Natuzzi SpA

Second Quarter and First Half 2017 Conference Call

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CORPORATE PARTICIPANTS

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Nazzario Pozzi, *Chief Officer, Natuzzi Division*

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CONFERENCE CALL PARTICIPANTS

David Kanen, *Kanen Wealth Management*

PRESENTATION

Operator:

Good day, ladies and gentlemen, and thank you for standing by and welcome to the Natuzzi Second Quarter and First Half 2017 Conference Call. At this time, all participants are in a listen-only mode. Following the introduction, we will conduct a question-and-answer session. 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, and then Mr. Nazzario Pozzi, Chief Officer of the Natuzzi Division, Mr. Giovanni Tucci, Chief Officer of the Softaly Division, the Chief Financial Officer, Mr. Vittorio Notarpietro, and Piero Direnzo, Investor Relations. As a reminder, today's call is being recorded. 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 second quarter and first half 2017 financial results conference call. After a brief introduction, we will give room for a Q&A session. Mr. Pasquale Natuzzi, together with the top Management Team, will be glad to answer your questions.

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 securities laws. Obviously, actual results might differ materially from those in the forward-looking statements because of risks and uncertainties that can affect our results of operations and financial condition. Please refer to our most recent 20-F filed with the SEC for a complete review of those risks. The Company assumes no obligation to update or revise any forward-looking matters discussed during this call.

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

Pasquale Natuzzi:

Thank you, Piero, and good morning to everyone. As I'm sure you are aware, the first half of 2017 has been a challenging one for our industry. Some of our competitors are reporting declining sales and some of our customers are closing branches of their stores. I am pleased to report to you that in spite of this difficult environment, Natuzzi has grown revenue in the second quarter over the second quarter last year. But, a single quarter may not give the entire picture, so let me give you a more comprehensive and updated view of our business.

As of week 37, which is September 17, this is the situation. Natuzzi Italia, the high end of our brand portfolio, which represents one third of the group sales, is growing at a significant rate in EMEA, Asia-Pacific and America. In particular, the Natuzzi Italia directly operated stores are doing better and show a sellout order flow with a strong double-digit increase driven by higher sales per ticket and higher number of contracts. The investment on the brand and the organization and stores started giving positive results. Edition is almost flat worldwide, but as a result of the combination of different situation in each geographic region, North America is almost flat, Brazil is improving, Asia-Pacific is growing strongly while EMEA is suffering some distribution issues in Northern Europe and in Italy with Divani & Divani.

Divani & Divani, which is the Italian version of the Edition product, was built at the beginning of 1990's as the first chain specialized in leather upholstery. So, it has in Italy a strong brand recognition and reputation. Such poor performance are related to some old location, the store concept that needs to be updated and consequently even the communication, and that's why we are focusing now. It's a huge project for us. Edition DOS, which are 10 and are located in China, are continuously improving their performance. As a confirmation of that, good performances are also recorded in the Edition franchise chain in China and Brazil. Softaly, our private label business, in spite of such positive result in the quarter, has been hurt by difficulties experienced by our top customer in North America, which has reflected a reduction in the volumes.

Having done this updated picture, let me come back to the actual results of the first six months of the current year. We are well aware that even with some positive signs for the future, the present says about the €13.1 million operating loss. We cannot forget that €9.3 million of those losses comes from the recent decision of the Italian Supreme Court against the Natuzzi of the Italian label issue. We will always respect any judgment, but as a CEO of the Company with a great history and future, while respecting judgments, we are disappointed and we are starting to think about any possible change in the group industrial section for the future. The rest of the losses instead do not concern myself too much. We have experienced higher SG&A than in the past due primarily to the startup time and cost associated with the opening of new stores as our footprint expand the existing stores will more than offset the cost of the new ones. For now, our primary goal is to expand our distribution platform and grow our top line.

I would like now to introduce Nazzario Pozzi, our Natuzzi brand division Chief Officer, who will go deeper in commercial issues. Nazzario, it's your turn. Thank you for now.

