BURBERRY

Burberry Group plc

Third Quarter Trading Update 2020 Analyst Call

Wednesday, 22nd January 2020

Julie Brown, Chief Operating Officer and Chief Financial Officer

Good morning, and welcome to Burberry's third quarter conference call. Slides are available to accompany this presentation on the IR section of the website. In today's presentation I'll spend the first few minutes running through our retail performance and sharing the progress we've made against our strategy, and then close with guidance. With me this morning is Annabel Gleeson, our Head of IR, and we will be happy to take your questions at the end.

Turning to slide two, I wanted to start with some context. This quarter delivered comparable store sales growth of 3%, led by mainline full price. Sales benefited from the continued build of new product in stores which delivered double digit growth and reached around 75% of the offer by the end of the quarter. However, as previously guided, the Q3 performance was partially offset by lower levels of markdown inventory made available for sale, as well as increased pressure from Hong Kong.

Turning to slide three and looking at the comp store sales by region. Asia-Pac delivered low single digit growth with mixed trends by country.

Mainland China had another strong quarter with mid-teens growth driven by full price sales. Both new and repeat Chinese customers continue to respond positively to the new product lines.

Trends in Japan were impacted by softer local revenues following the Consumption Tax at the start of October.

Korea similarly was softer in Q3, with markets impacted by lower levels of markdown inventory.

And finally, sales in Hong Kong fell around 50%. You will recall that we experienced declines of around 40% in Q2, so this increase is due to three rather than two months being impacted by disruptions.

By nationality, Chinese spending globally was flat, and this was slightly slower than Q2 which grew low-single digits. The slowdown was predominantly due to a decrease in Chinese tourists in Hong Kong. EMIEA grew high-single digits supported by tourist growth. We delivered growth across the UK and the whole of Continental Europe, with particularly strong performances in France, Italy and Spain.

The Middle East continued on a positive trajectory having returned to growth in Q2.

And finally, the Americas was flat year-on-year. The US continued to grow low-single digits despite a challenging environment. However, this was partially offset by Canada and other Lat Am geographies.

Turning to the fourth slide. This slide shows the major components of retail sales. You can see the 3% growth in comparable store sales. Space was -1% this quarter and year-to-date, reflecting the strategic changes to our network, with 37 openings and 46 closures over the last 12 months, relating to our store upgrade and strategic closure programme. The highest profile opening this quarter was a new flagship at the exclusive Ginza Marronnier building in Tokyo, and for the full year we still anticipate space being flat.

We've also continued our store refurbishment programme with an additional 23 stores aligned to our new creative vision, and bringing our cumulative to date to around 60 stores.

In total, retail revenue was up 2% at constant exchange rates and reported revenue up 1%.

Moving to slide five. Riccardo's product now comprises around 75% of our mainline range, and his runway and new season collections continue to deliver double-digit growth. The next phase of our product evolution is now to rebuild the replenishment line, which will involve developing the Burberry icons of the future. This work has started and will continue during the next financial year. By the end of this year we expect Riccardo's collections to represent around 80% of our mainline assortment.

Turning to slide six, I wanted to talk you through some of the brand highlights. We continue to build brand heat with the launch of Riccardo's first festive campaign 'What is Love?', featuring Carla Bruni as well as brand ambassador, Zhou Dongyu. The campaign achieved our highest ever number of views across major social platforms, and more than double last year's performance.

We talked to you at the interims about how inspiring Chinese consumers is key, and we maintained our focus here in the quarter. At the end of December we launched a dedicated Lunar New Year campaign celebrating a limited edition Thomas Burberry monogram motif in honour of the Year of the Rat. We announced we will be taking our Autumn/Winter 2020 runway show to Shanghai in April. And finally, work is well underway for the launch of our first social retail store in Shenzhen, in partnership with Tencent.

We also continue to innovate in digital. Firstly, after the success of our first digital game, B-Bounce, we extended it more recently to support our Lunar New Year campaign. In this version, Ratberry is a central character in the new world.

