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Natuzzi SpA

C-Meeting for Second Quarter 2023 Financial Results

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CORPORATE PARTICIPANTS

Pasquale Natuzzi, *Chairman*

Antonio Achille, *Chief Executive Officer*

Carlo Silvestri, *Chief Financial Officer*

Jason Camp, *Senior Vice President, Retail*

Piero Direnzo, *Investor Relations*

CONFERENCE CALL PARTICIPANTS

David Kanen, *Kanen Wealth Management*

PRESENTATION

Operator

Welcome to the Natuzzi 2023 Second Quarter and First Half Financial Results Conference Call.

As a reminder, anyone who would like to join the conference via telephone may do so by dialing 1-412-717-9633, then pass code 39252103#, in addition to the link already provided to join via video. As a reminder, if you'd like to join via telephone, it's +1-412-717-9633, then pass code 39252103#, in addition to the link already provided.

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 to queue up for questions.

Joining us on today's call are Mr. Antonio Achille, Natuzzi's Chief Executive Officer, Mr. Carlo Silvestri, Chief Financial Officer of the Natuzzi Group, Mr. Pasquale Natuzzi, Founder and Executive Chairman, and Mr. Jason Camp, Senior Vice President of Retail for North American market, and Piero Direnzo, Investor Relations.

As a reminder, today's call is being recorded.

I would now like to turn the conference call over to Piero. Please go ahead.

Piero Direnzo

Thank you, Kevin, and good day to everyone. Thank you for joining Natuzzi's conference call for the 2023 second quarter and first half financial results. After a brief introduction, we will leave room for a Q&A session.

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 annual report on Form 20-F filed with the United States Securities and Exchange Commission 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 Company's Chief Executive Officer. Please, Antonio.

Antonio Achille

Thank you Piero, and thank you everyone to join our 2023n second quarter earnings call.

Let me start by providing some facts about the market. I believe the fact that most analysts in our sector still refer to 2019 to compare 2023 data speaks by itself. We've been through an unprecedented cycle that brought the sector from one of the most positive momentum in its dynamics into a very difficult situation. If we look at what's happening around the globe in the real estate market, we do see signs of perduring uncertainty. I believe everyone has read with interest the news about the CEO of Evergrande being *de facto* put under physical restriction. We do see a continuing tension on the debt side because of high interest rates that limit the purchase of new houses, which is a primary driver for the industry. I want to share these elements to put into perspective our 2023 second quarter performance.

As you have seen by now, unfortunately our top line has been suffering versus 2022 quite seriously in terms of total sales, which are below also versus 2019. But I think that it's important to notice that if we look at the branded invoiced sales, which is in a sense the strategic direction the Company is heading to, they are above 2019, so above 5% vs 2019. Currently, our business is composed by more than 90% by branded sales, which means sales under the Natuzzi Italia or Natuzzi Edition name, our dominant brands. This is important to us, because we stated clearly our long-term strategy, that fully leverages on the strengths of the brands of the Company, being active in the higher price-point segments of the market.

Another element which is important to share is that, despite the very low sales, we have been working on costs to compensate the tension on gross margin level, that is to compensate the tension on production costs, which have been necessarily higher because of lower utilization of our factories. As you know, Natuzzi is a manutailer, which means it is vertically integrated, we have fixed costs not only in the retail but also in the factories. So, despite there is low saturation of our factories, we achieved 36.4% in gross margin compared to 31.4% in 2022, and 27.9% in 2019, a normalized year. So, the Company increased by almost 9% the gross margin versus 2019, despite the impact on production costs from reduced sales volumes.

How this has been achieved? This has been achieved by means of a better discipline in terms of pricing and better cost management. In 2023, we didn't implement any price increase. The last price increase was put in place in June 2022 for the U.S. market, so it's more than one year we didn't do any price increase. But what we've done, especially in 2022, has been to carefully look at all our pricelists to make sure that there was no situation in which a specific market or a specific partner could benefit from price conditions, thus not allowing us an adequate marginality.

In terms of cost management, we did a lot of work to contain the cost of our raw materials and better utilize our raw materials inventory. I remind you that gross margin does not include the cost of transportation, which has turned out to be deflationary this year, and therefore gross margin did not take an advantage from that. Indeed, cost management and lower transportation costs contributed to the 2023 second quarter operating breakeven.

