Ulta Beauty Inc. (ULTA) Management Presents at Wells Fargo Consumer Conference & Beauty Forum Conference (Transcript)

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Ulta Beauty Inc. (NASDAQ:ULTA) Wells Fargo Consumer Conference & Beauty Forum Conference September 26, 2019 4:40 PM ET

Company Participants

David Kimbell - President and Chief Merchandising & Marketing Officer

Scott Settersten - CFO, Treasurer & Assistant Secretary

Conference Call Participants

Irwin Boruchow - Wells Fargo

Irwin Boruchow

So thanks, everyone, for coming. So Wells Fargo Consumer Conference here in lovely Laguna. I'm Ike Boruchow, retail analyst at Wells. Really happy to have Ulta Beauty with us. I've covered this company since IPO. CFO, Scott Settersten; Dave Kimbell, Chief Merchandising Officer, thanks so much. So makeup is very topical right now. I'll jump right into it.

Question-and-Answer Session

Q - Irwin Boruchow

Cosmetics in the U.S. has been soft for a while now. I think you guys have - even when your comps were high single digits, you were calling out softness that began in 2017.

I guess you've been able to buck that trend for a long time, but now we've seen you lower guidance last quarter for the rest of 2019. You called that deteriorating trend in prestige cosmetics. So I guess what exactly are you seeing recently that's kind of altered the view of the category is the first question I'd like to start off with.

David Kimbell

Great. Great. Well, I'll dive in. First of all, Ike, thanks for having us. Beautiful spot here. Not a bad place to spend the day, so thanks for having us today.

The - yeah, on makeup category, I guess, first, what I'd just start with is despite some of the short-term challenges that we've been describing, we remain very positive and optimistic about the overall Ulta Beauty business model. The things that have been driving our success really in many ways from the launch of the company almost 30 years ago.

And certainly, over the last 5 or 6 years, we feel very, very confident about. We continue to attract at a high rate new members into our loyalty program. Our loyalty program is vibrant. Retention is strong. So we're 33 million members strong and growing at a high clip. Our brand awareness has grown quite a bit and now is a leader in the marketplace. We're gaining share in every category in which we compete. The non-makeup categories, skincare, haircare, fragrance, bath are all showing very strong, very healthy gains.

Our salon business is strong. So overall, we feel really positive about the Ulta Beauty model. And in makeups, specifically where we have experienced some challenges, we continue to gain share in both mass and prestige.

Our business model is unique because we are the only ones that offer products across all price ranges, all categories. So all things beauty all in one place is what we call it. And so we compete very heavily in both mass and prestige, and we're gaining shares -- gaining share in both sides of the business.

What we’re seeing more -- most recently in 2019 is not -- obviously not what we had expected or anticipated, hence the change in outlook for the second half of this year. And so what we've experienced is, as you said, Ike, there's been parts of the business, parts of the category, total category, not just Ulta, that have been slowing on our prestige side, in particular, but also some pockets in mass. We’d seen some slowdown, but it had been more isolated, isolated to specific aspects of the category or specific brands.

And we had said before where we were seeing challenges with at one point, challenges in the marketplace with a handful of our largest brands. What's different now and what's happened this year is the dynamics that have been driving so much growth, collective growth across the category.

Things like new behaviors, contouring, highlighting, strobing, new product categories like palettes or liquid lip or brows. We're still driving some incrementality even as late as probably last year, 2018.

And they're still big and important, but those drivers had slowed in their incremental growth in the category, and there has not been something to replace that. There hasn't been incremental innovation in the category in the near term.

And while makeup isn’t solely driven by newness of all the beauty categories, we see it the most influenced by newness and innovation because of the trend and fashion component to makeups. So we're seeing innovation having less of an impact. Innovation collectively across the industry is down this year.

That has brought down the total beauty market, mass and prestige so has actually gone from a slowing rate, which we saw from very strong growth in, say, 2016 to still healthy positive in ‘17 in some pockets of to now negative is our assessment of the total makeup market, mass, prestige, everywhere.

And so that, dynamic we think is innovation driven. And while we’re still gaining share, we would believe that we're doing probably the best in market based on the share gains that we're having because the total category has gone down even with our share gains. It's been below our expectations.