Secondly, to support Festive, we launched a digitally immersive pop-up experience in Brick Lane, London, powered by Google Lens. And finally, the B-Series also continued to perform strongly with increasing reach and engagement on major platforms. This helped underpin ongoing positive momentum in social media, with Q3 delivering double-digit year-on-year growth in followers and engagement rates across Instagram and WeChat.

Turning to slide seven. Before we turn to the outlook, I wanted to say a few words about responsibility. We were recognised for our leading environmental and social programmes, including at the British Fashion Awards for our work on the UN Climate Change’s Fashion Industry Charter for Action. And as part of our commitment to creating a truly open and inclusive workplace, we have announced a new global parental leave policy.

Now, turning to this year's financial outlook on page eight. We expect revenue to increase by a low-single digit percentage, slightly ahead of our previous guidance of broadly stable. Adjusted operating margin is expected to remain broadly stable despite around 150 basis points of negative impact from Hong Kong. For the purposes of detailed modelling for the full year, there are some changes to the component parts.

Firstly, wholesale is now expected to be broadly stable. Secondly, we now expect to achieve cumulative cost savings of £125m this year, ahead of our target of £120m. And capex is now expected to be £150m.

Finally, turning to currency. We have updated our guidance to reflect end of December spot rates. As a result, we now expect a £9m benefit to revenue and no impact to adjusted operating profit, as a result of a minor strengthening of sterling.

Turning to the summary. We are pleased with our performance in the quarter. We continue to see strong, positive consumer response to the new product, which now represents around 75% of our mainline assortment. And whilst mindful of the uncertain macro backdrop, we remain confident in our strategy and the outlook for full year 2020.

Q&A session

Question 1

Zuzanna Pusz, UBS

I have three questions please. First of all on the outlook upgrade. Am I right to understand that this has been mainly driven by wholesale? And if so, can you just clarify whether that's just been driven by the fact that you were able to rationalise some of the accounts quicker? Or is it just that the luxury accounts are more excited about your new collection? So that's the first question.

Secondly, I was just wondering if you could give us a little bit of colour on the Q4 expectation? If I'm correct, I think consensus is +5% for Q4. Now, Q3 came slightly better, some of the headwinds like full quarter of Hong Kong are let's say going away. So, can you just tell us whether you feel comfortable with that 5%, or could we see maybe a quicker recovery in Q4, and what sort of moving parts we should think of?

And finally, just on regional performance. I think APAC was basically up low-single digits in terms of like-for-like. If I assume mainland China was mid-teens, Hong Kong down 50%, that basically implies that the rest of APAC was up around high single digits. So, I'm just wondering if that means you have seen some repatriation of lost space from Hong Kong, or that's just basically driven by local demand? And also specifically within that, what was Japan? Because obviously we had the sales tax increase, so it's not clear to me if you were negatively impacted by that, and what sort of trends you've seen in the country. Thank you very much.

Julie Brown

Thank you very much, Zuzanna. Just taking your questions part-by-part. In terms of the upgrade to low-single digit percentage, as you mention it's been driven by two things. So wholesale you captured, because we've gone now to flat as opposed to a low-single digit decline. The reason for the wholesale improvement is largely due to improvement in the luxury accounts, and in particular in EMEIA. So we are on track to complete the rationalisation of US wholesale, and as you know we're closing 60% of the doors in US wholesale to elevate that distribution channel. So an improvement in the luxury accounts. We've also had an improvement in retail underlying. Hong Kong was obviously a serious headwind, but we've also had an improvement in underlying, largely coming from improved trajectory in EMIEA, and also Mainland China where we've continued to see good growth.

If we turn to Q4 consensus is 5%. We don't comment explicitly on that. But what we would say in terms of the overall dynamics, just to allow people to model it, is we expect to see a continued strength in our mainline full price, which has been the driver of growth now over a number of quarters. We will still see a significant headwind from Hong Kong. Hong Kong last year, to put this into context, was 8% of our business before the disruptions started, and we're still seeing and expecting considerable pressure on Hong Kong going into the fourth quarter.

The final point to mention is markdown. With regard to markdown, the larger markdown period for most luxury players is in Q3. There's an element still running into Q4, which is largely EMEIA and Japan, which runs into the January period. So there will be some downward pressure from that, but nowhere near as significant as Q3. So hopefully that helps you model the situation, together with overall revenue for the full year being a low-single digit increase, which is the key point.