Nazzario Pozzi:

Thank you, Pasquale. Good morning and good afternoon. During the second quarter, the Natuzzi branded revenues have increased by 4.1% over the same period last year, as a consequence of the execution of our brand strategy which we went through with you in our previous calls. The average price per seat sold, first of all, has increased by 5.2% and this has reflected the value proposition we bring to our customers as opposed to competing on prices and affecting our margins.

As a second point, the product line extension which we have been pursuing over the last 12 months is progressing fast as a key component of our Harmony Maker brand strategy. In particular, furnishings net sales increased by 15.3% over the second quarter of 2016, and today furnishings do represent 20.2% of

Natuzzi Italia branded sale. Thirdly, the new retail strategy has delivered both like-for-like growth and positive operating profit and we have also pursued of course new openings as per our plan. Total net sales of the directly operated stores have increased by 32.3% during the second quarter of 2017 against the second quarter of 2016. On a like-for-like basis, growth was 17.7% against the first quarter of 2017 and 6.1% against the same quarter last year, so a significant like-for-like growth.

Operating result of our directly operated stores on a like-for-like basis was positive, €800,000 in the second quarter against a slight loss in the first quarter of 2017. Such performance is proving to be even stronger on a year-to-date basis through September 17, 2017. The order flow, the order portfolio from the direct operated stores shows a 3.4% growth on a like-for-like basis against the same period the last year, while when we include total orders, including new openings, order flow is up 38% versus same period last year, and the growth has been even stronger with regard to the core business of the Natuzzi branded retail sales, which as Pasquale has highlighted, is represented by Natuzzi Italia directly operated stores.

With regard to the Natuzzi Italia DOS, like-for-like growth year-to-date is up 11.7% against same period last year, and this has been driven both by customer acquisition plus 5.5% against last year same period, and also by higher value of average ticket, which is up 5.9% against last year. Such a growth is taking place across all our key countries. The Natuzzi Italia DOS like-for-like are up 20.3% in the United States, up 20.4% in the U.K., 21.7% in Switzerland, 4.6% in Italy, whereas it is flat in Spain. All these numbers are year-to-date and on like-for-like basis against same period last year; whereas total order flow of Natuzzi Italia direct operated stores year-to-date show an increase of 56.9% year-to-date versus last year.

As we have been anticipated, we have opened two new generation DOS in the first half of the year, one store in New Jersey, Paramus and one store in West Palm Beach in Florida and both of them are confirming our forecast of over US$2.5 million orders in the first 12 months as a forecast. At the same time, the turnaround of the six stores that we have acquired in Florida at the end of last year is progressing faster than expected and all six stores are already getting closer and closer to the performances of the new generation stores that we are opening as brand new stores.

With regard to the future, we confirm that three further openings of new generation stores will take place in the fourth quarter, last quarter of 2017, two in the United States, in Chicago and Philadelphia and one in the U.K. in Edinburgh, and we have also planned two additional openings that will take place in the first quarter of 2018 in Los Angeles and in outside London. In the meantime, we confirm that we continue to secure appropriate locations for additional openings of new generation stores all over the entire 2018 and following years.

I would like now to give the words to Giovanni Tucci and I will be available for your Q&A later.

Giovanni Tucci:

Good morning. Thank you, Nazzario. I am Giovanni Tucci and I am responsible for the global business of the Softaly division. Softaly represents the private label portion of our group and is of course the successor to Mr. Natuzzi's original vision having started in 1959. The business has changed much since then. It is truly global requiring nuances for different markets around the world. It faces many new competitive forces all of which have pressured these returns and threaten its ability to make money. We have worked hard to offset the cost elements of this competition and I am happy to report that we can compete in today's environment. We are now focusing on the rationalization of the business, the acquisition of new partners with whom we can have high growth and profitable relationships, continuing to build the organization and team around the world to support these efforts. It is my view that we are building the best team in the business.

