Luxottica Group Conference Call Transcript
Event Date: July 26, 2012

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Enrico Cavatorta, CFO

Alessandra Senici
Thank you, operator. Good afternoon and thank you for joining us today. Here with me are Andrea Guerra and Enrico Cavatorta.

Before we begin, I have a couple of quick items to cover. As a reminder, a slide presentation which we will informally follow during this call is available for download from our website under the "Investor Relations – Presentations" section.

This presentation includes certain non-IFRS financial information within the meaning of Regulation G under the US Securities Exchange Act. Further information, including additional information required by Regulation G, is also available in Luxottica Group's press release relating to its results for the second quarter of 2012, which may be found on our website under the "Investor Relations -- Press Releases" section.

This conference call is being recorded and is also available via audio webcast from our website.

During the course of today's call, certain projections or other forward-looking statements may be made regarding Luxottica Group's future financial performance or future events. We wish to caution you that such projections or statements are based upon current information and expectations and actual results may differ materially from those projected in the forward-looking statements. You can read more about forward-looking statements on page two of the slide presentation.

We also refer you to our filings with the SEC and Italian securities authorities. These filings contain additional information concerning factors that could cause actual results to differ materially from those contained in management's projections or forward-looking statements.

We will begin with our CEO, Andrea Guerra

Andrea Guerra
Welcome to our second-quarter business review. There is a lot going on. There is a lot of news. There are a lot of ups and downs. There is a lot of tension. I would like to be able to frame immediately where Luxottica stands, our position and what we are looking for and what we feel for the next periods.

So numbers first. Very solid first six months, plus 15% revenue. At constant currencies, very high single-digit growth. When we go back to October/November, when we were forecasting the year, we were trying to understand how to build our budget. We divided the world into regions, as we usually do, and we defined the US as a market where we could have strong growth. Emerging markets is another area where we could have strong growth all across the different regions and countries, also strong Australia and modest growth in Western Europe.

After six months, we got a reality check. This is where we are. I think we have grown more than what we expected in the US, strong emerging markets across all main countries and regions, and I have to say nothing more, nothing less. Strong Australia and we are extremely happy to see our performance in Australia. Plus 1% in Western Europe, which is closer to no growth compared to modest growth, with great differences inside the region and we will go through them.

So, I am happy. I think we finished the first quarter in a very successful manner. We finished the second quarter, again, in a successful manner. And I want to bring you back one second to our second quarter of 2011. And I think Enrico will give you some more color regarding what kind of Himalayan Mountains we had to climb in 2Q in order to be successful in 2Q 2012.
2Q 2011 had been by far our best quarter, and we beat that quarter, and I'm happy about it. It was not easy. We knew it. We had all our people ready for that and with enthusiasm we made it.

Profitability has grown more than proportionally. And again, very solid cash generation, another quarter of free cash flow at EUR180 million. And again, strong management of the different parts of working capital. Enrico will give you some color, some numbers, and then we will go back to how we see the quarter in the next months.

Enrico Cavatorta
Thank you, Andrea. Let's have a recap of our key numbers. First of all, as Andrea mentioned, we had a reported net sales growth of 15%, bang in line with the first quarter. Clearly, the help from currencies was slightly better in the second quarter than it was in the first. The dollar was 12% stronger, while it was only 8% stronger in the first quarter. Looking at the rest of the year, we see the dollar continuing to help us. Last year, in the third quarter, the average exchange rate of the dollar was 1.41, and the average for the fourth quarter last year was 1.35. So we do expect again strong help from the dollar in the third quarter and hopefully also in the fourth one.
Net sales at constant forex in second quarter were up 7%, solid high single digits. And as Andrea mentioned, last year, our growth at constant forex was 9.5%. So this 7% comes on top of a very solid performance in the second quarter of last year.