Just in terms of the regions. As you mentioned Mainland China grew mid-teens, so we had a repeat of the performance in Mainland China. In terms of the other elements in Asia Pac, we had a softness in Japan. This has largely been caused by the Consumption Tax that went into place on 1 October, and affected the timing of sales between Q2 and Q3. So we've definitely had a softness in Japan in Q3.

In terms of the other countries, we saw a strong performance. If you think about South Asia Pac, excluding Hong Kong, it continued to grow very well in the teens. We've also had a strong performance in Korea. Not as strong as Q2, because Korea was impacted by markdown, but a strong underlying full price performance in Korea. So it's really been isolated towards Hong Kong.

In terms of repatriation of Hong Kong clients, what we've been doing is been tracking this very closely. It's not a perfect science: in terms of the element of repatriation, we've provided some estimates. And we are seeing some repatriation to Mainland China, and we're also seeing an element to Korea. However, that's relatively small because 95% of our business in Korea is local anyway. But we are seeing some repatriation to Mainland China. Very, very difficult to quantify.

<u>Question 2</u>

Thomas Chauvet, Citi

Three questions please. The first one on Hong Kong. You mention the 100 bps negative margin mix impact. Can you elaborate a little bit on the maths, particularly what level of EBIT margin would you expect in Hong Kong on an annualised basis going forward? What have you also perhaps done, or will you do, to mitigate the fixed cost leverage?

Secondly, on the Chinese cluster. You comment on a flat LFL globally. Is that flat with your Group LFL at +3%, that means other nationalities have improved quarter-on-quarter? Did this come from Europeans, maybe to lesser extent Americans, and if so for these two nationalities do you feel you're starting to win back the developed market customers that you may have maybe lost under Christopher Bailey?

And finally, if we say goodbye to FY20 and we look at next year, you've already provided some building blocks with mid-single digit cost inflation, I guess gross margin is unlikely to rise in March. Can you tell us what are the main levers and initiatives you have to drive the revenue growth acceleration that the market is expecting? Thank you.

Julie Brown

Thanks very much, Thomas. In terms of Hong Kong, we'd just like to clarify it's 150 bps, rather than 100 coming from Hong Kong. Basically what we've done there is we've taken the total loss from the Hong Kong business in terms of the sales and the margin associated with that business, the operating margin level. We've also, very importantly, got the impairments that were triggered in H1, which relating to Hong Kong was £14m. So taking that into consideration, together with our forecast for the fourth quarter, we get to around 150 bps, which is the gross loss of margin in Hong Kong before we get the improvement in retail sales from China and EMEIA, as I mentioned, and also the wholesale upgrade. So it's the gross loss and impact on the margin.

We are taking significant steps to mitigate this. Obviously in the business as a whole we have, but also in Hong Kong, where we are focusing very much on the local business, appreciating the impact of the disruptions on the tourist trade, we're focused on local. We're also very much focused on the cost base in terms of rental renegotiations with landlords, which are ongoing.

If we turn to your second question relating to the Chinese. Yes, the Chinese have been flat. When we look at the Chinese trends across the world, they've all been positive, with the exception of Hong Kong where we've definitely seen reduced Chinese tourism into the Hong Kong market. Other nationalities, we are seeing as you said growth in developed markets. Yes, we've seen an improvement in the US. The US market is very much driven by the local consumer, and we're maintaining a low-single digit growth rate with the US market, which includes a headwind from tourists. So the local is a good picture. We've also seen an improvement in other nationalities. We saw a strength in Continental Europe. We've seen strength in the British consumer. So yes, I think we've seen a positive trend overall in developed markets.

Finally, your question about full year 2021 and the building blocks. I mean clearly we'll provide guidance as we get to the end of the year when we do our May presentation. But I think the key building blocks to consider are, we are seeing the business now increasingly being driven by mainline full price. We've had some serious headwinds on the revenues of the business this year. Clearly one of the things that we planned was less markdown, so that was built in. That will impact next year significantly less. We've also had this serious headwind from Hong Kong. It's taken 50% of the sales in that region. What we expect to happen going forward is that we expect this to annualise and then start to moderate. That's our view going forward with Hong Kong.

