Natuzzi SpA

First Quarter 2017 Financial Results Conference Call

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CORPORATE PARTICIPANTS

Piero Direnzo, *Investor Relations Manager*

Pasquale Natuzzi, *Chief Executive Office*

Vittorio Notarpietro, *Chief Financial Officer*

Nazzario Pozzi, *Chief Natuzzi Division Officer*

CONFERENCE CALL PARTICIPANTS

David Kanen, *Kanen Wealth Management*

Bjorn De Winter, *QuaeroQ CVBA*

PRESENTATION

Operator:

Good morning, ladies and gentlemen. Thank you for standing by. Welcome to the Natuzzi First Quarter 2017 Conference Call. At this time, all participants are in a listen-only mode. Following the presentation, 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, 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, Mr. Antonio Cavallera, Chief of Human Resources, 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, sir.

Piero Direnzo:

Okay. Good morning to our listeners in the United States and good afternoon to those of you connected from Europe. Welcome to the Natuzzi's First Quarter 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.

By now, you should have received an e-mailed 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 0039-080-8820-812 to receive the results by e-mail. You can also e-mail information request or questions to our e-mail 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 securities law. 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 that 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, 2016. This report is available within our website 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. Thank you and good morning. I'm Pasquale and I would like to emphasize that the judgment made by the Supreme Court last May 2017 regarding the 2 former workers caused to give me the disappointment and I'm sure did the same to you. I'm—sincerely, I'm not discouraged and you should not be either. We have the vision. We have a plan and we will succeed.

With regard to the first quarter, despite our slight decrease in sales in view of the very tough condition reported in the first quarter, we are seeing the value of our brand and of our strategy. Thanks to the investment we have been making for the last 3 decades, we now enjoy one of the best recognized high-end brand globally as a furniture brand. Our retail development is going well. Our customers are buying our products each time, and we are achieving better price. And our program to open direct retail stores is on track. Nazzario Pozzi will give you more details. I'm confident that we have the resources we need to continue to drive our growth which remain our primary objective.

Let me now introduce to you, Vittorio Notarpietro, our CFO, who will take you through the numbers, and then I will be here available to answer to any question. Thank you.

Vittorio Notarpietro:

Thank you, Mr. Natuzzi, and good morning, everyone. You know the Company is restructuring its Italian operations. One hundred and seventy six workers which we laid off started the legal proceeding against us. The claim was with regards to a technical element in law regarding rotation of workers in Italian plants.

As we recently disclosed, the Italian Supreme Court rejected the Company's appeal of a lawsuit brought by two of them ruling in favor of the plaintiffs. As a consequence of this decision, the Board of Directors decided, today to accrue additional €9.3 million in the provision for tax and legal proceedings, included in the other liabilities caption of the Company's balance sheet. So, today, the total provision for that is €13.5 million.

You know that these are quarterly unaudited financial statement under the Italian GAAP which, by the way, recently changed. We have so far accounted this as labor costs in the cost of goods sold. Having said that, the Company will continue to evaluate the implication of such decision and any future developments on its strategy and business organization. This issue comes from the past and it is the consequence of the restructuring of Italian operations which we continue to focus on. This new judgment weakens a bit our position, that's why we decided to accrue more.

Having said that, this will not affect our activities for the future of the Company. It's obvious that we will carefully consider future developments of this process. The Company already produces in three continents, not only in Italy. It has already capacity in Romania, Brazil and China and could result in the short term period of time additional capacity wherever is needed.

Having said that, let's start now the discussion on sales, on which my colleagues will elaborate more. Total net sales in the first quarter of 2017 decreased by 4% at €115.9 million. Of this, €109.1 million were from our core business, upholstery, plus bed, plus furnishings. Foreign exchange had a positive impact on sales of 0.9% and a slight negative effect on net operating losses of €0.2 million.

While sales from our core business during the quarter were down 4.3%, we reported double-digit increase, plus 37.5% in furnishing sales. This confirms that this segment of our products offering keeps on growing as well as the strength of the Natuzzi name among consumers. Of course, product extension remains an important part of our growth strategy going forward.

Within the core business, Natuzzi branded sales represented 74.3%, whereas, it was 71.5% in the last comparable quarter and 73.6% in the last quarter of 2016. This increasing progression reflects our willing to drive gross margins through high-end sales. Natuzzi branded sales were down 0.5% compared to last year's first quarter. But, it is worth highlighting that the fact that despite a difficult retail environment, the Company's drive its price per seat increase by mainly as a consequence of our sourcing, marketing and merchandising drivers, as well as the (inaudible) in global awareness of the Natuzzi name. The brand is strong and so we decided not to take part on the game of discounting prices to support the sales of our products. The brand and (inaudible), of course, are the assets that helped our Natuzzi sales to reach—to react to such retail conditions.

