Natuzzi SpA

Fourth Quarter and Full Year 2016 Conference Call

March 31, 2017

C O R P O R A T E   P A R T I C I P A N T S

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Pasquale Natuzzi, *Chief Executive Office*

Vittorio Notarpietro, *Chief Financial Officer*

Nazzario Pozzi, *Chief Commercial Officer, Natuzzi Brands*

C O N F E R E N C E   C A L L   P A R T I C I P A N T S

David Kanen, *Kanen Wealth Management*

Velin Mezinev, Donald Smith & Company

P R E S E N T A T I O N

Operator:

Good morning, ladies and gentlemen. Thank you for standing by, and welcome to the Natuzzi Full Year 2016 Conference Call. At this time, all participants are in a listen-only mode. Following the presentation, we will conduct a question-and-answer session and instructions will be provided at that time for you to queue up for questions.

Joining us on today's call from Italy are Natuzzi's Chief Executive Officer, Mr. Pasquale Natuzzi, Mr. Nazzario Pozzi, Chief Officer of the Natuzzi Division, the Chief Financial Officer, Mr. Vittorio Notarpietro, and Piero Direnzo, Investor Relations.

As a reminder, today's call is being recorded, and I would now like to turn the conference over to Piero. Please go ahead.

Piero Direnzo:

Good morning to our listeners in the United States and good afternoon to those of you connected from Europe. Welcome to the Natuzzi's full year 2016 conference call. After a brief introduction, we will give you room for a Q&A session. Mr. Pasquale Natuzzi together with the top Management team will be glad to answer your questions.

By now, you should have received an email copy of the Natuzzi's earnings results. If not, you can find this information within our website at www.natuzzi.com or please call our Investor Relations Department at 0039-0808820812 to receive the results by email. You can also email information requests or questions to our email address investor_relations@natuzzi.com. We will respond to you as soon as possible.

Before proceeding, we would like to advise our listeners that our discussion today could contain certain statements that constitute forward-looking statements under the United States Security Laws. Obviously, actual results may differ materially from those in the forward-looking statements because of risks and uncertainties that can affect our results of operations and financial condition. We have discussed such risks and uncertainties which have in the past affected and may continue to affect our results of operations and financial condition in our Annual Report on Form 20-F for the fiscal year ended December 31, 2015. This report is available within our website www.natuzzi.com or from us upon request. You may also obtain a copy of our Form 20-F filing from the United States Securities and Exchange Commission.

Now, I would like to turn the call over to the Chief Executive Officer. Please, Mr. Natuzzi.

Pasquale Natuzzi:

Thank you Piero. Good morning and welcome to our conference call. Joining me today are Nazzario Pozzi, our Global Head of Retail, and Vittorio Notarpietro, our Chief Financial Officer. I would like to emphasize that we are still working on our turnaround and we have much still to do. But, I can assure you that we spend the clear majority of our time on efforts aimed at improving our volumes, our efficiency and returning to profitability. As we have said before, we are well on our way in pursuit of our new direct retail strategy. We have invested much time and efforts in the Company in all areas as a base of this strategy to succeed. We have greatly reinforced our brand. We have broadened our product, offering—and product mix and we have focused much attention on procurement, production and delivery logistics, marketing and communication to evolve with the Company alongside the brand.

At the same time, we have managed our cost structure and negotiated successfully with the Italian Government for labor subsidy (phon). While our gross revenue declined in 2016, the rate of decline was its lowest in the last quarter and we are increasingly confident that our strategy will succeed and my highest priority is to return this Company to growth.

It is important to understand that we believe we could have grown revenues if we had cut price and with the favorable cost, we could have done so. However, we decided to maintain our strategy and focus on growing the value in our brand and our product, and even with the small decline in revenue, we are increasing our gross margin, our price per seat and our cash flow.

Softaly has been working on a similar focus. Our private label is growing in Europe and Asia, thanks to a well-structured organization, but we are having issues in North America where we are still working on an appropriate and skilled organization. We are committed to regaining our growth, maintaining our value and returning our great Company to strong profitability.

Let me turn the meeting over to Mr. Pozzi to update you on our retail progress, and then I will be available for you for any kind of questions. Thank you.

Nazzario Pozzi:

Thank you Pasquale. As Mr. Natuzzi has just said, we are aggressively pursuing our direct retail strategy around the world. As we've announced the new strategy last July, we have opened new stores in UK, in the United States and in Australia and these stores are in high density, high traffic areas. They have been designed and merchandised by our team in Santeramo. We have also acquired eight Natuzzi Italia stores in the United States, seven in Florida, one in Pennsylvania, three Natuzzi Italia stores in Mexico, and also five stores in Italy, Divani & Divani by Natuzzi.