If I look by single division: again, wholesale slightly outperformed our retail performance. Despite a slowdown in Western Europe, basically, wholesale achieved a very solid 8.5% constant forex growth. And this is basically almost entirely organic, with the only exception of Coach in the United States and, to a lesser extent, Tecnol in Brazil. Within wholesale, North America and emerging markets performed very much in line with the first quarter. North America again is in the more than 20% area; emerging markets is again close to the 20% area. So, the only significant slowdown was Western Europe and I am sure Andrea will talk more about that. Last year, wholesale, do not forget, grew 11.5% at constant forex. Now this quarter’s 8.4% comes on top.

In terms of retail, again, we had a 5% comp, very much in line with our expectations. Strong Australia, more than 8% comp. Very strong Sunglass Hut worldwide: again, a double-digit quarter following last year. And the only slowdown has been in LensCrafters, where we achieved a 1% positive comp during the second quarter.
If I move to profitability, these solid sales numbers translate into an even more exciting margin improvement, again, very much in line with the performance that we achieved during the first quarter. The overall profitability of the Group grew 80 basis points in the second quarter. And if I sum the growth, as we did in the first quarter, of the last three years, in total we have generated a margin improvement in excess of 300 basis points. So even better than the performance in 1Q.

And again, do not forget that last year, the second quarter was one of the most profitable quarters in terms of operating performance, in particular in wholesale.

Going to wholesale, we have experienced slight margin dilution: 40 basis points. Let me say it is entirely due to the Tecnol acquisition and the impact on the quarter was 60 basis points. So again, in wholesale, we have been able to maintain basically the same profitability as last year that was really the record high. For example, last year, the increase in wholesale profitability in the second quarter as compared to the second quarter of 2010 was in excess of 250 basis points. So basically we've been able to maintain such a high level of profitability. In three years in wholesale, as compared to the second quarter a year ago, the improvement has been close to 400 basis points.

In retail, the margin improvement that we have seen in the first quarter has continued in the second quarter and was very much in line at 150 basis points. The margin improvement is accelerating as compared to the first quarter, where we delivered a margin improvement of 120 basis points. And again, second-quarter retail profitability is the best result achieved since the record year of 2007, but clearly with a much larger sales base. We will provide more detail regarding retail profitability in a moment.

Going to net income results, we achieved a 10.4% margin, and we are just inches away from our all-time record high of 10.7% in 2007. I would say that in the last 10 years, we have achieved 10% net income profitability only once. It was the second quarter of 2007; and this is only the second time. And of course, this margin, the record-high margin is with a sales level that is 40% larger than it was five years ago. So, going back to basically the same margin with 40% more sales is clearly a result of which we are very proud. Our earnings per share has reached a record high for a second quarter at Euro 0.42 or US dollar, 0.54. Like the first quarter, both are new record highs for a second quarter for Luxottica.

A little bit more detail in terms of retail margin evolution. We said this is the year where we do expect solid margin improvement in retail. We did that in 1Q and we are confirming that in 2Q. Again, for the entire first half, our retail margin is increasing 130 basis points. And even excluding the currency effect, and on the other end, the dilution from our Latin American expansion, this is basically 130 basis points. and is confirming the 140 bps in 1Q and basically represents an increase in our so-called “core retail” profitability. So our North American profitability is now back to the record-high profitability before the financial crisis of 2008 and 2009. Australia, as Andrea mentioned, is also now increasing very well. It is still not at the same level of 2008, but is clearly recovering at a very high speed the profitability that was lost.

Cash, clearly with such a strong P&L and with continuous control of working capital, free cash flow was much higher than a year ago at EUR180 million generated during the second quarter 2012, up from EUR154 million last year. This is despite an increase of approximately EUR10 million in our CapEx of EUR84 million up from EUR74 million last year.
We have been able to maintain our leverage ratio unchanged versus the end of March and versus basically the end of the year at 1.7x, despite the fact that during the second quarter we paid a EUR227 million dividend. Let me say also that on a lease-adjusted ratio, that is the ratio basically used by the rating agency, we have been able to do even better than that, because our lease-adjusted ratio went down from 2.6x at the end of December to 2.4x at the end of June. And so this is confirming our healthy balance sheet and our cash generation.
You can see the effect, the positive effect on working capital. Despite sales growth of 15% at current forex, we have been able to basically maintain working capital at breakeven, absorbing only EUR23 million during the quarter. And this has been achieved thanks to a reduction in operating working capital of 11 days.