I think it's important to notice that this operating breakeven compares to an operating loss of nearly €8 million in 2019 second quarter having a revenue base, at that time, of €10 million higher than 2023 second quarter. What does that mean? It means that by working diligently on our cost structure, we were able to lower the breakeven point, which is a sort of underlying topic of this press release. We're not telling that these are the sales we aspire to. We try to accelerate the optimization of our "back-of-the-house" operational machine so to extract more value, more cash when, as I'm sure, growth will come back.

Let's now look at the cash. Cash at the end of June 2023 was €44.5 million, which compares to €54.5 million at the end of 2022. Despite a difficult year, we didn't stop investing in critical areas. During the first six months of the year, we invested €7.6 million, of which €5.3 million to optimize the Italian factories and €2 million to open new direct stores. Operating activities provided cash (+€1.6 million), despite the lower level of sales.

As you can understand by now, we don't anticipate a quick inversion of the market cycle, at least for the end of the year, and in this market context, we believe the cost and capital efficiency are of paramount importance. For this reason, we launched a set of initiatives to reduce costs and improve working capital management, which Carlo will comment later. This includes, for instance, working on our SG&A structure, headcount included. So, a turnaround approach rather than a transformation approach. I believe it's important to remind that we have already done since 2021 a "silent" restructuring, despite working in a highly unionized country like Italy. Indeed, since 2021, we already reduced our overall Group's workforce by 577 units, including people at headquarters and Italian factories, and we intend to continue in this direction with the aim to streamline and make more agile our headquarters and continue optimizing our factories.

Within our focus on cost optimization, we are also carrying on activities that refers to the simplification and streamline of our overall complexity. For instance, in presenting our new collections, we will focus on fewer and bolder launches in the market rather than operating with several launches, which was the typical *modus operandi* of the Company when it was primarily a wholesale distributor.

Our priority remains organic growth. One distinctive asset of the Company is that of having about 700 stores worldwide. We believe that is really where we should start from, because if we make these existing stores more productive, we're going to get more sales *momentum*, but also a better utilization of the retail investments, both those done by our Group and those done by our partners. Of those 700 stores, roughly one half are in China, and we'll expand later on China.

What are we doing to improve retail? We are improving our talent pool. We have built a central retail division which is helping to capture the best practices, starting from single individual markets like the U.S., codifying these best practices and disseminating them. We also invested in improving the IT system to help us reading very carefully the performance at retail level: this is now the standard we use to engage in discussions on store management, so with store managers, at all levels in the organization up to the country manager. We want to strive to excel in retail management, so to be a credible partner also to our franchisees. As you know, of those 700 stores, roughly 600 are operated by franchisees, so clearly the franchise business is an area where we expect improvements. In other terms, we're putting efforts in our directly operated store in order to be a credible partner for our franchise dealers and allow them to improve their own performances.

To support organic growth, we recently strengthened our marketing team. We hired a person which was already known to the group, Mr. Daniele Tranchini. He really brings a wealth of incredible experience. He has held senior positions in international agencies including “J. Walter Thompson” and “Publicis”, where he led the Italian business, and is already making a huge difference in shaping our unique story around the different markets.

Talking about markets, a couple of highlights on two important geographies. The first one, China. As you all know, especially the group of investors and analysts that follow us, in China we are in JV with Kuka, and we don’t consolidate it “line by line” because we own a 49% stake in the JV. Our aspiration is not to consider China as a financial investment, but instead as part of our operations, so to make sure that also the JV in China benefits from our learning curve and, most of all, manages the brands in the way they should be managed.

For almost three years, and at least since the beginning of my CEO mandate, it was impossible to travel to China. Since May last year, we have been to China already two times and each time spent there about two weeks together with the most important people in our organization, our Chief Brand Officer and our Chairman, Pasquale. Furthermore, and in full agreement with our Board, I take the full responsibility to support the China operations and work in partnership with our JV. China is clearly a market where the wind, not only for furnishings, has changed significantly. In this regard, I mentioned in my initial speech the difficulties of the real estate giant, Evergrande, currently down 90% in its market cap, and that is facing a really difficult situation. So, we are strengthening the quality of the relationship with our JV team in the spirit of making sure that they can really benefit from our brand, merchandising, retail knowledge and guidance. In accordance with our Board, I’m planning to be back in the next few weeks in China for at least two, three weeks, really to support this process.