Considering that this is a new effort, we are very pleased by the results we are having so far. So far in 2017, our like-for-like stores are improving both in volume and price, particularly with our high-end brand, Natuzzi Italia, and the new stores are performing even better. For the first two months of 2017, on a like-for-like basis, the direct owned stores increased sales by 6.9% over the same period last year, and if we include sales from on our new stores, the increase over last year is up to 39% in DOS, direct owned stores.

Divani & Divani continues to underperform its potential and also our expectations. But we have begun extensive restructuring of Management, store locations, store formats, product offering and our Marketing Group is developing a strategy to reposition this important product line. We will continue this strategy and we are in process for opening additional new-generation direct owned stores, namely in the United States, in the United Kingdom, and also in China. This of course is by its nature time-consuming and we are adding experienced managers so that we can accelerate stores openings going forward.

In addition, we are also stepping up our efforts to work better with our partners in branded sale. We have stepped up our efforts towards (phon) these franchise owners in store design for play and display, in merchandising, marketing lead generation, brand marketing and we are sharing with them the knowledge we are gaining from our direct retail experience, and our strategy is towards target sales as well as growth with these partners who represent the Natuzzi brand worldwide. We have still much work to do, but the team is getting stronger and we are making progress every day.

Let me now turn the meeting back Mr. Natuzzi who will discuss Softaly.

Pasquale Natuzzi:

Good morning again, thanks Nazzario. I'm covering today for Mr. Tucci who is in meeting with a very important client and hopefully crossing a very important deal today.

Softaly represents the Private Label portion of our Group, and is of course the successor to our original vision having started in 1959. The business has changed much since then. It is truly global, requiring new answers for different markets around the world. It faces many new competitive forces, all of which have pressured its returns and (inaudible) its ability to make money.

We have worked hard to offset the cost elements of this competition and the hard work on product and process innovation is giving us the first result. We are now focusing on rationalization of the business. We are positioning of new partner (phon) with whom we can have high growth and profitable relationships. We have made progress, but we have more work to do. We have gained new customer throughout Europe where we have also rebuilt the relationship with the largest retailers. This allows us to improve the production efficiency in our plant in Romania. EMEA grew revenue by 5% in full year 2016 versus 2015 on top of the plus 20% growth in 2015. So, we expect to show stronger growth in current year.

In addition to the 5% growth in Europe, we experienced a plus 13% growth in Asia-Pacific. We are continuing our focus in our Chinese manufacturing facility to increase efficiency and make it truly competitive with the largest of its local competitors. Our focus now is to recover our business in North America. We are restructuring and focusing our sales efforts on the customer who represents the greatest opportunity. We are working on our Management team to fill some key positions and are confident we will drive growth in the current year again, 2017. Softaly Asia and we (phon) continue to be uniquely strong player in the global private label upholstery market.

I will now the turn the meeting over to Vittorio Notarpietro, our Chief Financial Officer, who will go deeper into our financial results for the fourth quarter and full year of 2016.

Vittorio Notarpietro:

Thank you Mr. Natuzzi. Let me say first that in the fourth quarter of 2016, the Company adopted newly issued Italian GAAP rules. Under these rules, expenses previously included with caption other expenses net, specifically the impairment of long-lived assets and non-current investments and the accrual for the one-time termination benefits are now included in the cost of sales or selling expenses as SG&A expenses based on the function of the cost to be reclassified. Due to the requirement to adopt the principle on a retrospective basis, also previous year operating loss has been revised for a better comparability of the figures.

Having said that, let me start by reiterating what Mr. Natuzzi said, our revenues were down, okay, but we made a conscious decision to keep the value. So, we are quite pleased with the results, so far. While sofa sales were lower by 6.6% in 2016, we saw furnishings sales grow by 6.5%, which is a good sign regarding the potential for this new segment in the branded division and confirms the power of Natuzzi name on the market. We had a negative impact of foreign exchange of 1.6% on sales, but slightly positive on operating income by €0.3 million.

Total net sales, you know, were €457.2 million, including non-core sales of €25.5 million. So, that core business sales were €431.7 million and Natuzzi branded business represented 73 of total core business sales, or €313.1 million, of which €45.4 million were done by the directly operated stores chain, what we call DOS. Natuzzi sales performance was minus 4 compared, versus 2015. Private label sales instead went down by 10.6% and represented the remaining 27% of total core business sales.