So taking those two significant headwinds out, we expect to see an acceleration of revenue performance. I think the key thing with regards to margins is as revenue growth accelerates because we've now done extensive work on the cost base, we've cleaned the cost base, we've delivered or will have delivered £125m by the end of this year, we've got the opportunity then to have meaningful operating margin improvement as we improve the sales densities in the stores. And that's now the biggest opportunity.

Question 3

Antoine Belge, HSBC

Three questions. First of all could you give a bit of qualitative comment around the product categories, not only handbags, others, so maybe call out a few franchise product or products which have been originated by Riccardo.

My second question is back to Riccardo's products, so 80% at the end of the fiscal year, so how long will it take for that 80% to become 100%?

And finally, with regards to Hong Kong, I mean I understand that you said that it could maybe stabilise when it annualised. You said that since the beginning of January trends are still clearly very negative but maybe a bit less negative. If so, could you confirm that? And also, what's your assessment of what needs to be done in terms of maybe optimising the retail network in Hong Kong?

Julie Brown

First of all taking the product categories and just generally Riccardo's collection, we've seen a continued strong consumer response to Riccardo's products with the new collections in Q3, so this includes Winter '19 and Spring '20, delivering double-digit growth year-on-year.

The performance, as we mentioned, is being driven by mainline full price. We've had very strong performance in terms of tops and bottoms. We've put a lot more emphasis as you know in terms of outfitting and the look of a model, and what we've seen is now tops and bottoms, and also the new branded platforms, the TB, the Check, the Burberry London, have performed extremely well.

I think one highlight to call out is men's outerwear was particularly strong, driven by the down and the quilts and also the success of the bomber jackets that have recently been launched.

You mentioned accessories, and our accessories performance we're seeing as a medium term part of our strategy. We've continued to see improvements in Q3. We're building out the handbag pillars. We've had a strong initial response to some of the new shapes, such as the TB bag, the Lola bag, and in accessories we've also seen strong growth, double-digit growth in fact, in trainers, you know, overall. So we're really positive actually about the trajectory that we're on and the performance. Children's is also up double-digit.

The thing that is still the next phase to do, and it probably relates to the second part of your question, is Riccardo's product will be 80% of our business by the end of the year. The phase that now needs to take place is all related to the replenishment line, so this is still putting pressure on our overall comp in the business. And we're now going through the transition of moving a new creative vision into the replenishment line and creating the new Burberry icons of the future. Clearly that will take some time, it won't happen overnight, but it's all about building the category that will then become more continuative in our business which gives you supply chain efficiencies and inventory management benefits as you go through that phase.

I think the final stage is relating to Hong Kong. I mean, as you mention, we do expect to see ongoing falls in our Hong Kong business based on what we're seeing at the moment, and we've allowed for that within the guidance. By the time we get to the end of June, I guess during June, we'll start to annualise the whole situation. We are very clear about optimising the situation, we are putting a lot more emphasis on our local consumers in Hong Kong. We are negotiating with landlords around rentals, and we keep the situation under review. No change basically to the overall picture, and we have about seven main stores in Hong Kong, about 12 in total, and we just keep the situation under review. No decision to make any closures at this point, we just keep the situation closely monitored.

Antoine Belge

To just maybe a follow up on that, I mean would you say that the landlords are responsive or still a bit delusional and don't really want to lower rents significantly?

Julie Brown

It varies considerably based on factors like the length of the lease, the overall position. We treat them as partners and we're working with them as partners to try and get a win, win situation during this phase of the disruptions.

Question 4

Elena Mariani, Morgan Stanley

Hi, good morning, Julie. A couple of follow up questions from me. The first one is on 2021 and the underlying cost inflation evolution. You've talked about having kept quite a tight control over costs. If I remember well, your cost inflation underlying for this year is expected to be below 2%. So next year should we definitely expect that to go back to around 4%/5%? And if so, what would be the incremental increase related to? Would that be ASP or other line items? And do you foresee any incremental cost savings being potentially implemented in 2021? I know that the final £15m is currently planned to come through in fiscal year 2022, but maybe you're working actively to find other initiatives.

