Natuzzi SpA

Third Quarter and First Nine Months 2017 Conference Call

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

David Kanen, *Kanen Wealth Management*

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PRESENTATION

Operator:

Good morning, ladies and gentlemen. Thank you for standing by. Welcome to the Natuzzi Third Quarter and First Nine Months 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 and instructions will be provided at that time for you to queue up for questions. Joining us on today's call from Italy are Natuzzi's Chief Executive Officer, Mr. Pasquale Natuzzi; then Nazzario Pozzi, Chief Officer of the Natuzzi Division; Mr. Gianni 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'd now like to turn the conference over to Piero. Please go ahead, sir.

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 Third Quarter and First Nine Months 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 security 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 everyone. I thank you for being here with the Natuzzi Management and for giving me the chance to update you on the result together with the activities that we have been implementing in the last nine months and continuity with the restructuring plan from manufacturer to manutailer.

The financial result for the third quarter were disappointing me, because our numbers were damaged by the lack of proper coordination between procurement and production that resulted in lower invoiced sales and margin. But within that disappointment, I see reason to be optimistic.

Let me now explain what happened this year. 2017 third quarter results have very poor invoiced sales, minus 6.1% versus previous year, while 2017 nine months result gave a fairer view of how the business is developing.

In spite of such stable net sales, the operating margin is negative by €21.6 million, as a consequence of the following: first, restructuring cost for €1 million still in the cost of goods sold in third quarter 2017 deriving from a new organization plan that allows us to reduce the cost of headquarter management and we will benefit from that in 2018 figures, excluding certain items. Second, we accrued in the cost of good sold €9.3 million in the first quarter of the year as a consequence of negative judgment with regard to Italian labor issue.

It is important to say that we have just received a few days ago a new judgment from a different court, which is more positive for Natuzzi. We'll leverage on that in the next discussion with the Italian authorities. Excluding those additional two items, gross profit could have been in line with the previous year.

Other SG&A increased in the nine-month period by €9.8 million, of which €7.4 million are directly linked to our retailer expansion program. We have acquired 8 stores in the United States, 5 in Italy, 3 stores and 12 concessions in Mexico. These stores needed to be restructured—new store concept, new sales force, staff training, inventory, clearance to renew the floor sample in order to get them in line with our brand positioning.

Furthermore, in 2017, we opened two new DOS stores in United States, two in Spain, one in Italy and two in China. In 2017, we also opened 20 Natuzzi Italia and 34 Edition licensed stores, plus 115 galleries, 21 for Natuzzi Italia and 94 for Natuzzi Editions, bringing to 408 our total number of store and 630 galleries. For those stores and galleries, we gave opening contribution for a total of €1.4 million already included in the €7.4 million above mentioned.

A wider retail network also need to be supported by an adequate sales and marketing organization, and we have invested in the additional Management in America and in the headquarter. In addition to that, a significant investment has been made to improve the digitalization of marketing and media, sales stores, new cable spot, catalog and etc. All the above-mentioned investment have been made to support the Natuzzi-branded sales, which are now starting to produce a better result. As a consequence, the increase in order flow and mixed performance in operation made an increase in backlog that will be recovered in the next quarter, and as we have more stores, the ratio of SG&A to the revenue will be reduced.

Now let me give you more updated view on the business. The order flow trend as of November 12 shows an increase of plus 0.8% versus the same period of 2016, but this small increase is the result of very different performance within the two business divisions we operate.

Natuzzi-branded order flow instead is growing everywhere we operate globally at plus 4.6%. In particular, Natuzzi Italia, the premium brand on which we continue to invest, is showing a double-digit growth, plus

18.8%. That makes me comfortable for the future because it is growing in all these geographic areas, in all product categories, furnishings, in particular, and sales channels.

Within our Natuzzi Italia, 19 like-for-like directly operating store, the order flow is plus 10.6%. Our retail store are demonstrating capabilities above our expectation. Our traffic is improving. Our conversion rate are strong, and our customer are buying vignettes, not pieces. This is reflected in our higher average sales ticket, proving that our strategy is correct.

Softaly shows an order flow down by 8.3%, deriving from higher sales in EMEA, plus 6.4%, where we are already taking advantage of the work on complexity reduction and improving our product and industrial process innovation in Romania, which is the plan devoted to EMEA; double-digit increase in Asia-Pacific, plus, 42.2%, and double-digit decrease unlikely in North America, minus 28.2%, the most competitive market. And we have some of our biggest customers, that have been shutting down several stores and as a consequence, we have been suffering about volume.

But our plan anyway is to recover some lost customer, placing the work done in Romania into the Chinese one. In the meantime, we will continue to reduce those costs that are not needed to generate growth and returns, and it is my personal goal to return our company to profitability in 2018.

I would like now to turn the meeting over to Vittorio Notarpietro, who will take you through our numbers in greater detail. Thank you.