U.S. is the second engine of our airplane. U.S. is not just a single opportunity. It has been very central to the story of success of this group, and we believe it can go back to be as important as it used to be. To ensure we are closer to that market, we focused our organization on two channels, wholesale and retail, led by two talented managers. I already anticipated in the prior press release that we were very pleased to have Scott Kruger joining us to lead the wholesale and gallery business, which is still predominant in terms of total business in North America.

Jason, whom you know and fully respect for his retail competencies, will focus entirely on retail, that is the part of the business where the future of the Group is in terms of growth, especially for Natuzzi Italia. To make sure that the service provided to these two business units, retail and wholesale, are efficiently sharpened, we asked a senior manager of the Group, Mr. Ottavio Milano, to take on the role of President. In his new role, Ottavio will oversee the staff functions, including finance, customer care and HR, with the aim to provide streamlined and more agile services to both Scott Kruger and Jason Camp, who remains the person in charge for running and building the retail business.

Furthermore, even in a difficult year, we didn’t decelerate in terms of opening new Natuzzi stores in the U.S. We opened seven new stores, of which six are Natuzzi Italia, in primary locations according to our city development strategy. These locations include San Diego, Miami, Fort Worth and Manhasset, in addition to one new Natuzzi Edition store in Frisco. To elevate our brands, especially Natuzzi Italia, we look for flagship locations which are, let’s say, good “cathedrals” for our brands. If you have a chance, I invite you to visit our newly opened store in Manhasset, which is really a great example of this strategy. It’s located in the Miracle Mile in Manhasset, so that part of Long Island that goes to the Hamptons. It’s 10,000 square feet on two floors with a signature location, a singular design, and is the kind of quality we aspire to from a new location.

In conclusion, it’s evident that the current situation is unlikely to change in the next few weeks or months. We definitely see the current situation to endure until the end of the year and potentially it is something we’ll deal with also during the beginning of next year. Our strategic direction is clearer than ever: we aim to invest in our brands, with a focus on organic growth and on retail in our core markets, which are China, U.S., and Europe, principally Italy and U.K. At the same time, we want to continue and accelerate the work to reduce costs and enhance the agility of our organization.

You know that we don't provide guidance, but I want to tell you that we are highly confident in the strength of our brands and our long-term growth potential. We are talking of a brand which has more than 60 years of heritage, and heritage is something a brand cannot buy or copy. We believe this is central and will be an important element that eventually will bring us to achieve our midterm plans.

Having said so, I stop for potential questions. Together with Carlo, we're definitely going to be providing more details on the restructuring effort which keeps us extremely busy. But let me stop here for potential questions on this initial strategic introduction.

Operator

Thank you. At this time, if you'd like to ask any questions, you may do so by using the Ask a Question feature on your screen.

Thank you. Your line is now live.

David Kanen

Good morning, Dave Kanen. Thank you for taking my questions. Are you guys able to hear me clearly?

Antonio Achille

We do, at least I do.

David Kanen

Okay. Yes, so I guess at a high level, to me the call-out here is that, at €83 million in revenue, we were actually operating profit neutral and generated a little bit of cash, which is impressive given the cost containment, the increase in gross margin, and then the prospects for the future. That being said, I'd like to understand or drill down a little deeper on the new branded stores, the direct operated stores that you've been opening. So, my question is to Jason. When you look at all of these new stores, you've opened, Atlanta, Manhasset, Long Island, Houston, Fort Worth, etc., can you give me a sense as to what those stores will run rate in annual revenue, Jason?

Jason Camp

Dave, good morning. Listen, three of those openings have happened in the last 45 days, and so I think it's premature to attempt to predict an annual run rate on these openings. But I would say, based on the quality of the traffic that we're getting, we expect these stores to perform above our, let's say, network average for Natuzzi Italia.