Andrea Guerra
Thank you, Enrico. I will now go through 12 different points, two negatives and ten positives. And I will go through immediately the two negatives:

1) Western Europe wholesale performance. Plus 1% in the semester, which means, as Enrico was alluding to, plus 10% in combined sales growth for the two periods. The quarter ended up at minus four. I would say that this minus four has been basically led by one month, which was May. May was tough for a number of reasons. We could discuss long about Spring/Summer being later than a year ago or Italy and Spain turning negative. We could talk about many different things. But I would say that May has been tough. Moving to June and July they were constantly better. And I would say that week after week, we have seen a promising trend. And the last four weeks, we were in the double digits in Western Europe. Obviously, Western Europe is a group of many different countries, and with huge differences in demand patterns. I would say that our performance in Continental and Northern Europe --I would grade us excellent (Germany, Nordics, UK). France positive, with two phases: very, very tough one month, May; very strong in June and July. Italy and Spain, we were able to be basically positive up through 1Q and had an encouraging April. May, June and July have been tough and negative.
I expect that our performance in 3Q and 4Q in Western Europe will be better, and I think that we were able, with the amount of our sales and our kind of market share, to keep our sales basically aligned to those of a year ago. Because of our service levels and our Rx prescription business, we had a wonderful performance, and I think this is now the third year in a row I am talking about our prescription and Rx performance. Additionally, I think that all our great brands have great health. Let me add one thing, because I need to say it, I think that we had teams that really did their best over this six-month period.

2) When we think about the other black spot in this blue sky: LensCrafters' 2Q top line, plus 1%, which we could list as a negative, and I do, but we could also list it as a positive because we achieved probably the second-best-performing quarter in terms of profitability in the last 10 years. Why plus 1%? Obviously we have been quite used to seeing in the last two years and a half a different kind of growth rate. Three reasons:
The main, May and June are the two months which are the slowest in LensCrafters' seasonality. We decided to start up SAP and a new merchandising and planning tool on June 10th. It’s now seven weeks from implementation and we could say that after four weeks, we forgot about it. We had a couple of weeks where we didn't have issues at all with IT, but we had some issues with communication and our communications were pretty slow in the stores.
Second reason, we pulled away two promotional weeks because we were going into the SAP, and pushed our equity campaign quite significantly. This is, you can see it, a new era for LensCrafters. I’m really happy with the performance of this campaign in terms of brand consideration among consumers as it has steadily improved from 24 (points) in June to 27 (points) in July.
And I think this is qualitative information which is quite important. Consumers told us that we were really giving them new information about LensCrafters and that this kind of advertising and ”epicenter” on our web, was relevant. So we were happy to do it: SAP, pulled away two promotional weeks and April was bad. April was not a good month.
If I pull away April and think about May, June and July, we shifted from weeks at plus 2% to plus 4%, excluding a couple of weeks at minus 6% with the SAP startup. So am I worried? No, I'm not worried. And I think the good news is that we have really learned to manage LensCrafters’ profit and loss differently, especially at the gross margin level. And as I was saying, profitability is very close to the peak.

I have been long on these two negatives. I will be brief on the positives, because I think to all of you they are quite obvious:
1) North America results, plus 7%. Given that LensCrafters, which is the largest piece, was a plus 1%, you can understand what kind of performance we had from all other divisions, from Oakley to Luxottica wholesale to Sunglass Hut and all the rest.
2) Sunglass Hut, another quarter of double-digit comps, in the US and worldwide. Australia is coming back.
3) Wholesale at plus 12% globally.
4) Ray-Ban celebrating its 75th anniversary with another double-digit growth quarter.
5) Oakley, another double-digit quarter and record profitability. And I can tell you that Oakley now has a clear leading position in Rx.