Vittorio Notarpietro:

Thank you so much, Mr. Natuzzi. Our third quarter and first nine months results are obviously disappointing. As said before, these results were also affected by the imbalances between our production operations and supply chain versus a growth in orders, more concentrated in the second part of the third quarter, in particular for our Italian production.

In the third quarter, when we got an increase in the order flow, we had already planned our Italian operations, and consequently, we had already programmed the purchase of raw material and finished goods and furnishings from our suppliers. So we were not immediately ready to be provided in time with all the additional needs of material and accessories. This impacted both our production and deliveries, causing a delay in the invoiced process of about—that we calculate in the area of €11 million at least and, as a consequence, €4 million of additional contribution margin could have been done.

But let's speak about the future. Now the Italian operations are running faster and above their standard rates through an increase in work shifts per week. We confirm that the increased backlog is being reduced, and we expect that will support sales during the last quarter of this year. We are then planning to organize 2018 Italian plants in a different way, in order to be ready for additional production needs and some more flexibility.

As stated in the press release, our 2017 gross profit, which was €101.5 million for the nine-month period was affected by two events already described by Mr. Natuzzi, which—one is the accrual of €9.3 million for the unfavorable judgment with regard to Italian labor, then we incurred in Q3 restructuring costs of €1 million, as we reduced our management structure in Santeramo, which will enable us to begin saving next year. Then we have a small increase of industrial cost as a percentage of net sales due to lower volumes. Therefore, if we exclude those two items totaling €10.3 million, the gross margin for the nine-month period would be equal to €111.8 million, a little bit better than a year ago and in spite of the decrease in sales.

In the area of variable costs, in the first nine months we displayed lower transportation costs, which were 8.9% from 9.7% on sales. This is not the result of lower shipping rate, which are instead increasing, but the result of—the combined result of higher sales to clients with Free on Board or Ex Works delivery condition versus the ones which we provide with landed shipping services.

Commissions to agents are stable as a percentage of sales. Then we invested €1.1 million net more than a year ago as a result of higher advertising and marketing, including some additional cost for digitalization and adv campaign, on which I'm sure Nazzario will elaborate later. As a percentage of sales, adv—advertising and marketing went from 3.8% to 4.2% on sales.

Lastly, let's say again, on the other SG&A, we know that they increased in the nine months by €9.8 million, and we know that most of it around €7.4 million is consistent with our main driver in growth for such expenses, and such expenses are strictly related to our Natuzzi expansion program. These expenses increased mainly in the first two quarters, this is important to say, of the year. Indeed, if we consider the trend of these expenses, we see that in Q1 SG&A increased by €3.1 million. In Q2, the gap increased up to €4.9 million, while in Q3 the increase versus the same quarter 2016 has been €1.8 million, so the trend is improving and as soon as the productivity of the acquired and newly opened store improves, the ratio of our net sales will improve too.

Group's available cash as of September 2017 was €47.9 million from €65 million as of December 2017. So the difference is €17.1 million in cash. As a result, cash flow used from operating activities was minus 20.3, of which, is important to see the reason, which were, we had an earning before interest, taxes, depreciation and amortization, EBITDA, loss of 2.6. Then we had €12.5 million for one-time termination benefit paid in accordance with the agreement signed with Italian workers that accepted incentives for voluntary resignation. Third, working capital negative by €6.4 million, and €3.7 million of withholding tax on dividends from Chinese companies to Italy. Then capital expenditure were €7.1 million, and we generated cash by our financing activities of about €13.1 million with new medium- and long-term loans. Then we had 2.8 negative impact of foreign exchange on cash deposits in China.

As a result, available cash by the end of the period is, as said, a positive €47.9 million. I would underline that in this €17.1 million difference, we have 12 one-time—€12.5 million for one-time termination benefit and €3.7 million withholding tax on Chinese dividend paid to Italy.

Thank you so much. Now the Management is ready to answer your questions. Thank you.

Operator:

Thank you, sir. If you'd like to ask a question, please signal by pressing star, one, on your telephone keypad. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Once again, that is star, one, if you'd like to queue up for a question. We'll pause for just a moment to allow everyone a chance to signal.

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

David Kanen:

Hi. First question is what were same-store sales during Q3? In terms of your anomalous production issue in the third quarter that you state cost you about €11 million in revenue, you're indicating that you expect to fulfill that backlog in Q4. Will you be able to fill that backlog as well as resume a normal production and delivery on invoices at retail that come in in Q4 and thereby show growth in the fourth quarter?

Vittorio Notarpietro:

Dave, this is Vittorio. We are not sure if we got your question. Are you asking if in Q4, also the DOS will recover from the backlog we accumulated by the end of Q3?

David Kanen:

Yes. Well, you did state that you expect—or Mr. Natuzzi had stated that you expect to realize that $11 million in backlog, okay, that wasn't fulfilled in Q3. My question is, in addition to that, will you be able to on time produce and deliver and recognize revenues for Q4 at retail, the normal flow that you got? So in other words, pick up the incremental €11 million on top of normal invoices for Q4.

