Natuzzi SpA

Second Quarter and First Half 2019 Financial Results Conference Call

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CORPORATE PARTICIPANTS

Piero Direnzo, *Investor Relations Manager*

Pasquale Natuzzi, *Chief Executive Officer*

Vittorio Notarpietro, *Chief Financial Officer*

Nazzario Pozzi, *Chief Commercial Officer*

PRESENTATION

Operator:

Welcome to the Natuzzi Second Quarter and First Half 2019 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 are Natuzzi's Chief Executive Officer, Mr. Pasquale Natuzzi; the Chief Financial Officer, Mr. Vittorio Notarpietro; Mr. Oscar Severi, Global Strategy and Finance Development Director; then Mr. Nazzario Pozzi, the Chief Commercial Officer; Mr. Gianni Tucci, Chief Commercial Officer, Key Account Private Label; 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:

Thank you, Sandy, and good morning to our listeners in the United States, and good afternoon to those of you connected from Europe and Asia. Welcome to the Natuzzi Second Quarter and First Half 2019 Conference Call.

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. Good morning to everyone. As you know, last month, we informed you about a general worsening in the global trade environment, and more recently, the further escalation in the trade dispute between the United States and China. These external factors, in particular the current 25% tariff that will become probably 30% in a few weeks, have hurt our performance.

Despite this worsening environment, we have actively reacted with an important efficiency improvement in our industrial operation with the implementation of a specific action.

Consolidated net revenue decreased by 10.6% over the first semester of 2018. In 2018 these numbers included our retail business in China, which is now reflected as 49% of our joint venture. After adjusting for this change, sales for the period would have decreased by 7.6%. Vittorio will give you more detail on this.

As business condition gets tougher and consumer tastes are changing, we are performing significant changes in our model. We are continuing to implement the manutailer strategy, that is a manufacturer and direct retailer of our product, making the change to how and where we manufacture.

Tariff cannot be fully absorbed in our price. As such, we are revising the existing value chain and streamlining the process, structure and operation, extending our Natuzzi-branded distribution and retailer operation in key geographical areas.

The Company is taking specific action, including: reshaping the manufacturing operation to manage global trade condition; selling non-strategic assets, including our tannery and foam operation; getting financial support from Italian government for workers, training, innovation and digitalization; activities to move volume from China to Vietnam; accelerate the shifting of product manufacturing to Romania, which are no longer sustainable in Italy; moving from complete vertical integration to a supply chain model, which will improve our flexibility and reduce our working capital needs.

Our wholesale business is the most sensitive to Chinese tariff. For this reason, we have decided to outsource part of our production to Vietnam as fast as possible. As far as European production is concerned, we are exploring the outsourcing with a new partner in Belarus, which has a cost of labor lower than Romania. Outsourcing will support in revenue, as well as improve our margin and increase flexibility.

Natuzzi Italia, our high-end product line, will continue to be manufactured exclusively in Italy and, as such, is not subject to the tariff, thank God. In China, we plan to reduce our manufacturing footprint substantially, so that it will be sized for the sales needs of the local Chinese market as well as other parts of Asia Pacific.

Our direct retailer network is producing improved result in terms of volume, margin and cash flow. The main drivers of this improvement are the good performance of the three DOS opened in 2018 in the United States, namely Costa Mesa, Chicago and Philadelphia King of Prussia, then the successful restructuring of operation in our Florida store, and the revival of Divani&Divani by Natuzzi in Italy.

Such best practice achieved in part of our DOS chain will be deployed in the rest of direct operating store and also in the franchising one, primarily in the franchising network, favoring this organic growth for next few months—coming months.

I'm extremely pleased to announce that two new managers have recently joined us: Mr. Jason Camp, and Mr. Oscar Severi. Jason Camp, most recently a senior executive at Restoration Hardware, will lead our business operation in North America.

Here in Italy, we are all pleased really to have Jason, our manager in America, because his expertise has been in wholesaler and retailer and has been very successful in his career. We are very pleased and confident that with his ability, our Company will perform much, much better in America.

While Oscar Severi, he comes from an international company, from L'Oréal France, big company, and from Murdoch media, another skilled manager that will help us in a strategic financial project that we are going forward. Then eventually, if you want to know a specific project, what we are doing, Oscar is available certainly to answer because he's with us today here.

The group is developing the management retention plan that will be based on our sale price and designed to align the success of our managers with the return generated for our shareholders.