And then, still on 2021, could you give us a preliminary indication of what the FX impact could be, because we understand that there might be quite a meaningful headwind, particularly in the first half.

And final question, going back to your replenishment lines and the fact that it's going to take time for these to be revised and for them to come through, how long do you think it will take? Is it a matter of one year, two years? Can you walk us through the steps and the milestones you need to see for specific products to tick the box and become the new evergreen products? Thank you.

Julie Brown

Thank you very much, Elena, a very comprehensive set of questions. So if I turn to the first one relating to full year 21 and cost inflation; so we're expecting for this year cost inflation to be around the 2% level. For next year, and we've guided that going forward we'd expect the inflation of the cost base to be around the 4%, possibly the 5% level. Obviously we do our best to hold it to the 4%. There's an element of variable cost inflation within the cost base, particularly relating to rentals in Asia where you've got a variable element, and that can bump up the underlying inflation depending on performance in Asia.

I think just in terms of ASP we'll get into the guidance as part of the May results, so at this point we won't be guiding on ASP particularly.

Just in terms of the cost saving programme in relation to your second question, so we're pleased with what we've done here. We've increased the cost savings to £125m this year. We therefore will be upgrading, this is not a timing difference, this is a real difference in terms of the changes we've made in the business in the way that we operate, particularly in some of the enabling areas, and it means that our full cost programme now will be increased from £135m to £140m, to be delivered by full year 22. This doesn't include also the store closure programme which generates a further cost saving of £25m on top of this, so it's a considerable reshaping of the cost base that we're undertaking.

With regard to your question about when does the incremental come, based on the phasing of the programme and a number of the big enabling functional transformations the bulk of that jump from the £125m to the £140m comes in full year 22. However, as you've seen we're always on a journey of continuous improvement, we're always looking for opportunities, and if we can accelerate some of the programmes, (it's more difficult to accelerate structural programmes) but if we can find ways of working changes that are sustainable we will definitely be delivering them. But we'll give you more of a flavour about this when we come to the full year results.

The third question related to foreign exchange. So when we run the December spot rates, end of December spot rates, we would expect a headwind on exchange of about £10m to £15m to occur next year. Some people may have expected this to be slightly higher, the difference is largely due to some of the fulfilment contracts we're running which are more long term in nature which gives us a slight subdued impact of exchange. And you're absolutely right, it's more pronounced in the first half. Clearly we had some exchange benefits in the first half of this year, so you get the comp effect.

Finally, replenishment. So in terms of the major, I mean I think we've made considerable progress with the product transformation under Riccardo, and as you know, by the end of this year we'll be at 80% of Riccardo's product. The next phase is all about recreating those replenishment lines, and what we're doing, and we've already started this, is looking at the lines within Riccardo's seasons that have longevity that we can take into replenishment, largely based on how they're performing in terms of customer reception, the margins we're achieving on them etc, and then we will gradually move them into replenishment next year. In addition to Riccardo reviewing the replenishment line, and in particular the trench, I mean he's done some work on this already in terms of runway collections and updates, but it's really him taking a look at some of those lines.

<u>Question 5</u>

Luca Solca, Bernstein

Yes, good morning and thank you for taking my question. I'm wondering if you could give us a bit more granularity in terms of growth drivers, if there's anything that comes from product category mix, changes.

And I think there was a question on leather goods and handbags. My understanding, and that is my second question, is that there's an ambition to upgrade the Burberry profile within the handbags category. I wonder if you see that reflected in a more buoyant demand in higher priced products, and how satisfied you are with this upgrade programme. I understand it's going to be a multi-year journey, but are you seeing any encouraging signs in what you've been bringing to the market at the moment?

Thirdly, I'm very impressed by the cost efficiency programme that you have embraced, and that continues to provide potential upside to the overall contribution for the bottom line. I wonder if you could give us more granularity on where you're finding the efficiency opportunities and if there's a significant amount of fat that you've been finding in any area or how close to the muscle and how close to the bone these initiatives have gone? Thank you very much indeed.