6) Strong emerging markets performance, all across. I think that we are working day and night in Brazil, this is lowest seasonality, in order to be ready by mid-September, basically from an organizational point of view as one team, one organization, one company.
7) Australia, particularly satisfied, because what we did was risky and I am happy how they executed it.
8) Luxury and Premium, double-digits, with some of the brands at high teens. With the reorganization of Dolce & Gabbana completely done, portfolio is solid. Enrico was talking about the great success of Coach.
9) Working capital management, keeping on moving, inventory, receivables.
10) I think that we are facing this new nervous period with a very solid strategy and a very solid team.

So when we look to the remaining part of the year, I would say July has been in the trend, so we still have five months to go in the year. Out of five months, three are important, two are not as important, so we could say that we have done a lot of our homework so far. Not so easy to predict nowadays, but as I was saying, quarter portfolio in wholesale was up 8%, 7%, 8%, 9% -- I don't remember the exact figure.

But I would say that if the world doesn't go upside down, we are in good shape and we will continue to perform. I would finish it up here and allow you to make comments, ask questions and request information, so I will hand the call back to the operator.

Q&A

Daniel Hofkin - William Blair
Good evening. Very encouraging results, particularly stripping out some of the noise. And I guess your commentary about the second half is encouraging, given what appears to be a weakening macro picture.
I'm just curious what do you think is contributing to the resiliency of your wholesale customers in particular. That would be one question. And then I just wanted to confirm that I heard you correctly, where you said during the last several weeks, up in the double digits in Western Europe. Did I hear that correctly? Thank you.

Andrea Guerra
So the second question, yes, it is true, and driven by France, Germany and Nordics. Spain being exactly as it was and Italy exactly as it was. So no good news from both of those countries.

In terms of wholesale, I would say that today I think we got two, three, four pieces of good news. The first is the North American trend, where, I think, the sun market is positive. On the other side, I think that our team in the US is really conquering back our fair share. And it is now 24 months and we are moving, moving fast, and I think there is a long way to go.

I think in Europe, our resilience is partially attributable to the license we signed with Armani, which obviously has got no operational impact, but I think a strong psychological impact.

Emerging markets, I think every three months, every six months, we're slightly stronger. In Brazil, we are growing. I think all the strategies that we have put in place are working. A little bit of homework to be done in getting the teams together and getting the manufacturing to proper quality. In September, we are launching the first Luxottica brand inside the Tecnol factory. So I think there are a lot of things going well in the various emerging markets.

On top of this, I would say that our brand portfolio in terms of luxury and premium is quite healthy. I mean, we like it. It is other people doing a good job on their brands, and obviously, we are taking care of them in optics. So, I think this is where we are. In Italy, we are by far the strongest player, but at the end, it accounts for a smaller part of our profit and loss.

Daniel Hofkin - William Blair
Regarding the premium and luxury, can you comment about the price-mix impact overall in the quarter versus unit volumes?

Andrea Guerra
Yes, I would say that we had basically seven, eight quarters in a row where we were basically all units and less price-mix. I would say that price-mix is higher this quarter. I would say in the region of 30%; so 70% units, 30% price-mix.

Flavio Cereda - Merrill Lynch
Good evening. Two questions, please. First one, if we look at LensCrafters, and let's take a little bit of a worst-case scenario and assume the like-for-likes at LensCrafters actually don't pick up much, and then you are looking at very low single digits of the order 1 through 2, 2.5% for the, say, next couple of quarters. Do you think, I would like to have a sense to what extent the current levels of profitability do you think are actually sustainable or potentially even can improve if you don't have a pickup in the like-for-likes at LensCrafters. That was my first question.

The second question was are you confident, Andrea, that you can hit your guidance as far as, guidance, inverted commas, as far as emerging markets are concerned by the full year? Thank you.