We had anticipated that the category would at least stabilize or perhaps even turn to a little stronger growth in the second half of the year. As we got further into the year, we recognized it doesn't appear like it's going to happen, and that's why we reset our expectations going forward.

Irwin Boruchow

So I guess a follow up to that, and then I'll - to Scott. So it just [indiscernible] I've covered you guys for a really long time. Never really seem - it seems so sudden what you talked about in the last earnings call about how this kind of happens.

So because of that, is this a trend? Or is this just maybe kind of a freak occurrence? Like how do you think about how long this headwind, whatever word you want to use, could potentially last?

Scott Settersten

Yeah. So going back to what Dave described, there's been kind of a long tail. This isn't something that just occurred. The lead, so to speak, leading the leads, this is something that's been developing over a longer period of time, which took a sudden turn, I guess, to the negative here in right at the end of the second quarter in late July and in early part of August as we're gathering our data points, looking at industry trends and putting our guidance together for discussions with the Board and the share with investors.

And so we, again, luckily for Ulta, there's lots of levers. There's lots of things we have to optimize our business whether it's doubling down on services, different promotional leverage that we have, whether it's more marketing things or loyalty things, we've been moving towards over a long period of time.

There is been assortment improvements we've had across our box. So we've had extensions of brands, like some of the great - our well-known department store, iconic brands that we've increased our distribution points within our network.

So there's been a lot of ways we've had to mitigate, some of the pain that we've been feeling from the weakening category, call it, cosmetics category here over the last couple of years.

So it just became more of an acceleration, I would say, as we got deeper into the year. And as we looked at the performance of some of the newness in the first half of the year, we just said, well, this is a point where we're kind of at a point in time where some of our mitigating strategies aren't going to be as effective in the second half.

And unfortunately, for us, I mean, prestige color is a very rich margin part of our business. And so without that and then the connectivity of the fashion element of that, the cosmetics part of our business and the traffic driving that it does to our stores. When you combine all that into an algorithm, you come up with an output that's not as optimistic or not in line with our expectations for the year.

So it was kind of a double edge sword, so to speak, in a lot of respects that just put us in a position where we had - it's the reality that we're faced with today. So it's better to, we think, give prudent guidance and alert the investing public on where we stay with things and what are outlook is.

Irwin Boruchow

And we know your - the comps guided to be slower, the categories been. How does market share look for you guys? Are you gaining - are you still gaining share? You're getting less share? Like how do we think about the share perspective of Ulta as its going on?

David Kimbell

Yes, we feel really good about the share that we're seeing across all categories. Makeup, as the category has slowed, we're still, like we said, we think the total category is negative now based on our assessment and valuation of both reported and unreported data of total makeup. We're still growing. Even though it's slowed, we're still growing. We're gaining a meaningful amount of share, and so we don't think that's kind of decelerated and our share growth.

And then across skincare, haircare, fragrance, bath, all those categories. Because again, our proposition -- our model even though, like you said, it felt abrupt on some of the changes around makeup, nothing fundamental has changed about Ulta and the proposition that we're delivering, and our guest is not - probably not as close to all of the dynamics.

He or she is just looking for a great experience, and we're still delivering that every day. And so our membership is growing. Our awareness is growing, and that's led to more market share gains across every category in which we're competing. And our focus is continuing to do that, deliver great experience.

What our guests tell us, and we have just really strong competitors, and we have a lot of respect for the competitive environment. But again, we're really unique in the beauty category because nobody delivers the type of experience. Nobody has the assortment that we have. So there's kind of all things beauty from all price points and all categories.

But perhaps even more important, what our guests tell us that they really like about Ulta is as the experience when they walk into one of our stores, they feel welcomed. They don't feel intimidated. They feel like they can discover on their own terms.

We've most recently been communicating our brand proposition in a campaign called The Possibilities Are Beautiful, and what that means is there is no standard definition of beauty. There is no one definition. Everybody expresses beauty in their own way, in their own terms.

And for us, we don't see ourselves as defining beauty. We see ourselves as being an environment that allows people to come in and discover and play and be helped when they want it but not feel intimidated or pressured if they don't want it.

And so people are still responding to that. That's allowing us to drive share gains, and we think that's going to continue even with a tough underlying trend on our largest category.