Julie Brown

So if we take the growth drivers in particular by category, I mean, we're very pleased with the performance and we see a growth driver in the outfitting initiative with tops and bottoms. That has started extremely well and continued now for a number of quarters, so we're very positive about that.

In terms of other growth drivers we've also seen early success in terms of new collections in certain categories within accessories. The shoe business is growing extremely well, the trainers are growing extremely well, so we're again very positive about that. Similarly, the men's line in particular, the puffers, the bomber jackets have gone really well, but really outfitting has been the biggest single driver.

In terms of leather, we've always said, as you know, that this is a medium term change in our business and in terms of handbags in particular, women's handbags, we've seen a sequential improvement quarter-on-quarter in the trajectory, so definitely improvement. The new shapes are being perceived and seen extremely well, so in particular the TB, the Lola's been extremely successful and we've got also the launches of the Title etc, a number of different bags that Marco referred to when we did a presentation in November, they continue to perform very strongly.

In terms of Leather overall we still have the replenishment line that is pulling down the overall performance of the category, so these are some of the older bag shapes, and over time we will build out the new bag shapes. And we're very pleased now with the architecture that we've got, I think it's just a case of time now as we move forward in that category to become a growth driver. And we see it as being just a very important luxury symboliser for our clients and obviously for Burberry going forward.

In terms of cost and efficiency we are pleased with the performance in this space. Delivering £125 million cumulative by the end of this year is a significant achievement given our cost base of about £1.4bn, which a third is people, a third is property and a third is other, so it is a considerable achievement. The areas where we've really targeted have been all about ways of working and operational efficiency. Some of the major changes we've made, such as implementing Burberry Business Services where we transferred people from Westminster and New York to a captive centre in Leeds, that involves five functions, that's delivered considerable savings, together with some of the procurement initiatives where we brought in a new head of procurement a number of years ago now who looked at the business expense base by category and we drove out considerable improvements by looking at categories globally. And so it's really changes to ways of working, it's not affected the commercial front line of the business, it's been more enabling in nature.

Question 6

Charmaine Yap, Redburn

Hi there, good morning. Julie, can you please give a sense of the delayed capex in terms of if it's just a phasing of store refurbishments or openings, anything on that front.

And also separately, in terms of your sales we haven't spoken about digital e-commerce sales for a while now. Is there anything that you can highlight, perhaps the work that's undergoing? Are you still focusing on this area or is it less so the case? Any colour would be helpful, please. Thank you.

Julie Brown

Thanks very much. So in terms of capex we've got a very comprehensive programme in terms of store refurbishments, as we've alluded to, with basically 80 openings and refurbishments planned by the end of this year. The capex change, we were guiding to about £180m, we're now guiding to £150m. There's been one office project that we've delayed from this year into next, so there's a timing difference there, and also we have gained some efficiencies in some of the refurbishment programmes in the stores as we've gained more experience through this. But largely I would attribute it to timing. A store refresh or refurbishment, one major one can make all the difference in terms of the capex spend, and that's really what's happened here.

If we move on to digital, just thinking about the performance, performance was definitely led by China where we saw strong double-digit growth driven by continued localisation. We're actually now best in class for luxury in purchasing on WeChat due to the extended product assortment that's available. We saw strong performance from our third party partnerships and we've also continued to be successful in generating inspiration, using our digital channel. So we launched our first online game which was B-Bounce and that's been played over a million times now in 40 countries and it's resonated very strongly with Americans and Japanese. And then we've recently extended this now to support the Lunar New Year campaign featuring Ratberry, given the Chinese zodiac.

Marco talked extensively about our exclusive partnership with Tencent, this is a social retail store that will be our first, and we've also done a number of digitally immersive pop up experiences. I don't know if you managed to visit Brick Lane in London but this was a fantastic opportunity to use a Google Lens app to support our festive campaign.

So overall we're pleased with the digital performance in our strategy and we definitely see it as very importantly an e-commerce site, but very importantly a data source for our consumers and also a communication channel, and we're using it as those three.

Concluding comments: Julie Brown

I'd like to say thank you for joining this morning's conference call. Our next update is 14th May with our year end results and we look forward to speaking to you then. Thank you.