David Kanen

Okay, and just as a reference point, Jason, what is the network average?

Jason Camp

Just shy of about three per unit.

David Kanen

Okay, according to your internal plan, will these new stores run above 4 million per year, or will it be just slightly above €3 million?

Jason Camp

We're watching these new guys carefully and obviously going to align on budget per location as we get closer to the end of the year, but I think for public consumption purposes, I think I've probably said as much as I can say and should say.

David Kanen

Okay. It seems clear to me that, given the production per location and the high marginality, it's critical — and I've had these conversations before and I know that you acquiesce to them —that we open up more DOS-branded stores. So, can you give us an update? I know that we need to preserve our balance sheet, but also at the same time opening these DOS stores puts us in a position over the next two years to get revenue back over €100 million per quarter, where it seems we could generate meaningful operating profit.

Antonio, the question is we've had a, let's call it, a non-core asset in North Carolina that has a meaningful value, that could potentially subsidize the next 10 stores, if not more than that. Can you give us an update on that and just reiterate that this is a top priority to open these DOS stores, hopefully getting to 15 or 20 additional in the next two years?

Antonio Achille

Thank you, Dave, for the question. I'll answer with two sentences. The first one is that we do confirm that opening Natuzzi Italia DOS in North America is a strategic priority. We are factorizing the opening of new DOS in our 2024 budget, trying to find the right balance with the money associated with such investments, as we need to safeguard cash.

As for the dismissal of the non-strategic asset, namely the building in High Point, there has been some progress. We are considering different options. I cannot say more than that, but there's been some positive, let's say, evolution, so we hope that there will be some good news on that front. However, I remind you, that is a decision to be taken by the Board because it goes beyond my autonomy. We've always said publicly that we are considering assets to be disposed of, such as the tannery in Italy, then the iconic building in High Point, North America, plus some terrain we have in Greensboro. For each of these three assets, we have offers pending or that are at an advanced stage. So, for NATCO, our Italian tannery, we have started a process, then for the asset in the U.S. we have offers which we are evaluating, or some final due diligence needs to be carried out before getting the approval from the Board. But this is something we will follow up on.

David Kanen

Okay, thank you for that update. Here's my view, not that I have a crystal ball, but I think there's a high likelihood that interest rates are going to be lower during 2024, possibly, my opinion is in the first quarter of 2024 and at that point, we'll see mortgage rates come down. There is a high correlation to housing as it relates to furniture, which should put us in a position where we start to see the business growing again organically. I would like to see more stores by the end of 2024 so that we could start doing €90 million, €100 million per quarter, generating significant profitability given your leaner structure and higher gross margin profile. So, I just wanted to reiterate to you guys that I'm hoping that you don't take your foot off the gas pedal in expanding some of these great markets in North America.

Antonio Achille

Yes, this goes toward the direction that I mentioned before in terms of organization. As we really intend to expand our retail business, we do need to have, lets' say, a heavyweight in terms of competences, as Jason is, and he needs to be focused entirely on retail business development.

But, you know, there's been a lot of changes, unfortunately not always for the good, in the U.S., and some brands and companies, which in our view are also interesting companies, are at risk of exiting the market: I'm referring to Mitchell Gold that, you know, is filing for Chapter 11. So, we're looking at the all possible ways to accelerate our growth on an individual-store-basis.

So, absolutely Dave, we are aligned. But we need also to make sure that this, the store expansion, will happen in a self-financing manner, and the disposal of non-strategic assets is clearly the way to accelerate our self-financing capability.

David Kanen

Okay, so the next question is for Jason, which you alluded to in your prepared remarks, are the organic growth initiatives at our DOS stores. Jason, could you drill down into some of the opportunities you think exist to drive meaningful same-store-sales at your current small fleet of North American stores?

Jason Camp

Sure. First of all, I'd say, when we study the last six months of written orders compared to written orders as to 2019, our 13 like-for-like stores are running around 44% above 2019, so there's been a lot of work to build a much more solid base from, let's say, pre-pandemic times.

Second, as we look towards the future, I think there are really two significant opportunities here. One is for the team and I to build a talent base in those stores that can fully capitalize on any incremental trade and design project business. Our average order, even compared to last year, is up in the neighborhood of 20% year-over-year, and so we're fully committed to building a team that can engage in more design project work, more complete rooms, more multiple rooms, whether that's with our clients directly or through trade partners.