Irwin Boruchow

So we know, obviously, e-commerce continues to be a thing that we all need to keep an eye on. The consumer shift to DTC, and away from maybe some of the larger players in the space, could that be a contributor to the slowdown you're seeing? We've all seen these digitally native brands, the growth in online. Does that have something to do with potentially the slowdown?

David Kimbell

I'd say no. Both - certainly not at Ulta. And I'll tell you because I think we've been leaning into some of these brands. And I don't think so in the total category either. I think it's been a net positive because when you think of innovation, probably the most sustaining, most impactful innovation is true product-oriented innovation.

I've brought - I've created something new. I've invented a new formula or a new proposition, a new product oriented or I created a new behavior through that because that - those probably have the biggest impact.

But in our view that probably almost as important is brand and marketing innovation and what the -- what brands that have started on their own, independent brands that are creating, bringing new thinking and new creativity into both makeup and skincare and haircare and finding new ways to connect with brands are innovating often through product, for sure, but also through how they go to market and how they speak and communicate and connect with guest. And that's working, and that drives incrementality to the total category as well.

And so I think it's a net positive for the industry, but it also requires the big established brands to figure out how they want to innovate their own brand proposition. As much as they need to innovate their products, they also need to make sure their brand is staying relevant in the marketplace.

And some have done that very, very well and some have struggled with that. And so it just forces of those brands to be innovative across everything they do, but we're excited about it.

Scott Settersten

And I would just add, things that are within our sphere of control, we were doubling down on. So we've made investments. We've got a great e-commerce platform, right, that we continue to invest in to deliver best-in-class experience to our guests. Our business is growing at 20% to 30% this year, and it's still on target with what we expected.

We extended our reach with things like buy online, pick up in store, ship home when we're not a stocking store, so just continuing again to invest and to leverage our strengths where we're able to.

Irwin Boruchow

So Scott, to kind of - let's go back to the guidance. So on the last call, you lowered comp guidance from 6 to 7 to 4 to 6. I guess as we're talking about this category and the category weakness, does this plan assume that the cosmetics business stays the same, gets worse, gets better or what's kind of embedded for that category in that comp?

Scott Settersten

So let me just echo what Dave said. The current environment, as tough as it might be here in the near term, doesn't give us any less confidence in how we see this business and our strengths over the longer term. So we're really going to adjust. We've got a little bit of a shock here with what's going on in the color business, and we're all hands on deck, so to speak, right now.

We’re looking at every element of our business on where we can right-size the expense structure to match what we're expecting to be a little growth environment here for the foreseeable future.

So the guidance itself, so the data points that we saw in July and early August, again, we updated our full year comp guidance to four to six. So a bit of a wider range than we had been using up to that point in time. And we - it was just realistic. So we're not planning the business for a four comp for the full year. That's not our expectation. But based on some of the data we saw, we felt that it was right to let folks know that if those trends continue, that could be a possible outcome.

So again, we're driving - we're not raising the white flag. We're driving the business every day to drive sales. That's the best way to deliver your numbers. We all know that internally at Ulta, and so that's what we're focused on, both in things that we directly control and in discussion with our vendor partners and influencing decisions on new product innovation and introductions and things like that. So we're planning to deliver as we always do, the best overall financial outcome that we can based on the sales trends that we recognize.

Irwin Boruchow

Got it. And then for holiday, last year, holiday I think you had a fantastic comp. You launched Kylie. I think every analyst wrote about it, tried to quantify it. But obviously, you had a great performance, a great quarter. You said - I believe you said that you expect Q4 comps should accelerate from Q3 this year.

So help me - help us kind of understand why on a tougher comp or the tougher environment that you see potential for comp acceleration to get to this year's holiday?

Scott Settersten

Yes. So there is just one very important word missing in that description, and I would say moderately accelerating in the fourth quarter. So it's really predicated on two things, pretty straightforward. So some of the newness that we feel best about that will resonate are not - some are in color cosmetics, but a lot of it is outside of color cosmetics that's coming in the third quarter.

So when I finish maybe Dave can touch on a couple of those that we feel very good about. So again those will be sequenced as we move through the third quarter, and so we'll get the full benefit of those in the fourth quarter.