DOS, directly operated store operations, are still delivering encouraging results that support us in executing the retail-based strategy so far undertaken. On total Natuzzi branded sales, €12.1 million came from our directly operated stores or DOS. Now, if we consider the consolidated industrial margins regarding from our DOS network is around 64%, it's easy to understand that as the percentage of DOS sales increases within our total sales, the group's consolidated margins will be positively affected. This is due to high margins associated to DOS dynamics. Therefore, we are quite encouraged to keep on expanding our current DOS network, with new generation stores in primary locations, within high traffic areas and with specific characteristics in terms of dimension, merchandising and product offerings. We have been testing this retail format in some locations and we believe that this will help the group to recover growth and get back on profitability. We have a precise DOS opening plan. Nazzario will surely elaborate on this.

Other efforts in marketing and retail margin are delivering positive results, also if we consider the regional breakdown of the Natuzzi sales. We are pleased to report a 6.6% increase in net sales in the Americas and an 18% increase in Asia-Pacific region, whereas the EMEA region reported a decrease of 11.4%, mainly due to the ongoing restructuring of our Italian-based *Divani & Divani by Natuzzi* network. So, Italy today is the sales issue we're facing.

Sales from our wholesale division, Softaly, reported an overall decrease of 13.7%, mainly due to lower sales with one of our major customers in North America. Without considering this customer, customer sales would have slight increase. However, year-to-date order flow data indicates that we might see a recovery in Softaly sales during the second part of 2017, with order flow trending through 2016 levels. Softaly remains the second pillar of the group's overall strategy in order to get higher volume and take advantage from further economy of scale. For this reason, top Management Team is working to re-establish a business relation with big wholesalers in the EMEA and Americas regions, with the aim of recovering growth for the group. I am sure Giovanni will say something about that.

Operations at our industrial plants continue to benefit from lower raw material prices. We do not expect such decrease to continue in 2017. But at the same time, price are quite stable so far. Lower raw materials, together with higher efficiency in manufacturing process and notwithstanding labor cost increase we experienced in our foreign plants, allowed the group to improve industrial margins from 34.3% to 35.2% before, of course, the special charge we accounted for legal issues.

We also benefited from lower transportation costs, from 10.3% to 8.9% of sales in first quarter 2017, mainly due to lower tariffs and more favorable geographic mix in shipments and increased FOB shipments or free-on-board shipments.

As for other SG&A, we saw an increase in terms of percentage on total net sales. This is mainly a consequence of our retail-based strategy. In fact, in order to properly manage the retail expansion, we hired top professionals and this affected our SG&A cost. Therefore, excluding the charge for litigation in the quarter just ended, the group would have reported an operating loss of €0.9 million and a net loss of €1.7 million, again, excluding the charge for litigation we have just accounted this quarter.

Net financial position was at €12.8 million, down from €28.9 million at the end of 2016, but up from €5 million at the end of first quarter 2016. This is a seasonal effect as we saw over the last year. In other terms, we had an acceleration of production in March and consequently, an increasing trade receivables and inventory for finished products and raw materials. So two factors, the increasing trade receivables inventories were the main drivers on liquidity during the first three months of 2017. Our cash position is solid. Through the group's ordinary operations, we think that we can carry on with the investment associated to our DOS expansion program in addition to ordinary capex.

In this regard, let me briefly recap the main characteristics of the DOS dynamics and investments needed for the DOS, directly operated stores. The investment is necessary to open a new generation of DOS. It ranges from €400,000 up to €800,000, depending on the location, size and other factors. So, that's not a huge investment. Then, consider that the financial cycle associated to the DOS is, by far, narrower as compared to that with a third-party operated stores. In fact, in the DOS, once the final customer places an order, we receive an advanced payment that can go on average between 30% to 50% on the total sellout ticket and immediately. In fact, with the third-party operated stores, we get paid the selling price by the independent retail on average at least after 60, 70 days from shipment. You can easily understand how faster this financial cycle from a DOS point of view. Another good reason to stay focused on retail business alternatives.

Thank you. Nazzario, will you please continue?

Nazzario Pozzi:

Thank you, Vittorio, and good morning, everybody. I would like to elaborate in more detail on the Natuzzi branded business. Natuzzi branded revenues in the first quarter was €81 million, down 0.5% versus the first quarter last year. However, order portfolio in the same period, the first quarter this year versus first quarter last year, was up 3.5%. This is further improving as of April. So year-to-date, since January the 1st, our order portfolio for the Natuzzi branded business is up 5.6% versus the same period last year and it is mainly driven by our high-value product, Natuzzi Italia and by Asia-Pacific and America. Asia Pacific is delivering a 30% year-on-year increase since the beginning of the year, whereas, Americas is delivering an 8% increase versus last year. Natuzzi Italia high-value products are delivering a 35% increase versus last year.