Then to complement our efforts, I think we have an opportunity with the headquarters partner team to really study our assortment and add items inside the living space room and outside living spaces, to build the size of our average ticket to sell more things to a similar number of customers or a growing number of customers. So, that's really the strategic path that we're focused on.

David Kanen

Okay, thank you. I'll return back to queue, so other people can pose questions. Thank you.

Antonio Achille

To further expand on your question, we can organize a meeting, in the form of a special conference, not necessarily linked to an earnings call, inviting our retail division that will walk you through the initiatives we are implementing on the retail side. I mentioned earlier, for instance, our new IT systems which provide really accurate data. According to my experience — you know my background, I've been for 25 years consultant in retail, and I must say I'm biased on retail —this is one of the best IT systems installed ever. So, maybe for those of you who are interested, we can organize a special informative session to share some of these initiatives we do on trade, or those to support our team with improved IT system tools and, more generally, to give you some more details on our retail initiatives, as we may seem to be a bit generic here.

We are going to capture your interest for a follow-up session in the next weeks - it doesn't need to be tomorrow, but we definitely do a deep dive on retail if you're interested in that.

David Kanen

Sure, thank you for that.

Pasquale Natuzzi

If I may, Antonio …

Antonio Achille

Please, Pasquale.

Pasquale Natuzzi

First of all, thank you very much for the way you are explaining the performance of the Company and our concern. And thanks to David for his optimism, which is very important to us. Certainly, what we have created is a lifestyle brand, which is not something easy in the furniture industry. Few people really created it. As far as I know, there is certainly Restoration Hardware, there is Natuzzi, and Roche Bobois. Those are the global brands that really have been able to create a lifestyle brand.

So, in order to promote a lifestyle brand, retailers play a strategic role because they need to show what the lifestyle brand could represent, how the brand can really be attractive for the consumer. I must say that we have done great progress on lifestyle brand, certainly, but also on retail in the US, thanks to Jason, and also in other geographies. Again, today we need to be optimist on one hand but also realistic on the other hand. Consumers' confidence is very low everywhere. There is no geography where there is enthusiasm to buy, because for reasons that everybody knows. That's just what I wanted to emphasize. Thank you for listening.

Antonio Achille

Thank you, Pasquale, for your comment, and especially for your entrepreneurial passion and enthusiasm. Thank you so much.

Pasquale Natuzzi

You're welcome.

Operator

(Operator Instructions}

Antonio Achille

Kevin, one suggestion. So, while people digest things just listened and think of possible questions, I would ask our CFO, who, you know, joined us almost one year ago, to provide some more color about what I would normally call “transformation”, but the ambition of impact we want to create pushes me to call it “restructuring”. So, Carlo can provide some more color on that, while we are waiting for other questions. If you agree, we can go ahead this way.

Operator

Please proceed.

Carlo Silvestri

Thank you, Antonio. Good day to everybody. As Antonio anticipated, I will give more color of this restructuring process that we already started.

Allow me to say that, as top management, we are fully aware that given the reported sales, the current cost structure is no more sustainable. And it is crucial, vital for us to deliver a structure that can be more agile and resilient to volatile markets. What we have been doing is analyzing all our operating expenses, that include mainly selling expenses and administrative expenses.

As a general comment on our P&L, I will not go deep into what Antonio just mentioned on our improved marginality, but as for the operating expenses, I can say that we did benefit from a generalized decrease in transportation rates, that counterbalanced the increased costs for opening new DOS in the U.S. and for strengthening retail and marketing staff. But, given the analysis on our costs, we did realize that we need to intervene on both the industrial side and selling and administrative costs.

As for the industrial side of our operations, we already started the process a few years ago and we will keep working closely with our operations department in order to find opportunities to improve marginality and add a more agile, versatile industrial footprint. Furthermore, we keep working with our outsourcing in Vietnam and we have reduced the number of workers in China and Romania to align our structure there to the current level of demand. As for the Italian operations, the upgrading of the plants and the reduction of redundant workers is part of the plan, and that keeps going.