And then the second piece of that is color cosmetics generally plays a little less of an important role during the holiday gift-giving season. So there, we - the marketplace and consumers are more focused on things like fragrance and gift sets and things like that. So again, the penetration is a little less during the fourth quarter, and so that'll help.

David Kimbell

And some of the innovation that Scott mentioned that is launching kind of as we speak, as Scott said, will have impact on Q3 that will be in, obviously, for all of Q4. So - but just this week we had three significant launches, all kind of different but all we think will drive incrementality.

So we launched with Millie Bobby Brown, the young 15 year old star of Stranger Things, a line called Florence that she's created. We've worked with her. It's exclusive at Ulta Beauty. It's a skin - a natural kind of clean, beauty, skin and color line, a mix. And so we just launched that on Sunday, and that's off to a good start, obviously, early.

Also this week, we launched a brand with Tracee Ellis Ross, called Pattern, which is a haircare line focused on people with curly, coily hair, so more textured hair. It's a growth area in the industry, and Tracee is seen as a real thought leader in that space. It's been a passion for her for a long time, and she's been very influential and so an exclusive launch in partnership with her.

And also this week, we mentioned Kylie coming in. We launched her largely Lit line last Q4. We just launched her skin business this week as well. In addition, we've got exclusive - and that's exclusive to Ulta beauty.

We also have exclusive fragrances. We've had one with Ariana Grande that launched earlier this quarter. The Thank U, Next line that's doing well, and then a Jennifer Lopez exclusive. So there's a lot of innovation that we believe collectively will have a positive impact.

Irwin Boruchow

Got it. And then so Dave, stick with you. Let's shift over to the environment. I mean we know deceleration, negative, so pricing and promotion, if can you talk about the channels kind of looking like? And then Scott, can you then kind of comment on what that means to Ulta, what gross margin, merchandise margin just how we kind of take that on?

David Kimbell

Yes. Yes. So beauty is, in particular, I think makeup, the total category is there's always a level of promotionality to the category. It's an intensely competitive category. We think up to 70,000 physical locations where at any given day you can go buy beauty products.

And there's a lot of - as I've mentioned, a lot of great competitors. It's an attractive category, which we're glad we're in it, but it's also something that our competitors across both mass and prestige, big and small, are excited about, and with that competition comes intensity.

So there is always a level of promotionality that is going on. But in moments of challenge in the category, or one of the levers that does get pulled, is maybe an acceleration in promotional intensity, and we're seeing that across the category. We're doing that as well where we need to where it's smart and appropriate.

What we feel really good about is -- our overall objective is to not -- we're not a promotionally driven brand or business. We'll use it where it's smart and appropriate. But we want value to be driven through innovation and brand creation and all of those things. But what we do have is a robust set of tools that allow us to pinpoint and try to optimize the type of promotions that we do, and that largely comes out of the strength of our loyalty program.

And so with the understanding of consumer’s behavior, we're able to more pinpoint the types of promotions. So sometimes, that might be broad-scale promotions, particularly on the mass side of buy 1 get, 1 free. But often it's promotionally pinpointed. We’ll take the same promotion and segment it out to different consumers to try to drive the most efficient result both on sales but that has the least impact - minimal impact on margins.

So we leverage loyalty points where we can. We leverage - sometimes guests with purchase. Brands will help participate in different things to try to drive some engagement, and then occasionally we'll do dollars off or percentage off.

So we're seeing that. We’re definitely seeing some of that in the marketplace, not anything that we're overly concerned about, but it's something that we're tracking and monitoring. You want to talk about how we look at that from a…

Scott Settersten

Yes. So we in our guidance, we've assumed, again, fourth quarter is always promotional by its general nature. So we compete -- in the holiday, we compete gift-giving with everybody across the retail spectrum. So it's always incrementally more promotional compared to the rest of the year. But this year, because of the challenges in this category, specifically, we've assumed an increase, a step-up in the promotional environment.

And again, during the holiday season, you have people visiting your stores for the first time usually. I mean 100 new stores a year, so that's usually the question there, same thing with your digital engagement with guests.

So we're not in a position, we're not going to give up on traffic because even in the toughest times, recessionary period, it's driving people to engage with your brand and in your stores, right?