In 2016, we improved the industrial margin by 2.7%, mainly due to favorable raw material prices and industrial process efficiency and we did this in spite of lower sales. The Company was capable to reach further efficiency in transportation cost too. As a result, Natuzzi has almost reached the operating margin breakeven despite lower sales. It's interesting to underline that in the fourth quarter 2016, with sales of €124.6 million, down by 5.4% from the same quarter of 2015, the Company was able to achieve a 2.4% operating margin, positive operating margin, higher than the 0.6% of fourth quarter 2015. Still in the fourth quarter of 2016, the Company was able to reach a little net income in spite of higher tax rates.

Net cash from operating activities continues to improve and was positive by €26 million at the end of the year and more than offset the net cash invested of €10.7 million. As a result, the net financial position almost doubled and reached a positive €28.9 million.

As Mr. Natuzzi said before, the Company has just begun our direct retail strategy. I would like to say something about the associated capital expenditure. The cap ex to start a new direct operated store with the characteristics we have in our high traffic model are in the range of 400,000 to 800,000 per store depending on the location and other factors, so not so huge. Having said that, the financial cycle of DOS is largely positive versus the normal financial cycle we have with independent dealers. In fact, in the case of DOS, we get paid between 30% and 50% of sellout at the time the final customer enters the store and writes an order so well in advance. In the case of wholesale business, the independent retailer pays us the selling price in an average of 30 days from shipping. So, direct retail model generates cash faster than the franchised business.

I would like to talk a little about our early results in 2015— '17, I am sorry. Please keep in mind it is still very early in the year, so this information is preliminary. In December, we experienced a slowdown in order flow that affected January 2017 invoice of sales, but we started recovering in February and March. We continue to see an economic slowdown in some countries, some concern in other countries, but as we said, we are now starting to see the first signs of recovery in the order flow. DOS metrics are improving. It's our intention to continue to open, acquire existing franchisees, and maybe consider joint ventures with some of our stronger dealers to accelerate sales growth and capture the available synergies.

I would like now to turn the call back to Mr. Natuzzi.

Pasquale Natuzzi:

Thank you Vittorio and the Nazzario. We had a strong and dedicated—I would like to again emphasize that more than ever, today we have a strong and dedicated Management team. These executives are supported by longstanding managers at our Company and as a CEO, I am pleased with their efforts working together. Our environment is still soft as the world struggles with the new political reality. But our goals are clear, our dedication is unwavering and our results are starting to reach towards their potential. We are the most recognized high-end furniture brand in the world. We are global in every aspect of our business, unique among our competitors. We are strong, we are focused and we are growing the value of our Company while maintaining the highest standard of design, quality and customer satisfaction.

I will now be happy to take your questions. Thank you.

Operator: Thank you. Ladies and gentlemen, if you'd like to ask a question, please signal by pressing star, one on your telephone keypad and if you are using a speakerphone, please make sure that your mute function is turned off to allow your signal to reach our equipment. Again, you can press star, one to ask a question, and we will take our first question from David Kanen of Kanen Wealth Management.

David Kanen:

Good morning guys. Congratulations on the nice improvement in 2016. First question is the shift in strategy to opening direct to consumer, opening your own Natuzzi Italia stores; can you tell me how many stores were opened in the fourth quarter and how many were opened in the first quarter and what the plan is total number of openings for 2017?

Pasquale Natuzzi:

Sure. Since we've approved the strategy, the direct retail strategy in July, we have opened six stores, one direct operated store and five franchise stores. We have opened the direct operated store in end of January in New Jersey; and the five franchise stores in UK and Australia since September until December 2016. Our plan for this year 2017 is to open between eight and 10 stores, namely in the United States and in UK, four direct operated stores and four franchise stores. But, it is not a matter of how many doors we're going to open, but it's about opening those stores in the right location, high density, high traffic retail parks with the right format and offering the right merchandise needs, and these of course take time. So, we're going to accelerate these as fast as possible. We are further strengthening our team to scouting for appropriate right locations and this is our plan for 2017.

David Kanen:

Okay. Can you just clarify something for me? You said you plan on opening eight to 10 stores in 2017 in the US and the UK. These are direct operating stores and four franchise, so is that…

Pasquale Natuzzi:

These four franchise and four direct.

David Kanen:

Okay, okay, I see. So, the total is eight to 10?

Pasquale Natuzzi:

Because these are locations we have already acquired. So, these locations are secured.

