer sentiment of the middle class.

We tend to be shopping more in Mainland and these channels follow different trends and different -- depending on the moment, depending on the situation, but the equities of the brands are strong, as seen by the overall progress, particularly certain brands which are doing -- growing in the total already as we speak and continue to accelerate in our portfolio. And the future of the -- this is positive.

There is a sense of recovery in the overall consumption, although via channel, there are different percentages, different evolution, and this can be different also by quarter, by semester, depending on the various trends that happen. So we look internally to the Chinese consumer as a whole and not only to the various parts.

Then your question was what have been the key drivers behind this. Now one of the key drivers, obviously, is the skin care trends, and the fact that in the post-COVID, the consumers have been having -- are having a period where they're focusing more on experiences -- on overall experiences a consumption, spending in their portfolio on overall experience like travel, like other categories or like restaurants or like things like that.

So this will evolve, it's evolving in every single market after COVID and become more balanced over time. That's our experience, and that's visible already. So that's one of the drivers. It's the consumer priority by category and experiences versus goods.

The second thing is the -- we are accelerating innovation in a big way. We have invested in a R&D center in China. We see the results of this innovation, but with the first innovation coming from the R&D center will be in quarter 4, and we will see the impact of it, which is very dedicated to specific Chinese consumers, so part of the drivers has been the amount of innovation and the quality of innovation that can be deployed for quality, I mean also local relevancy of the innovation and this is an improving trend.

It is already enforcement trend, which gives very, very solid indications for the future. So the other driver has been promotionality. The market has been during COVID promotional, but in this moment, all the activities that the governments have decided to do on the structured market is reducing the level of structured market, also the price increases that many of the retailers are taking also in travel retail are in the short term are impacting the consumption, particularly the middle class level in Mainland.

But on the contrary, in the long term will further balance the proportion between a structure and structured market, which is obviously in line with our goals and is the objective. So it's a positive long-

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term trend, which is happening. So -- but the market will remain promotional. And so that's why we have the activation of promotionality, particularly in the area of sampling, gifting to the points that Tracey was making before, is on a decrease and the level of discounts is on a decrease trend and that's the change in the proportionality model.

But all in all, I just want to make sure that we understand that despite the short-term softness of the market in Mainland China, the overall trend of Chinese consumers is positive and this trend is expected to accelerate in the future.

Operator
Our next question comes from Steve Powers from Deutsche.

Stephen Robert R. Powers ***Deutsche Bank AG, Research Division - Research Analyst***
So I wanted to clarify, I think Olivia had asked about it, but on the trade inventory in China, it sounds like on certain SKUs, certain parts of the portfolio, you're ahead of schedule and clearing that inventory backlog. But the total portfolio seems like it didn't quite hit that April 1 target you had. So is that the right read?

And just your confidence in being able to ship to consumption across the total portfolio in the fourth quarter? Is that intact? Or is that part of the lower sort of organic outlook for the fourth quarter versus what was implied back in December. The second question that I really want to -- sorry, go ahead, Tracey. And I can follow up if that's okay.

Tracey Thomas Travis ***The Estée Lauder Companies Inc. - Executive VP & CFO***
No, no, go ahead with your second question, Steve.

Stephen Robert R. Powers ***Deutsche Bank AG, Research Division - Research Analyst***
Well, that was a clarification. So I wanted to pivot actually to Clinique on Amazon. Historically, you've cited for a long time, hurdles launching on that platform that were at least to me, a combination of questions around achievable unit economics on that platform, the brand experience for consumers and being able to curate that effectively. And then just your own sort of visibility into the required consumer insights. So just to the extent that that's correct, how did you overcome those hurdles and get to a point where Clinique on Amazon in your mind is the right time for that?

Tracey Thomas Travis ***The Estée Lauder Companies Inc. - Executive VP & CFO***
Okay, Steve. So I'll take the first part of that question on the inventory in Asia travel retail and Fabrizio will take the Amazon-Clinique follow-up question. Regarding our -- the inventory in trade in Asia travel retail, we did reach the objectives that we had in the third quarter actually before April. And so the reason that we ended up shifting a bit more from a -- or doing a bit more from a replenishment standpoint in the third quarter is because we actually reached those levels a bit earlier than what we had anticipated.

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We anticipate reaching them by April, which is the beginning of the fourth quarter, obviously and we reached them within the third quarter. So that is the reason why some of the shipments were a bit higher in the third quarter, and we will expect the retail sell-through in the fourth quarter. And so -- and as Fabrizio mentioned, we are expecting as well an acceleration of retail in the fourth quarter.