I would now like to introduce Vittorio Notarpietro, our CFO, who will take you through our numbers. Thank you. I'm available for any questions after Vittorio finishes his speech. Thank you.

Vittorio Notarpietro:

Okay. Thank you, Mr. Natuzzi. Good day to everyone. Let me also welcome Jason and Oscar.

Let me start by explaining the change in accounting for our Chinese retail. As already said, in July 2018, we finalized a JV agreement with KUKA Group for the exclusive license to distribute our brands in China Mainland, Hong Kong and Macau. Consequently, starting from August 1, 2018, we no longer fully consolidate the Chinese business. Obviously, we continue to supply the JV as a manufacturer.

Total adjustment on first half 2018 sales derived from that is €7.3 million; €2 million comes from DOS sell-out and €5 million from sell-in, the production that we sell through third-party retailers. If we adjust the 2018 revenue base to reflect this change, 2019 first half revenues would have decreased by 7.6%, as said before, instead of 10.6% reported, reflecting a 4.1% decrease in the Natuzzi division and a 15.3% decrease in the unbranded or private label division. In this regard, we have explained in our press release that the most recent trend is improving for the Natuzzi division, while private label division is further worsening.

In terms of seats sold, so excluding furnishings, volume was down by 18%. Despite such lower volumes, 2019 first half gross margin was 29.1%, slightly up from 29% last year, thanks to a better product mix, positive trend in raw material prices, selective price increases and efficient cost management in our industrial plant.

We accrued €1.4 million of layoff costs within the industrial costs — so in the cost of goods sold — due to the reduction of some blue and white collars in Italy. Net of such accrual, gross margin for the period would have been 29.8%.

The percentage of SG&A on sales from 34.3% to 35.5% this year increased mainly because of declining sales in the period, but in absolute value decreased from €76.2 million to €70.3 million, favored by the deconsolidation of the Chinese vehicle. The reported operating loss for the period was €10.8 million, including, as said, €1.4 million for the layoff cost in Italy versus €8.1 million last year.

Last year, we consolidated internally the positive operating result of our Chinese operation with a positive EBIT of €1 million. Today, having deconsolidated the Chinese business, we recorded 49% of around €2 million net profit reached by the Chinese vehicle below the EBIT line and specifically under the share of profit of equity-method investees line. It is important to underline that the Chinese vehicle more than doubled its profit in one year.

To summarize, despite much lower seats sold, the consolidated operating loss would have been in line with last year, minus €7.9 million EBIT, considering the €1.4 million for layoff cost, the €0.5 million negative impact of U.S. tariff net of price increases and the €1 million of net profit from the Chinese vehicle.

I'm not changing the sense of the numbers, but these details are important to better understand the mechanics, some mechanics in our profit and loss. The manufacturing played a significant role in reducing the impact of lower volumes by increasing efficiency and lowering operating costs, even fixed cost in some cases, like China.

Supply chain improved its efficiency in the last quarter. SG&A costs are under control, but volumes are lower for reasons explained by Mr. Natuzzi. I'm sure we will further discuss later. As said, we are revising the international manufacturing footprint of the group.

Oscar will give more flavor, but we are in an advanced stage of talks in Vietnam, which would both avoid tariff, 25% today and 30% expected in a few weeks, and save at least 10% versus our CURRENT manufacturing cost in China. We are actively trying to get the production in Vietnam to start at least from Q1 2020.

In the meantime, we are moving to downsize our Chinese operations. Our current plant in China is under lease agreement expiring in third quarter 2020. We have planned a smaller plant to be leased. This facility will be devoted exclusively to meet the Chinese and the rest of APAC demand.

In addition to the tannery and foam operations that Mr. Natuzzi said, we are divesting—we have identified other assets that we intend to sell. I'm referring to real estate properties we have in the United States of America and Italy. Total net book value of all assets to be sold is €25 million.

On the basis of today's information and the current stage of negotiation, we expect to achieve about €35 million from the sale of such asset. Thanks to the outsourcing and sale of asset, we will lower the group working capital by €6 million, and we will end up with a more flexible group structure by lowering operating costs in the region of €6 million, €7 million.

For the first six months of 2019, in spite of declining sales, cash flow from operating activities was positive by €2.7 million, also thanks to a more efficient working capital management. In addition, we used €18.1 million to repay short and long-term borrowing.

Consequently, cash net of bank overdraft repayable on demand as of June 30, 2019, was positive by €37.4 million. The Company expects third quarter 2019 sales almost in line with the same quarter of the previous year.

Thank you.