We are suffering in EMEA, due to the ongoing restructuring of our Italy-based retail network, but in EMEA, Natuzzi Italia business is delivering a positive 3.8% increase versus last year. It is being achieved without compromising on our high-value margin strategy. So, we have decided not to decrease pricing to push sales and to speak to our branded retail strategy. Our retail direct stores are continuing to deliver a significant increase year-over-year.

On a total network basis, our retail direct stores are delivering year-to-date at 35% increase versus last year which is mainly driven by our high-value Natuzzi Italia business which is delivering a 50% increase versus last year. But also, on a like-for-like basis, our direct stores are delivering a significant improvement versus last year.

Overall, the network is up by 1%, whereas Natuzzi Italia is up by 5% versus last year like-for-like same store basis.

Last, (inaudible) number of stores, right locations, consistent with our retail and merchandising strategy, which are delivering a double-digit growth versus last year. As Vittorio and I have mentioned, margins are stable at 64% gross product margin in our direct stores and they are even higher in some geographies, such as U.S., where gross product margin of our branded stores is about 70%. The average ticket, meaning the purchase we have of our consumers in our stores is up double-digit, is up 18% versus the last year in our Natuzzi Italia stores. That's the foundation of our strategy for the remaining of the—for the next three quarters. Since the beginning of the year, we have opened three direct stores and one franchise store according to the new retail format we have designed and executed since last year. We are committed to open eight new stores by the end of the year, four DOS, direct stores and four franchise stores, according to the strategy.

I will be happy to answer to your questions later on, and now I would like to let you make any questions to each of us.

Operator:

If you'd like to ask a question, please press star, followed by the digit one. 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, star, one to ask a question. We'll pause for a moment.

We'll take a question from David Kanen with Kanen Wealth Management.

David Kanen:

Good afternoon. Good afternoon. Thanks for taking my questions. Can you tell me on the new stores that are being opened recently, you call new generation stores in Paramus, what do you expect the average sales to be per location so I can figure out what the incremental gross profit margin contribution will be. Should I model out—you disclosed DOS margin was 64%. Is that a good number going forward?

Nazzario Pozzi:

Hello. So, I do confirm that the retail format which is driving our growth strategy target between €2.5 million and €3 million retail sales, depending on cities and locations around the globe, and we do have evidence that retail openings are achieving or even, in some cases, overachieving this target, including the latest opening which is Paramus. Gross margin, we mentioned, 64% is the average across all geographies and products and brands. But, as I mentioned to you, Natuzzi Italia retail format in U.S. is already having a gross product margin which is above 70%, and this—of course, this varies across countries. This is why we target our new retail format P&L. So, upcoming, upcoming openings which I mentioned to you, we have the same target on a yearly basis, starting from full year after the opening.

David Kanen:

Okay. Can you please confirm something for me? You're saying you expect to have eight of these new generation store openings this year. Are three already included? So, is it five additional or is it eight additional from Q1?

Nazzario Pozzi:

It is eight additional from Q1 which is consistent with our plan which we designed at the beginning of the year and we are sticking to this plan. It will be eight additional by the end of the year. Four of them direct stores and four of them franchise stores.

David Kanen:

Okay. Thank you for clarifying that. Then, as far as the court ruling, was there—in Q1, was there any legal expense that one should consider nonrecurring, and if so, can you quantify what that was?

Vittorio Notarpietro:

Can you say again, David?

David Kanen:

Yes. My question is, was there legal expense relating to this incident in Italy, your labor dispute? However you want to categorize it. Was there nonrecurring legal expense to lawyers and so forth, and if so, how much was that? Just so that I can model going forward what a good operating expense run rate is.

Vittorio Notarpietro:

Yes. Of course, we didn't start few days ago with this issue because we know we are under restructuring and we knew we laid off those people under Italian rules. But, the legal situation was a bit different. We had in mind and accounted some legal €4.2 million provision for that. Obviously, this most recent judgment coming from the Cassazione Court weakens a bit our position and the Board considered to increase—to be prudent from one side and to get a settlement on the other side this issue.

David Kanen:

Okay. Just one more question on the other SG&A which was €23.9 million versus €20.7 million. Can you give me additional information or detail into that increase?

Vittorio Notarpietro:

Yes, as we said before, first of all, as a percentage, the increase comes from lower sales. Unfortunately, we reported a minus 4% in sales in this quarter. But, on the other side, it's absolutely true and clear that we are investing in our retail commercial organization. In order to do all the good things that Nazzario is saying about new DOS developments in the United States and wherever, we need to get new and additional skills in this Company which was an wholesale basically Company few years ago, and that's what we are doing. We started with United States of America, where we have the most important retail organization within the Company and which is the biggest opportunity in terms of retail for this Company, and indeed, a priority of Mr. Natuzzi, absolutely.