So when the business bounces back, you continue to have that great relationship with them. So that's a place where it's especially sensitive to make sure we're making the right decisions.

Irwin Boruchow

So in this kind of promotional environment, can Ulta still continue to take merch margins higher or how do we think about merchandise margins for Ulta relative to the pricing in the industry?

Scott Settersten

Yes. So it's good. We've started our due diligence. You've heard us talk about EFG and the different buckets and things we've been working on there over the last, I guess, in earnest, over the last 12 to 18 months. But I think we stated clearly, we - even at the low end of the comp guidance, we would expect to be able to expand merchandise margins.

And that’s based on some of the good work, hard work, we've been doing around improving our internal processes. I think we talked about transitions during our first quarter call.

So those are things, again, areas that we are - we can control and influence directly, we're executing, we’re delivering the goods there. We can deliver overall financial improvement.

Irwin Boruchow

Got it. So Dave, I think switching something to a little bit more upbeat. Can you help with skincare relative to cosmetics? I feel like that's category has been pretty healthy to you. And what are the margin characteristics of skincare versus first cosmetics just...

David Kimbell

Yes. Ike, this has all been upbeat. So I was talking to you and it has been great. So -- but yes, skincare for sure. So the -- yes, I mean, so that's one of the great things about our model is, yes, makeup is our biggest category, but we're not as penetrated in makeup [indiscernible] maybe some of our competitors are because we have a nice balance. We have a very strong robust skincare business, very strong haircare business, linked to our salon, a very big and healthy and vibrant growing fragrance business, bath business, accessories.

So again, all things beauty all in one place, and that's a big part of our proposition. And our goal is to continue to deliver against all aspects of that skin. Though you were right that there's a lot of growth and a lot of enthusiasm in the category, and what we see going on in that space is a few things.

One, we just see a consumer -- a broad sense of consumer, particularly younger consumer, the millennial consumer, who's aging somewhat or aging a little bit and continue to do -- that there's maybe an increasing awareness about the importance of skin - healthy skin.

You’re having a great makeup look starts with great skin, and so we hear that from consumers, which is increasing awareness about the importance of taking care of yourself and taking care of your skin, and that's really important, so that's what's driving it.

But we’re also just seeing a lot of innovation, and those 2 types of innovation that I talked about, product innovation, for sure, so just continuing to find new technologies and formulations that are just getting better and better, new formats across all different types.

But also a lot of cool new brands that are being developed that are really speaking to consumers in meaningful ways that really understand the importance of just overall health and wellness and skin and taking care of yourself and how that reflects in your skin, and that's coming to life.

And so we see just a lot of innovation and a lot of newness coming out of that, and we don't think it's going to slow down anytime soon. We see a really strong vibrant category.

One of the dynamics that's probably helping that category a little bit is when there's a little less enthusiasm about the makeup. And we can't - I don't think that's a long-term thing, but there's certainly the innovation isn't getting people fired up and out of running out -- off their couch. They're still engaged in beauty, and they're hearing cool things coming out of it and seeing cool things coming out of skincare.

So some of that dollars are getting shifted over there. So we're excited about it. We're seeing it both in mass and prestige. We've launched really brands across the spectrum from a number of, again, small, cool independent brands that are doing really amazing things to big brands.

We've been expanding our skin bar with Kiehl's in a number of stores. We launched last year some of the bigger established brands like Origins and Shiseido are still playing an important role.

We launched The Ordinary more in the mass price point earlier this quarter, I guess, a few weeks ago and that's doing well. So we're innovating and bringing the brands, and we see that as a big growth driver.

Scott Settersten

I’m just going to add that it reinforces the strength of the Ulta model, right? The flexibility of our stores and what we do, the price points and the assortment that we play both mass, prestige and all things in between, right?

Irwin Boruchow

So to some degree, it sounds like you can adjust square footage to the assortment, depending on which category is hot versus trending down?

David Kimbell

Yes. Yes, right. I think there's probably a few ways to look at that. One, yes, the actual physical footprint in our store, we're not thinking right now, I don't know, that things could always change. We're not thinking a radical shift like we're going to take 25% of the makeup space and put it into skin.