Just remember for the cadence of what we're anniversary-ing, we actually had some disruption even in the fourth quarter as it related to Hainan last year. So we are going to see a bit of a disconnect between retail and net for a couple of quarters because of the significance of the interruptions that we had both at the beginning of the third quarter last year and the end of the fourth quarter last year as well. And so we would expect that net will, as we replenish relative to the comparison year-over-year to last year, then that would be ahead of retail, but we will be maintaining the inventory levels in the range that we and our retailers have agreed to.

Fabrizio Freda ***The Estée Lauder Companies Inc. - President, CEO & Director***
Yes. And on Clinique on Amazon, I want to say, one of the important progress we are making on Clinique is the initiative of building on Clinique heritage in active derma and relaunch the brands in North America and U.K. in this moment and globally soon on this overall platform.

The Amazon introduction in the U.S. is also right for Clinique in the context of this big relaunch because a lot of new consumers that are very high consumers of active derma are also in this chart. Amazon provides expanded consumer reach, a lot of new consumers, we expect to recruit to engage and to educate new consumer by this new channel.

Amazon, in this moment, is a fast-growing online platform in the U.S. and their Premium Beauty Store has been clearly a contributor to the overall market growth and particularly has been an important brand discovery for some consumers and also consumers are new consumers to Clinique.

And so the early results are very promising. And the first period has been extraordinarily positive, frankly and we have expectation that this will continue and will accelerate over time. So part of your question, why was the right moment now, I think because now the model of Amazon has evolved in a situation where there is a better fit between the Clinique brands and the Amazon model and the opportunity to communicate the heritage, the equity, the education and the various ideas behind the science of active derma of Clinique is now there.

And so we believe the brand can express its fundamentals correctly on the platform and the work that the Clinique team has done in providing amazing asset quality of execution to achieve a very good quality expression of the brand on the platform also reassured us that is the right moment and is a very good fit. And as I said, initial results are confirming that.

Operator
And our next question comes from Andrea Teixeira from JPMorgan.

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Andrea Faria Teixeira ***JPMorgan Chase & Co, Research Division - MD***
I have a question for Fabrizio and then one clarification for Tracey. Fabrizio, I have a question on the U.S. sales. If you're seeing any acceleration in shipments as you exit the quarter, it seems that the third quarter was still negative, excluding the strength in Brazil and Mexico. So I wonder if you can comment on how this innovation that you're putting and more money behind M·A·C and Clinique has been handing out as you exit the quarter? And also a clarification for Tracey. I appreciate all the details of the profit recovery into fiscal '25.

By my math, roughly the $700 million operating profit benefit at the midpoint. Should we be thinking of this benefit being mostly spread with seasonality and excluding the shorter quarters or mostly back half weighted as you do this plan.

Tracey Thomas Travis ***The Estée Lauder Companies Inc. - Executive VP & CFO***
So I'll take your last part of the question first. We'll give more guidance on the calendarization of the profit recovery plan in August. We're still -- we're well into the finalization of some of those plans and making -- taking some decisions within the next couple of months. So we'll be able to provide you with much better guidance on calendarization in the August time frame.

Fabrizio Freda ***The Estée Lauder Companies Inc. - President, CEO & Director***
Yes. On the U.S., no, I think -- actually, U.S. in quarter 3 has been growing low single -- sorry, North America in quarter 3 is growing low single digit. And if you exclude the M·A·C loyalty program, actually it's getting closer to mid-single digits. So is -- there is growth in North America in said this, there is softness in consumer sentiment in this moment, also the -- and the market growth is moderating in North America. So obviously, there is pressure in -- particularly in certain channels.

There is pressure, but the quarter 3 was in the right direction and it was in line with our goals. And for us, the positive is that we had, for example, a positive impact on Clinique on the part of March. And in this part of March, already, we saw the impact of that positive impact of that. If we -- you can assume that we will have in the full quarter for the impact of Clinique on Amazon, this, for example, will be a positive element in the mix. We assure that.

Operator
And ladies and gentlemen, this will conclude today's question-and-answer session. If you were unable to join for the entire call, playback will be available at 01:00 p.m. Eastern Time today through May 15. To hear a recording of the call, please dial (877) 344-7529 using passcode 5758677. 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. You may now disconnect your lines.

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