David Kanen:

Okay. I'm going to allow other people to ask questions. Thank you for your time.

Vittorio Notarpietro:

Thank you David.

Pasquale Natuzzi:

Pleasure.

Operator:

As a reminder, it's star, one if you would like to ask a question,. We'll pause for a moment.

Next, we'll take Bjorn De Winter with QuaeroQ.

Bjorn De Winter:

Good afternoon. I have a question regarding your branded strategy for this year. Can we expect the same amount of advertising and market expenses as in previous years to support your branding strategy?

Nazzario Pozzi:

Absolutely, yes. We have sources—the same resources which we want to use to our Natuzzi brand strategy. So with that, you need to consider such marketing and brand building expenses as a pillar of our branded strategy.

Bjorn De Winter:

Yes. Okay. Do you have as of today any actual numbers, what your current market share is within your industry?

Nazzario Pozzi:

We don't deliver these figures at these calls.

Bjorn De Winter:

Okay, that's clear. Thank you. Those were my two questions.

Pasquale Natuzzi:

Thank you for your question.

Operator:

Next, we'll take another question that from David Kanen with Kanen Wealth Management.

David Kanen:

Okay. I should've asked this before, but I know you're opening up eight additional DOS stores this year. What is your strategy over the next three years? What is the total number of directly operated stores you'd like to open up?

Nazzario Pozzi:

So, first of all, what—our plan for this year is the first year of a continuous strategy which we will push in the coming years as well. So, we have clear views, clear plans on how to continue to grow the value, sale and the profit of our branded business through the retail value stores. So, the numbers I told you for this year will be further pushed year-over-year. So, we plan—in fact, on the other side, sorry, we never compromise on the quality of the locations which is a key cornerstone of our retail format. Before, we have set up dedicated teams to search for new locations in key geographies, starting from U.S. and U.K., but also in other countries as well and we are actively searching, as of now, locations to open next year, in 2019 and 2020. So, we plan to keep the same pace we are having now, so opening around 10 and 13 new direct stores year-on-year.

David Kanen:

Ten to 13 per year is your plan?

Nazzario Pozzi:

But, we will be happy to leverage on any appropriate opportunity. In terms of location scouting, we are actively committed to search well in advance from opening date.

David Kanen:

Okay. So, help me to understand this. Let's say, over the next three years, you open up 10 per year, okay, at an average of €2.5 million in revenue, okay? That's about $75 million of incremental revenue, at let's say, 65% margin. So, that has the potential to generate $50 million of additional gross profit. What would be the impact in operating expenses in order to get that $50 million of incremental gross profit? What do you think other SG&A would increase by in order to support that kind of growth?

Vittorio Notarpietro:

David, I will be happy to discuss to you about the next business—three years business plan after having discussed that finally with my boss and the Board of Directors. We are saying that this year, we basically checked what we did in Thurrock, London the very first new generation stores, and we told you that this year we will open additional eight of those new generation stores. We are telling you that we could have opportunities, we could have the money to accelerate the business in the next year. It will be a matter of two things: first, opportunities; secondly, the financial sustainability of those plans. You know that we are focusing the entire Company on Natuzzi branded business. So, this means that we will increase—we are already increasing day by day our focus on that. Don't ask us please the next year business plan the precise percentage of income.

David Kanen:

Well, let me ask it a different way. In terms of your plan for this year to open up eight additional stores, four and four, what impact do you expect that to have on other SG&A?

Vittorio Notarpietro:

G&A will increase because in absolute terms, because in G&A, we account the labor cost of eight DOS. But at the same time, if the DOS will be successful, as a percentage of sales, G&A should not increase. It will be a matter of how many and how fast and how successful those DOS will be. If the new stores will be so successful over Q1, we have been shaping in the last 12 months, we should not increase because of DOS. We will increase for some people in some region where we will focus our DOS focus but we think that we are trying to leverage on DOS, and DOS, if successfully managed, will not increase costs. It will improve margin for this Company.

David Kanen:

Okay, understood. That clarifies it. Thanks very much.

Operator:

Please press star, one to ask your question. 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, star, one if you would like to ask a question,

As a reminder, it's star, one if you would like to ask a question. We'll pause for just another moment.

At this time, there are no further questions. I would like to turn the call back over to the speakers for any additional or closing remarks.

Piero Direnzo:

Okay. This is Piero. So, since that there are no further questions at the moment, and so this concludes the conference call. Of course, if you, ladies and gentlemen, have further questions, please don't hesitate to contact us, or email us. Okay. Thank you. Thank you for coming by.

Pasquale Natuzzi:

Thank you.

Operator:

That will conclude today's call. We thank you for your participation.