Conference Call 2Q – 1H 2009 Results - August 4th 2009

Roberto Vedovotto - CEO

Thank you very much. Good evening to you all, and welcome to Safilo's second quarter and first half 2009 results conference call.

We were supposed to do this call last Monday, but, as previously communicated, our Board of Directors has decided to adjourn the meeting in order to carefully review the situation in light of the fact that the discussions with potential financial investors had been terminated.

Today's agenda will be focused on the following topics - second quarter and first half 2009 performance, current rating, update on corporate activity.

As the operator had mentioned, I'm here with Francesco Tagliapietra, Christian de Felice, and Barbara Ferrante. And we will all together answer any questions that you might have.

Let's now go into the key themes. The key themes of our second quarter 2009 business performance are the following. First, market conditions continued to be challenging.

Second, we had already indicated during our last conference call that April had shown a modest improvement over March, although declining by 10% or 11% vis-a-vis April 2008. May was a very difficult month for us, especially in some Asian countries, where we decided to postpone shipment towards a number of critical, key accounts in light of our ongoing monitoring of the solvency level of our clients. June showed an encouraging improvement, being the first month of the year in which we actually registered flat sales versus the corresponding previous-year month and where we partially recovered May's underperformance.

Three, we continued to experience a shift of consumer purchasing habits towards more accessible products. Our customers' final consumers are trading down to lower entry levels of sunglass luxury collections and are penalizing our performance in the high-end segment. On the contrary, our prescription business continued to prove more resilient and this, it seems, particularly in the context of still tough market dynamics.

Four, our performance in America has been substantially stable, notwithstanding competition, with a resilient prescription business in the independent optician channel and tough trading conditions at the department stores and retail channels level.

Number five. Europe and Asia continued to be extremely challenging - in Europe, particularly Spain, UK, and north European countries; in Asia, Japan.

Sixth, the wholesale channel is showing a decline. At the same time, our retail network is registering a moderate growth rate.

Now, on the back of these key themes and on the back, more significantly, of these difficult trading environments, our operating performance has shown a modest improvement. And we clearly continue to focus on all the projects and initiatives that we are implementing to strengthen our industrial, organizational, commercial, and product setup.

I just wanted to mention to you very few examples. We continued to reduce the number of models and SKUs, and we also continued to simplify the complexity of our production cycles in agreement with our licensors. I wanted to briefly give you some color around this. In 2005, we had 22 brands. We now have 25 brands, up 14%. In the same period, our new models went up by 26%. The number of active models went up by 41%, and, yet again, the number of SKUs went up 41%. We are reducing, and we will keep reducing, the number of new models, by 16% this year and by 22% next year. As far as number of SKUs, we will reduce them by 20% this year and by 40% next year. This will clearly have a positive impact on production costs, inventory, obsolescence, and cost savings on sample production.

In terms of other projects we are focusing, I want to give you a few more examples. We are redesigning our commercial architecture, and we are streamlining our sales force. Compared to December 31, 2008, our sales force has been reduced by 97 people, 7%. We have reallocated some of the territories, we have closed down a number of nonperforming clients, and we have, finally, created a number of key accounts to manage top customers.

We are also increasing the level of integration with our clients. We call is Project Smile, whereby we offer to our clients a more defined-- a better defined management of their inventory, which, as a consequence, gives us a better management of our inventory.

We reduced our inventories by 600,000 pieces, thanks to a better integration of the different stock houses that we have around the world and thanks to a number of improvements which we quickly implemented into our planning department. We are focusing more and more on vision merchandising. As I had mentioned to you on my first conference call, we are focusing on sellout rather than sell-in.

We also started a program whereby we are constantly updating the high-end collections of all our fashion brands, where we try to create and increase an increasingly higher appeal to meet consumer needs in terms of style, brand, and target price. We have extended the collections that we carried out towards more accessible prices, and we will slowly have about 15% to 20% of our collections priced below EUR200.

We keep focusing on our house brands; namely, Carrera. Carrera, as I will tell you later, maintained a double-digit growth also in this quarter. This is a business segment which is responding better than any other that we cover, and we are also farther expanding Carrera's geographical footprint.

At the same time, last but not least, we maintain a strong commitment on cost-cutting initiatives, and we are very selective in the investments that we're cutting out in our retail network.

Our results, which I'm going to discuss with you shortly, as you might have seen from the press release that we sent out 20 minutes ago, have been impacted by total extraordinary noncash items of EUR128.1 million. Let me briefly explain this number.

EUR7.4 million are related to the restructuring of our production activities. I'm sure you remember I mentioned to you this project in my last conference call.

The agreement that we reached with trade unions, particularly regarding the resizing of production capacity in Italy and Slovenia, which involves around 750 people, leads to redefinition of the plan of incentives and unemployment benefits to the worker for a value which we decided to completely set aside in this first semester of EUR7.4 million.