We have made progress, but we have more work to do in specific areas. We have gained new customers throughout Europe, in U.K., Germany, France and Italy. In fact, we remind that EMEA grew revenues by 5% in full year 2016 versus full year 2015 on top of the plus 20% growth in full year 2015 versus the previous year, and thanks to the solid support and partnership we created with all the leading retailing groups on the European industry, we continue growing by 4.5% in the second quarter 2017 versus the same period of the previous year.

Total sales of our Softaly division in the second quarter 2017 were €29.5 million, up 7.6% compared to the second quarter of 2016 as a result of a 15.2% increase in the Americas and 4.5% increase in EMEA, as I just mentioned. While in Asia-Pacific, sales decreased by 31.2% in the second quarter of 2017 after increasing by 101% in the first three months of the same year, and the activities planned as well as the recent acquisition of new large account in Australia and New Zealand should bring the targeted results during the current year. In spite of such positive results in the quarter, Softaly, our private label business and specifically, North America has been hurt by the combination of consumer reluctance and price sensitivity. In addition, the difficulties experienced by our top key customers in North America have reflected a reduction of the volumes.

We have been developing new customer relationships which are beginning to bear fruit. In addition, we have re-imagined the production line and are optimistic about how it will perform in the coming quarters. Therefore, our focus now is to recover our business in North America. We have made a major effort with the three larger customers to recover and improve our sales together. We are working on our Management Team to fill some key points and present an extended program at the coming High Point market in October with the aim of adding new major accounts, part of the top 100 furniture retailer list in the short-term.

I would like now to introduce Mr. Vittorio Notarpietro, our Chief Financial Officer, who will discuss our results in greater details and stay (phon) at your disposal. Thank you.

Vittorio Notarpietro:

Thank you very much, Giovanni. Let me follow the sense of our CEO and also my colleagues' speech going deeper with some additional details and numbers. Just to summarize, again, as of September 17, the sell-in order flow says that the group order flow is better than previous year by 1.1%, but within that number, which is positive, we can see that Natuzzi branded order flow is up 5.9%, while private label is down 10.4% under current exchange rates.

Furnishing sales which relate to the Natuzzi Italia total living selling proposition is delivering strong results everywhere with the business given the positive sign of the appropriateness of the brand and retail strategy. As of today, we have within Natuzzi branded business, a still small directly operated retail division with 60 stores all over the world, Italy, Switzerland, Spain, U.K., United States, China and recently also in Mexico.

Consider when we are commenting the numbers that Nazzario has displayed before, that today the percentage of total retail sales on total group turnover is 13%, 14%. But, as said many times in recent quarter's conference call, our retail expansion is the key of our strategy and we must go deeper in analyzing today's small numbers to better understand also today actual numbers, including SG&A and future growth plans. Nazzario has already explained in detail the retail numbers demonstrating that that business is improving.

Let me come back to the second quarter profit and loss. Cost of goods has improved, but we know there is a positive impact of raw materials and we also know to have room to improve the efficiency in our manufacturing costs. All the variable costs of transportation and commissions and advertising have been properly managed. The total percentage on sales went from 15.7 million in Q2 2016 to 15.3 in second quarter 2017, as you can appreciate from the press release. As a result, the contribution margin before all the other selling and G&A cost increased, improved to 19.8%. Then we accounted higher SG&A of €4.8 million versus the same quarter a year ago. This phenomenon started in Q4 last year as a result of the reinforcement of sales and marketing organization to develop the retail strategy. In Q1, the increase in other G&A was already €3.2 million versus Q1 2016. In the second quarter that we are commenting today, the increase has been €4.8 million, but I can ensure you we did not lose control at all. Three million of the €4.8 million increase in SG&A directly comes from the new and larger business structure. One, the new sales and marketing organization in the quarter and mainly in the United States of America to sustain the strategy; and two, the newly acquired stores, seven stores in Florida, three stores and 12 concessions in Mexico, plus five stores in Italy with all related costs, personnel, leases, utilities and so on.