David Kanen:

Okay. So, half of the eight to 10 will be franchise, the other half will be direct operated, and then can you tell me going forward on these stores what the margin impact is to your overall results?

Pasquale Natuzzi:

Can you say again? Sorry.

David Kanen:

Can you explain to me, what you expect the margin impact to be on those direct operated stores?

Pasquale Natuzzi:

We have a clear vision on the targeted operating margin and EBIT at store level. So, first of all, as Vittorio has mentioned, we have an initial investment, which is between €400,000 and €800,000 depending also on—depending on locations, and also on annual (phon) contributions, and the shift in the cash flow cycle allows us for a payback between January the first year and the second year because of margins. So through DOS, we capture all value of our brand from sellout and margins, and those margins are targeted to be up to 10% at store level in the second year.

David Kanen:

Okay. So, the benefit—I just want to make sure I understand it correctly. So, you are going to capture both the retail margin, which is about 10 points in the second year and then you are going to capture the wholesale margin. So—and then the other thing that you are saying is that from a working capital perspective, this is positive, I am assuming because people give you a deposit upfront, you are not tying up our your money in inventory and receivables. So, you get a deposit upfront in the store to build it, which helps you with working capital and then they pay the balance upon delivery. Is that pretty much how it's structured?

Pasquale Natuzzi:

Okay, let me say something about margins. In the Natuzzi existing direct retail operations, our stores, the new ones, they have already a 60% gross margin including everything, okay, and this is much better than the 34.3% that we displayed so far because the composition, the mix of our sales between wholesale and DOS. Having said that—and this captures all the values you are mentioning rightly. Working capital, we already have our working capital to produce since we received the order. The opening of DOS will have a first negative impact because of the openings. So, the amount of cash you have to open between €400,000 and €800,000. But, as far as the entire financial cycle is considered, you're right. We get paid 30%, 40%, in some case 50% of sellout price at the moment of the order. So, when you enter the store and then we get the balance to delivery. Today, when we do the—in the United States, wholesale business we get paid in an average of 70, 75 days from invoicing. So, you can imagine that for sure, a well-managed DOS will generate cash.

David Kanen:

Okay, and then what would be the—so, the cap ex impact will be assuming you open 10 stores would be about $6 million. Is that correct of 600,000 on average?

Pasquale Natuzzi:

Yes, yes, on average yes, you're right.

David Kanen:

Okay. So…

Pasquale Natuzzi:

To further comment on your—sorry, to further comment on your question, I gave you the number of franchise and direct stores which we are going to open in 2017 for Natuzzi Italia new format retail store, which I have already mentioned to you. Let me add that of course our plan also includes openings in other countries, and a specific comment on the plan we are designing for for China where our current directly operated stores are delivering so far like-for-like in 2017 dramatically increasing sales year-on-year, and that's why we are also planning stores for Natuzzi addition in China with an overall plan for the full year, which are ahead and we start executing these in 2017.

David Kanen:

Okay. So, are you implying based on what you saw in the first quarter, which is basically complete and with these store openings, are you implying that you expect 2017 to be a growth year with margin improvement?

Vittorio Notarpietro:

I have already said something about what is the situation today. We are working to grow, as Mr. Natuzzi said, and of course, we are working to improve our margins. I would remind that two years ago, we reached EBITDA positive, this year EBIT breakeven. So, next goal would be—is to go further.

David Kanen:

Okay, and I have other questions, but right now, I'm going go back into queue in case there's anyone else and then I may ask a couple of follow ups. Thank you for the insight.

Vittorio Notarpietro:

Okay, thank you sir.

Operator:

As a reminder, ladies and gentlemen, you may press star, one at this time if you do have a question. You may press star, one to signal for questions. We will pause a moment so that everyone has an opportunity to signal. We'll go to our next question from Velin Mezinev of Donald Smith & Company.

Velin Mezinev:

Hi guys. What would be the impact of the border adjustment tax, should they pass?

Pasquale Natuzzi:

Are you mentioning duties, possible duties?

Velin Mezinev:

Yes.

Pasquale Natuzzi:

Okay. We have, I mean, we have been thinking about that based on Mr. Trump announcement that very often we have new scaring announcement around the world, but we have a production system. (Inaudible) in the last five years through the product innovation, which means not a new style or a new function or new trends, but just the way we engineered the product, we revolutionized the way we engineered the product in order to create a synergy between various components, but also we redesigned the production process. Our factories are relatively revolutionized compared with our older system and that allow us to manufacture quality product anywhere in the world with unskilled people. This is really the miracle that we have made in our operation after 59 or 58 years' experience.