Then, in consideration of the current evolution of market conditions, in consideration of the results achieved during the first half, and also taking into consideration generalized increase of risk rates, the Group has decided to carry out a complete impairment test on the goodwill value. This new impairment test highlighted the need to write down the goodwill value as allocated to some cash-generated units for a total amount of EUR120.7 million. EUR120.7 million equals to 14.9% of the total value of the goodwill. Of these EUR120.7 million, about one-third is a direct result of the trend of the above-mentioned risk rates.

I think that in order to present you our ongoing operating performance, it will be appropriate for me to make comments referring to the adjusted results; therefore, excluding the just-mentioned extraordinary charges. Please note the following key financial highlights.

First half total sales were EUR562.1 million; EUR274.2 million in Q2. This represents a decline of 11.7% and 11.8% versus first half 2008 and Q2 2008.

First half EBITDA was EUR51.5 million; EUR21.3 million in Q2. This represents a decline of 39.5% and 44.6% versus first half 2008 and Q2 2008.

Net financial position - EUR592 (sic - see Press Release) versus EUR617.7 million registered at the end of March.

Let's now quickly go into Q2 2009 results. As said, I will discuss now our adjusted results.

Second quarter performance was not too different from what we registered in Q1. In particular, total sales were down in Q2 by 11.8% reported, 15.7% at constant currency, taking the total decline of the first semester, the first half of this year, at 11.7% reported, or 15.4% at constant currency.

Let me go briefly into the key drivers of our organic, top line performance; first, higher and higher demand for Carrera. I'd like to start from the good news, and I've got to tell you that Carrera in the second quarter exceeded the already-strong increase registered during 2008 and during the first quarter 2009. Carrera has been growing by over 40% in the period. We are very, very satisfied with the results of this house brand.

This is clearly proof that-- Two factors are important - right product at good price with strong brand image. It's a winning strategy. On top of that, the business segment where Carrera is positioned is by far the less affected by the declining consumer demand, as the segment is today showing a much higher resilience. And this is true especially in sunglasses.

The other factor is that Carrera continues to gain market shares in Italy and in some other countries, like Spain and France, and this is not only related to Champion and Safari but to the collection as a whole.

Let's go into geography for a second. Americas, as I said before, were flat in Q2 reported, minus 10% at constant currency, and slightly decreasing, by 1.5%, in the first half, minus 11.2% at constant currency. We continue to be satisfied with the performance of our products at the independent optician level, where our market shares are very good, especially in the prescription frames business. On the other hand, though, business conditions remained, as I mentioned before, very challenging at department stores level, as well as at the large retail chains level.

Europe slightly improved versus the decline reported in Q1, but I'm not satisfied. The area declined 17.8% during Q2 and minus 19.5% in the first half, on the back of still difficult trading conditions in Spain, UK, and Nordic countries. In this area, the sunglass business, and particularly in the higher part of our product ranges, remained the most affected by the slowdown in the market.

Asia in the second quarter was the worst-performing area, with sales down 16.8% reported, minus 24.8% at constant currency. In the Asian area, certainly, Japan was the one again dropping double digits in the quarter, unfortunately, closely followed by the duty-free business, which continues to be impacted by the heavy decline of the business travel, as well as by a generally, I would call it, depressed average purchasing ticket. And this has materialized even more so during second quarter and also because the Group has carefully monitored the solvency level of its client, and this is particularly true especially in China.

Let's go into product categories for a second. Sunglasses. Sunglasses sales in the second quarter declined by 13.5%, in line with Q1. The drop was more marked in Europe, where the penetration of high-end products is certainly higher. As mentioned, we are acting quickly to provide collections fine-tuned with consumers' demand; also, for our fashion brands, in full agreement and in total accordance with our key licensors. The US is today the market where the consumer is more reactive to this new product proposition.

Prescription frames. Prescription frames business continued to show a more resilient performance in all our priority markets. In fact, prescription frame sales were down 7.2% in Q2, with some better results in the US area. Once again, as previously mentioned, Carrera has in the second quarter exceeded the already-strong increase registered during Q1.

From a distribution channel standpoint, let's start with wholesale. Wholesale revenues were down in the second quarter by 13.2% reported, 17.1% at constant exchange rates. In this area, we continued to have a strong, strong focus on quality of receivables rather than sales.

On the other hand, the retail business was up 2.1% in the second quarter reported, slightly declining at constant currency. As of end of June 2009, we had 327 stores around the world versus 283 stores at the end of June 2008. Comp sales were down 19% in the second quarter; minus 18% in the semester. This is also due to, unfortunately, the very weak performance in the quarter of, as you would expect, the Mexican stores. The Mexican stores were hit hard by the drastic tourist drop in the country after the outbreak of the swine flu. We are confident, and we believe that tourists are now starting to come back. And they're now starting to buy again our products from our stores in the area.