When we open a new store, we start immediately having to account costs due to lead time from the customer orders to the final delivery and invoicing, we have on average three months period. We must work on that logistic still, we know that. In addition to that, in case of new openings in new locations, the productivity of any new location is normally lower in the first months, but we admit that we have to better perform on the timing of openings to reduce sales gap. The remaining €1.8 million mainly comes from additional sales to promote sales, higher repair costs and higher accruals for doubtful accounts, see some clients in Italy and North America.

At the end, yes, we had some extra costs, but the main issue has been the fact that the new organization is still in the development phase and as yet has not reached the target results in terms of sales. All in all, the retail-based strategy appears to be working in U.K., China and United States even though with some delay in execution. Italy is not working yet and we are changing our approach to the market. The increase of cost was planned to sustain the strategy. It started in 2016. It's not the real issue, but we have to improve the execution time of both cost and sales actions. Softaly business volume in North America is the real issue and we have to fix it and get back volumes. We have to continue working in this direction accelerating each of the single operational step needed and doing it by priority. Thank you very much. We will be happy to answer any of your questions.

Operator:

Thank you. If you would like to ask a question, simply press the star key, followed by the digit one on your telephone keypad. Also, if you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Once again, press star, one at this time. We'll pause for a moment.

David Kanen, Kanen Wealth Management, please go ahead.

David Kanen:

Good afternoon, gentlemen. Congratulations on growing the top line. I just have some questions about the increased SG&A and then a little bit about the DOS model going forward. First, how many stores do you expect to open in 2018 that are directly operated, and then can you explain to me the gross margin impact on the growth from those stores? Your blended gross margin I think was around 35%. What is the contribution margin from the additional sales from these directly operated stores?

Nazzario Pozzi:

Hello, hello, Nazzario speaking.

David Kanen:

Yes. Did you hear my question?

Nazzario Pozzi:

Yes, yes, I did, thank you. Thank you very much. For 2018, we plan to open up to 10 directly operated stores of Natuzzi Italia and some of these locations have already been secured, whereas some others are still under negotiations or we are still scouting for the right locations. This is our plan, but as I mentioned in the past, we will never compromise on the quality of the locations. Given this plan, we target breakeven or low single-digit profitability at store level in the first year of opening in the first 12 months, because as we—as Vittorio has highlighted, our business model is mainly represented by special orders. Customers do buy today and they pay deposit today, we make product on a made to measure basis for customers and we deliver invoice after certain lead time. When we open one store for the first quarter, we get 100% of operating cost, whereas we only get revenues after the third month—in the third month and forward. The full year EBIT reflects such starting financial of the business.

David Kanen:

Okay, I understand. What you are saying is you absorbed the costs in the first three months without the benefit of the revenue, I understand, 10 stores targeted and—for DOS stores for 2018. Then on the store level, you expect breakeven to positive EBITDA, but what I'm trying to understand is the margin impact, is it safe to say the average store will do like $3 million of these new generation DOS stores. Is that about right?

Nazzario Pozzi:

Over $2.5 million in the first 12 months and then growing year on year.

David Kanen:

Okay. Let's say you opened 10 stores that averaged $2.5 million in the first 12 months, on that what I am saying is on that $25 million of incremental revenue, what is the gross margin being that you are vertically integrated, what is the gross margin that contributes overall to the Company?

Nazzario Pozzi:

The operating margin?

David Kanen:

Not operating, I am saying gross margin.

Nazzario Pozzi:

In terms of product, gross product margin…

Vittorio Notarpietro:

Hi, David. Nazzario mentioned the retail business model that after the first startup cost, the startup period has the aim to reach EBITDA of around 10%, I mean in the best location, the best format. As a producer, for Natuzzi Italia, for example, we have very good contribution margin that we mentioned, we discussed it in previous call, which is around 30% on average. Okay? If you imagine the two companies, one is retail, the goal is to have an EBITDA of 10, the other one is the manufacturer and as far as Natuzzi Italia is concerned, we have, in our price list, a contribution margin of around 30%. You can make the calculation that you are trying to do with the new addition of 10 stores.