What has become new, and I guess of more interest in the discussion at this stage, is the work that we are doing on our SG&A structure, where we did start a deep analysis on our processes to verify the maximum level of optimization in terms of costs and headcount and get significant savings as well as a deep analysis on the way to boost all these actions. So, to let you understand what we are doing, I will give you some examples.

We are focusing on reducing the complexity of our industrial operations. As initial program, for example, we focused on the overall Natuzzi Edition cover codes, and for cover codes I mean the variety of possibilities that we give to our customers: we were able to reduce the number of codes from 152 to 53. You can imagine what that implies in terms of purchasing stock, management of the stock, and in terms also of communication and retail experience. Once we will put in practice all of these findings, we will expand this approach to the other markets and to Natuzzi Italia, and Mr. Natuzzi has been involved in this. Of course, this will not have impact in terms of quality and variety of our offer. In addition, we have specific programs that incentivize the depletion of the stock.

Talking about the stock, we are also shortening the supply chain processes and we are getting our suppliers’ portfolio closer to the relevant manufacturing plants, so that we will save on delivery times. We are also reviewing all the algorithms for the forecast of the purchases to align such forecast more carefully to the recent trends, and we are also working with the purchasing department to see if there is any possibility of inter-company transfer to optimize the stock management.

Another activity we have done recently is the centralization of the group credit management at HQ level to reduce the related positions abroad. By doing this, we have reached positive results in reducing the number of group DSO, and we are now able to better forecast our cash flow. As you can see, there is a spectrum of activities that we already launched, and there are analyses that are going on in this moment to find the best set-up for the future with the aim of achieving significant savings.

To be even more specific, giving our finance structure, we did report €2.7 million of finance costs, of which €1.6 million represented by interest expenses and bank charges, whereas interest expenses and bank charges were €1.1 million in the same quarter of last year. While we worked to have a selective utilization of the available credit facilities and securitization to protect against unfavorable conditions, interest rates have significantly increased compared to one year ago. Of course, we will keep considering any possibility to improve our working capital management and to go towards a self-financing model that is necessary in this period of high interest rates, and provide cash for investments, especially on the retail side and on growth.

Antonio Achille

Okay, thanks Carlo, and of course this is turning into quite a detailed discussion, but I think it would be helpful to focus on our strategic priorities, that I remind being: priority number one, retail expansion; priority two, reducing our SG&A. I would put both priorities on the same level, at least in the short term. We will keep reporting on those two priorities in the follow-up conversation we will have during our next quarterly review or intermediate press release.

Kevin, maybe you want to again poll the audience to see if there is any emerging curiosity or question.

Operator

Certainly. (Operator Instructions).

We do have a follow-up from David Kanen. Your line is now live, sir.

David Kanen

A quick question. Given the mix now that will continue of branded product, considering hypothetically €100 million per quarter in revenues, is it reasonable to assume with the initiatives that we've already taken that gross margin would get up to around 40% or better? This question is for Silvestri. Thank you.

Carlo Silvestri

I think your assumption is directionally right.

Dave Kanen

Okay. Thank you guys, good luck.

Antonio Achille

Thank you.

Operator

Any further questions at this time…

Antonio Achille

I might suggest…

Operator

I'll turn the floor back over to you, Antonio.

Antonio Achille

Yes, thank you Kevin. Once again, thank you all for being so attentive in following our story. We have high confidence in what we represent, which is an incredible brand, an incredible potential given the strength of our brand. We are very sure we're going to weather this difficult circumstances, emerging stronger from a cost and financial standpoint.

I might suggest Piero to reach out to Kevin — I don't know if that can be done — to survey you and capture interest for a follow-up conversation on retail, and, should an interest arise, we can make this public by organizing another conversation on retail in the following weeks, without waiting for the next press release.

Other than that, I wish you a great start to the week. Of course, as a servant to the Company, I stay at your disposal if you wish to have follow-up conversations in respect, of course, of our public company status.

Thank you so much and have a wonderful day.

Operator

Thank you. That does conclude today's webcast. You may now disconnect and have a wonderful day. We thank you for your participation today.

Pasquale Natuzzi

Thank you all.