We actually do not even need to do that, right? And now - we've got space. We've got - we feel like we've got space to optimize across the store. Where we continue, we've been gradually expanding our skincare business anyway, the space that we're allocating to it. But we're not right now thinking of a change.

What has changed, and that is part of our model, we try to build just a lot of flexibility, both into the physical aspects. So we're offering free - well, every time you walk into the store, we're featuring and highlighting select brands in the front of the store, on our [indiscernible]

So we're leaning heavily into skin because that's where a lot of the excitement is. We can do that very quickly. And then certainly in our marketing channels, we - a huge presence in all things digital, all aspects of it, social and our app and of course, push notification, all aspects of digital. But also, we produce a magazine 14 times a year, so we're increasing the presence of skin in that. So yes, there's - yes, we can definitely shift those things easier.

Irwin Boruchow

Okay. So Scott, let's fast forward and say we get to 2020. We emerge from the slowdown 5% to 7% comps. Is that still something that you - we think will Ulta can return to and then kind of getting back to that double-digit EPS algorithm?

Scott Settersten

Yes. So we're -- should I say it again? Still very confident in the long-term outlook for our business. So we think we've got a winning formula right our model. You've heard Dave, you've heard me describe numerous times in smaller group meetings today, so we feel very confident in the long term for this business.

In the shorter term, we need a minute here to kind of assess both at our vendor partners kind of the category dynamics and what the pipeline looks like and what we can do to influence to accelerate maybe some things that we're more optimistic about, to see how quickly maybe we can turn other trends there.

And then we, just to remind people, although we've - over the last couple of years we've taken the opportunity either through very high comp growth to drive in top line or some of the tax benefits we got a year or so ago to accelerate investment in the business, right, to get ahead of the curve on some of the things I mentioned around omnichannel investments and other things we want to do to drive a good, healthy business for the long term.

So now we’ve got kind of a different kind of assumptions to deal with here with the change in trajectory in the color business. And so that's what we're doing right now, we're looking hard at every element of our business, what our expense structure looks like, what some of these investments that are in our longer term road maps look like, and thinking through whether we can toggle some of those, slow them down, defer them, maybe with limited risk, maybe not, maybe choose not to do some things.

But again, doing all that in a very thoughtful way. I mean we would hope that by spring of 2020, we'd be in a better position, it's more clarity about what the longer term might look like.

Irwin Boruchow

Got it. I think the last question for me is, if we assume the next several years, can Ulta potentially continue to take margins up in a low-growth environment if it has the chance to kind of a rebase itself and think about expense and cost structure just trying to think, do you need that category to really get back to what it was doing to make Ulta a margin story again? Or how do we kind of think about those two things together?

Scott Settersten

Well, I'd say we're in a little bit of a gray area here, so I don't want to make it too complicated. We would hope that the color business overall or at least get back to zero and ultimately something in the positive zone would be a great tailwind to have. But there's still a lot of levers on our business that we have to pull.

So I mentioned EFG. I'm sure some of you are very familiar with that, and the CPI opportunities that we have around just all the core elements of our business and how we execute transitions and how we make assortment decisions.

And so we're still, I would say, in the early phases of that around improving our analytical capability and some of the tools that we have to help us better manage our business. And at the end of the day, that's where it is in margin, it's all around the core decisions that we make and how we execute there.

So we would still, I guess, without overstating it, and I'm looking at my coach, I mean, we would still be optimistic about being able to expand margin overall even in a lower growth environment, but it's going to take us a little while just to make sure we've got our metrics in place and our assumptions squared.

Irwin Boruchow

We've got a lot of - and so your - or your thought if this extends to makeup - if makeup extends for multiple years

David Kimbell

First, we do think that - well, it's not our outlook right now. I mean there's been cycles before and we're positive. But to your point [indiscernible] I mean, our model is flexible. We set off in our highest margin business, we actually -- professionally -- or business, and it's a strong healthy vibrant business.

So we can shift and adjust if there truly is. We're not anticipating that, but we're preparing to have the flexibility to maximize our margin story even if the makeup business is softer.

Irwin Boruchow

Got it. Well, Dave, Scott. Thank you so much. We appreciated it.

Scott Settersten

Thank you.

David Kimbell

Thank you.