Let's talk for a second about profitability. EBITDA in the second quarter was EUR21.3 million, 7.8% of total sales compared to EUR38.5 million in Q2 2008, 12.4% of total sales. EBIT - 3.7% of total sales, or EUR10.2 million; 9.1%, or EUR28.2 million, in Q2 2008.

We closed the second quarter 2009 with a net loss of EUR9.6 million, taking the net result of the semester to a loss of EUR7.9 million.

I want to briefly discuss with you the main drivers of our operating performance.

Gross margin. Gross margin declined 80 basis points in Q2 2009 compared to Q2 2008, reaching 57.1% of total sales. In the first half of 2009, gross margin improved by 30 basis points over the corresponding period last year, mainly driven by the components that we already described during Q1 - new product development processes, industrialization processes, lower level obsolescence products in stock, use of social security cushions at our Italian factories.

Gross margin in the second quarter was affected by some inefficiencies related mainly to the reduction of production output, as well as by, certainly, less effective work flows due to the transition process, given the reduction of production capacity.

SG&A remained high, mainly due to the higher impact of retail cost, which were mainly influenced by store expansion and even more so by negative comps results.

As in previous quarters, fixed costs continue to have a higher incidence on sales. As a reminder, advertising and promotional expenses are a typical example of these, and I'm sure all of you that follow this Company and the industry know that these advertising and promotional expenses relate to commitments towards our licensed brands. And, unfortunately, they're set on previous-year sales.

In the wholesale channel in the second quarter, total SG&A costs declined by around 6%, also thanks to the ongoing cost-cutting initiatives which were put in place by the Group in order to improve operational leverage. G&A costs increased in the second quarter as a result of the prudent increase of our reserve for bad debt.

In the wholesale business, EBITDA, as I mentioned before, reached 8.6% of revenues compared to 13% in Q2 2008.

In spite of negative comp sales, the retail business broke even in the second quarter with a very small, positive EBITDA, EUR235,000, mainly related to the various cost-cutting actions we are focusing on to improve profitability.

In the first part of 2009, the retail business lost altogether EUR2.6 million at EBITDA level. This was mainly impacted by negative comp sales and by startup costs related to the new stores opened during the period.

Below the operating line, net financial charges declined in the second quarter to EUR8.1 million from EUR12.9 million in Q2 2008.

In the quarter, we registered net ForEx gain of almost EUR5 million due to the US dollar spot rate at the end of June.

Net result was also impacted by taxes of EUR10.8 million.

Free cash flow. Free cash flow in first half 2009 registered an outflow of EUR18.6 million compared to the EUR2.4-million outflow in first half 2008. Here, we experienced two opposite dynamics.

One, on one side, decrease of investing activities - EUR19.5 million in first half 2009; EUR57.4 million in first half 2008, where, as I'm sure you remember, Safilo acquired the Mexican and Australian retail chains. CapEx in this semester included around EUR6.5 million, mainly maintenance of our production facilities, and EUR6.5 million cash out related to the China plant.

The second-- The opposite dynamic to this one was lower cash flow from operating activities, which was mainly due to the lower profits of the period and to higher absorption of resources from working capital. Here, trade payables were the main driver, due, as we explained the previous quarter, to different scheduling of payments of our Asian products.

Net financial position at the end of June 2009 - EUR592.1 million, cyclically higher than the position at 2008 yearend, EUR570 million, but certainly a little bit better than the position at the end of March 2009, which was EUR617.7 million.

Current trading. Only a few words here, on July. July was an okay month. We saw the consolidation of some of the previously described business trends, especially in US, where the market remained good at IOs level, independent opticians, while remaining tough at the department stores and at our Solstice stores level.

The new collections keep performing well. They've done so in July. And all of them have been showing progressive improvements over the previous collections in terms of how much clients and customers have liked them. Once again, Carrera continued to achieve also in July, outperforming results in all countries where the brand is present at the moment.

Two words on corporate activity. We have tiredly worked alongside with all our stakeholders and advisors to identify a potential financial partner to effect a recapitalization of the Company in order, as I've mentioned to you previously, to ensure the sustainability of our medium-, long-term capital structure. However, as we have communicated last Monday, at this stage, all the discussions with the leading, international, private equity investors have been terminated, and no binding offers have been received.

The Board of Directors has given me mandate to continue to implement all the initiatives to strengthen the Group's capital structure, in line with the Group's investor strategy with the support of all different stakeholders of Safilo.

As the discussions with the financial investors have been terminated, the Group will continue to focus on its core business, cutting out all the unnecessary actions to further improve operating performance, with the full support of the lending banks. We are therefore currently evaluating with our advisors the situation and assessing the best way forward. We will clearly and constantly keep you posted and updated as progress is made.