So, I mean, we are ready. Today we don't have any reason to do further investment and manufacturing the products in America because we are all focused in developing a retailer, but it depends because if we talk about the 2%, the 3%, the 5% duty assuming that America will decide to apply a new border tax of 5%, I believe that based on the strength of the brand, we can absorb that 5%, will be not a big difference because our average ticket in America in our store is $4,000. So, if it instead is $4,200, I don't see big difference, but in the case that there is a very high duty, then we'll take six months at least for us to come in America and build up the factory. Consider that our Americas regional headquarters is based in North Carolina since 25 years. So, we're still in America as our almost second home. No, it is our second home. It's not by coincidence where we went public in New York. So, certainly we hope that this does not happen, but if in case happens, we are ready. We are ready to come in America and manufacture the product locally, improving the delivery time and all the rest.

Velin Mezinev:

Thanks.

Operator:

As a reminder, ladies and gentlemen, that is star, one if you'd like to signal for questions at this time. That is star, one. We will pause a moment. We do have a follow up question from David Kanen of Kanen Wealth Management.

David Kanen:

Okay. Gentlemen, can you please reiterate what you had said about, I believe it was January-February or February-March that you saw a like store increase. Are you saying that same-store sales were up 6.9%? Could you just reiterate that? Just want to make sure I understood it correctly. It sounded like you're saying same-store sales in Q1 were up about 6.9%.

Nazzario Pozzi:

That's correct. Our like-for-like stores had a 6.9% increase year-on-year versus last year and this is the existing store base, whereas with the addition of the new openings which I mentioned, overall sales increase versus the same period of last year is 39%.

David Kanen:

Okay, and this is for what month? Is this for the entire first quarter or just January, February?

Pasquale Natuzzi:

January, February.

David Kanen:

Okay, and then can you share with us your e-commerce strategy at this point, some of your plans to acquire customers in a cost-effective way, if you have that?

Pasquale Natuzzi:

Yes, we are very much interested now and focusing on developing the online business. We are working on defining the models. The model, which means primarily which platform we are going to use, and we are in favor to use an existing platform to start with in online business. We are in touch already, we are talking since now almost couple of months with people, with different company to finalize the way we should start distribution, which we consider very important, not for the business itself, but just to show the Company and direct the consumer in the store because as far as we know through our network colleagues around the world and those customer, still furniture people prefer to go in the store, touch the furniture, sit on the sofa, try the comfort. But anyway, whatever will be the future, but again, we all believe that the future is online, not in the same way of the apparel, obviously, but we strongly believe that it's important for us to initiate this new venture.

David Kanen:

Okay. On a different subject, I'm going to—just a comment for Mr. Natuzzi and for the Board of Directors, as a fellow shareholder, I mean, number one, I would like to commend you for the good job you've done in turning around the business, rightsizing it and now generating substantial free cash flow, okay? However, that—and positioning us well and having a strategy for growth and margin expansion in the future. However, all of that being said, with that being accomplished, looking forward, when I look at your balance sheet and the valuation of the stock and the financial attributes going forward, it seems to me that it would be wise for the Company to have in their capital allocation strategy a stock buyback because we're trading almost for tangible book value, okay, generating very substantial double-digit free cash, free cash flow yield when we look at the enterprise value. So, as a shareholder, my commentary is I think it would be wise for the Company to buy back stock, significant amounts of stock and a significant portion of their free cash flow. So, just a commentary at something that I would like for you guys to contemplate and talk about on the Board level. Thank you.

Pasquale Natuzzi:

Thank you so much for this question. For the moment, we are investing in our expansion, okay?

David Kanen:

Okay, good luck, thank you.

Operator:

As a reminder ladies and gentlemen, you may press star, one to signal for questions at this time. That is star, one to signal for questions. We will pause another moment so that everyone has an opportunity to signal for questions. There's no other questions in the queue at this moment, but I'll just give one other reminder, that is star, one if you would like to ask a question at this time.

Just another reminder, you may press star, one if you would like to signal for a question at this time, that is star, one. We will pause just another moment.

Pasquale Natuzzi:

So, while there are no more questions, I'd like to thank you very much all the listeners and I look forward to talk with you again in the next conference call or any time you would like to. Thank you very much again. Have a good day. Bye, bye.

Operator:

That does conclude our conference for today. Thank you for your participation and you may now disconnect.