Andrea Guerra
When we look at LensCrafters, we have gone through this quite extensively, and we still have a good margin to be exploited in the higher parts of our profit and loss. So, we still have margin where the team is doing an excellent job at the gross margin level, including all the lab services, all the lens profitability, frame profitability, quality and shrink. I think the team is doing a wonderful job, because they have really analyzed that part of the profit and loss in a completely different manner. I still think that there are some quarters where, even without growth, as you are alluding to, that can still be profit enhancing. So, this is where we stand on LensCrafters.

In terms of emerging markets, probably we will be more in the region of the 20% rather than a 25% to 30%. I think that we were a little bit optimistic in how we could have integrated Tecnol faster. And it is not taking longer, but we thought that really we could have had some performance benefits a little bit faster. But no major issues there.

Sophie Dargnies - HSBC
Hello. Sophie Dargnies, HSBC. I have three questions. In wholesale, can you give us the impact of Coach and Tecnol in 2Q? And in retail, can you also give us the impact of acquisitions and what was that?

My second question is on LensCrafters. Maybe I did not hear well, but you say that May and June were the slowest months, and you said April was plus two going to plus four end of the quarter. So can you come back a bit on that and tell us about July? And that's it.

Andrea Guerra
So about LensCrafters, April was slow. May, I don't remember the exact figure, but between 3% and 4%. June until the 10th, 3% and 4%, then SAP. July, between 2% and 3%.

Regarding Tecnol and Coach, I would say in the quarter, we are in the EUR25 million to EUR30 million range. At Coach, Coach is not fair to say that we are adding it on, because we canceled two licenses a year ago, so Coach’s net effect is much less than that.

Sophie Dargnies - HSBC
In retail, the impact of acquisitions.

Andrea Guerra
Retail is in the region of…

Enrico Cavatorta
EUR15 million this semester.

Andrea Guerra
Exactly. So I think in retail, it is quite small, EUR15 to EUR20 million.

Sophie Dargnies - HSBC
Can I have a follow-up question on LensCrafters? SAP was in June, so do you expect SAP to continue to have an impact on 3Q?

Andrea Guerra
No, no, we already said that it's finished, it's over and we forget it.

Sophie Dargnies - HSBC
Okay, so that means that you expect 3Q, even if July was a bit lower than June, to be better quarter after quarter or month after month?

Andrea Guerra
I didn't say this.

Sophie Dargnies - HSBC
Do you expect, what is your view on LensCrafters in the next month?

Andrea Guerra
I think that LensCrafters in the next month will be more or less where July is.

Sophie Dargnies - HSBC
Okay. So that means that the American consumer is a bit more difficult.

Andrea Guerra
No, I think we also need to look at the benchmarks and what we have done and LensCrafters. I mean, when I am saying that Sunglass Hut is posting another 10% comps and it's the third year in a row, and the total sales in North America of Luxottica, having LensCrafters as +1%, was almost plus 7%, I wouldn't come to this conclusion.

Sophie Dargnies - HSBC
Okay. Thank you very much.

Andrea Guerra
May I give you some precise numbers? So precise numbers on Tecnol, Coach and retail in 2Q. Net Coach was EUR10 million, because it is EUR14 million minus EUR4 million of licenses that have gone away; EUR11 million of Tecnol; and just about EUR20 million in retail. I was giving some details.

Sophie Dargnies - HSBC
Sorry, I just have a new follow-up question. So you said that the acquisition had a EUR20 million impact on sales. In terms of margin, can you update us?

Andrea Guerra
In retail, we gave it.

Sophie Dargnies - HSBC
Okay, sorry.

Andrea Guerra
It is on page

Enrico Cavatorta
On slide 8 of the presentation. The dilution is not just GMO it also includes the retail part of Tecnol, which is minimal and the Sunglass Hut expansion in Mexico. Altogether, they've diluted first-half profitability by 50 basis points.

Operator
Gentlemen, at this time, there are no more questions registered.

Andrea Guerra
So with many of you, probably we are going to see you on the wonderful Lake of Como tomorrow. And have a wonderful evening and talk to you soon with 3Q. Thank you and bye-bye.