David Kanen:

I see. That $25 million of incremental revenue probably will have a gross margin closer to 70% and a contribution margin of 30%.

Vittorio Notarpietro:

What is the 70% sorry?

David Kanen:

I'm sorry.

Vittorio Notarpietro:

You mean integrated contribution margin for the entire Company?

David Kanen:

No, no, I'm just saying that $25 million of incremental revenue that comes from DOS of Natuzzi Italia product, the gross margin on that—what I am trying to understand is the gross margin on that should be much higher because that's branded product.

Vittorio Notarpietro:

Yes, yes, you're right. Please, when we can see that the 2.5 multiplied by 10 equal to 25, that's the retail, the sell-out. When we consider the impact of that gross margin for the manufacturer, you have to calculate the markup, okay, the retail markup, so 25 if we have a markup of 2 for the industry, for the plant is half of that.

David Kanen:

I understand. Okay, I see how you account of it. Okay. Then on—I would just like to understand the $4.8 million increase in SG&A. Have you made most of the hires that you need to support the growth in DOS going forward? Will SG&A remain roughly at this level to support that growth, or are you going to continue to ramp it up as you add, let's say, in 2018, you are going to add what another 10 stores hopefully, what will be the increase in SG&A if at all?

Vittorio Notarpietro:

I understand your question. Okay, let's divide the problem in two. First one is the portion of those costs related to, let's say, headquarter retail management. Of course, we will not have two or three or five marketing, international marketing managers. So, that part of the structure maybe will grow, but normally should stay more stable than grow. Then the second part of the business, which is stores, stores must be open. For each store, you have to hire new people, you have to pay new leases, new amortization, new depreciation and new utilities and new—so on. There is a portion of that that will stay stable. There is a portion of that that will continue to grow according with the number of the new stores we will open.

David Kanen:

Okay. How should I model that out like if you open 10 DOS stores, what is the variable component of SG&A? How much will it increase to support those 10 stores for that $25 million of revenue?

Vittorio Notarpietro:

You could model the core structure for stores opening by considering P&L breakeven at store level in the first 12 months. As I mentioned to you, store opening will bring fixed and variable cost and some of those operating cost is embedded in the EBIT breakeven I mentioned to you in the first 12 months.

David Kanen:

I see. I see how you are looking at it, okay. I will go back and retroactively figure that out, okay. Then the last question and I'll let somebody else, I'll get back in queue is you were talking about—you gave some color on how orders are going through September. Can you just repeat that, what kind of sales momentum if any that you have going through the month of September for Q3?

Nazzario Pozzi:

We started this morning with the updated order flow of all the groups just to give guidance about that. We are 1.1% all-in in our order flow by the 37th week. That's the sell-in portion of the business and that's the reality, which is the combination of good things and some reduction in some areas that we mentioned, Italia is what it is, Editions in Northern Europe is another issue, and we mentioned private label, which is negatively contributing to those numbers. You have a fair idea about the entire year with the order flow I mentioned at the very beginning of my speech. Then we will manage the retail sell-out, but you know that the sell-out so far is just 13.8% of our total turnover, so any miracle that Nazzario and my colleagues should do in the next month will not change the year end numbers so dramatically this year, and that's the point on which we are focusing on; the scale of retail business.

David Kanen:

Okay, thank you.

Operator:

As a reminder, that is star, one if you would like to ask a question or make a comment. We'll pause for a moment. Once again, that is star, one to ask a question. Once again, star, one if you would like to ask a question or make a comment. We'll pause for a moment.

It appears there are no further questions at this time. I'll turn the conference back over to our presenters for any additional or closing comments. This will conclude today's conference. Thank you all for your participation. You may now disconnect.