Vittorio Notarpietro:

The €11 million are calculated at the wholesale level; in those numbers, there is a portion for DOS. So yes, we will have a benefit also in the DOS sales because of the backlog we had at the end of the Q3.

Then, David, we are assigned to accelerate any kind of delivery, including, obviously, the DOS deliveries, which are, as you know very well, very much important for the consolidated results. But you know that—and we were putting all our efforts in order to speed up any kind of deliveries including the DOS in Q4.

You know that revenue recognition for DOS is when I arrive at your house and you pay me the balance with a receipt. So the revenue recognition is something that we will—we have to address in Q4. But yes, we are very motivated on recovering that amount that will be at least €11 million.

David Kanen:

So—yes, my question is, will you get the benefit of both bill? I don't know if you fully understand my question. Will you get the benefit of growth in DOS in normal Q4 as well as catching up, for lack of a better word, on that €11 million? And do you expect overall—excluding Softaly, do you expect overall to show growth in the fourth quarter?

Pasquale Natuzzi:

David, this is Pasquale. For sure, a part of the €11 million backlog increase will be delivered in the fourth quarter. That means, we will recover volume and invoice that we did in the third quarter. A part of this volume increase will be delivered through final consumer, through our DOS stores, which means, we will gain also a better margin for our DOS.

Now if I understood well your question, you are saying, if, in addition to the recover of the €11 million backlog increase, we will also deliver whatever order we will get in November. I mean, if that's the question, because to...

David Kanen:

Yes. In other words, do you expect production and deliveries to be normal in the fourth quarter for your production to catch up with the deliveries, or rather the deliveries to catch up with production?

Pasquale Natuzzi:

The problem we had with our vendor have been resolved, okay? We are sure that we had a good backlog as end of September, and we are now—while we resolve the problem, we are manufacturing and delivering the product.

Now we know how much order we got until last week. We don't know how much order we will get until the end of the year. You know what I mean? So—but anyway, you will see a good performance. We all expect good performance for the fourth quarter, no question about.

Vittorio Notarpietro:

The issue, to be clear, has been fixed. The issue we experienced at the end of the quarter.

David Kanen:

Okay. I am going to let it go for now. Thank you.

Operator:

Once again, everyone, that is star, one if you'd like to ask a question. Once again, please remember that if you're using a speakerphone, make sure your mute function is turned off to allow your signal to reach our equipment. That is star, one if you'd like to ask a question. We'll pause for another moment to allow everyone a chance to signal.

One more time, that is star, one if you would like to ask a question. If you're using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Star, one at this time if you'd like to ask a question. We'll pause for another moment.

One more time, that's star, one if you would like to ask a question. We'll pause for another moment.

We'll take our next question from Anthony Lebiedzinski with Sidoti & Company. Anthony, your line is open. Please go ahead.

Anthony Lebiedzinski:

Yes, good morning. Can you hear me now?

Operator:

Yes. We can hear you.

Anthony Lebiedzinski:

Okay. Just wanted to follow up on the previous caller's questions about the same-store sales, if you could provide those, what those were for your third quarter, and if you could perhaps break that down by region, that would be very helpful? Thank you.

Nazzario Pozzi:

Nazzario Pozzi speaking. Let me first confirm the overall like-for-like growth in the third quarter. So overall, like-for-like growth in the third quarter is 10.6% across all our brand, which is Natuzzi Italia, Natuzzi Editions and Divani & Divani. This is our like-for-like retail DOS network.

The vast majority of this business is made of Natuzzi Italia, our lifestyle brand. Natuzzi Italia has delivered a increasing progression during the year, because like-for-like growth of Natuzzi Italia in the first quarter of the year versus the same period in 2016 was 2.6%.

In the second quarter, the like-for-like growth of Natuzzi Italia DOS, again, versus the same period of 2016, was 12.5%. In the third quarter, like-for-like growth of Natuzzi Italia was 22.8% versus the same quarter of 2016. So this is a progression that quarter-after-quarter Natuzzi Italia like-for-like stores have delivered.

On the other side, overall, Natuzzi Italia has being delivering over the year a 18.7% increase. This is the all business, both stores and—DOS store, franchise stores and galleries, and such 18.7% increase year-to-date have been delivered across all markets, so all markets have contributed strongly to this growth.

Year-to-date, the Americas grew 23.5% versus last year. Asia-Pacific grew 29% versus last year, and EMEA grew 11% versus last year. This is overall Natuzzi Italia.

Within this, I would like to mention the contribution that came from furnishing and accessories because we have been steadily executing our lifestyle brand strategy, which, of course, includes furnishing and accessories as a key component of our value proposition to consumers. Furnishing and accessories on a year-to-date basis have grown 44% versus last year in the Americas, 45% versus last year in Asia-Pacific and 25% versus last year in EMEA.

As of today, Natuzzi Italia already accounts for over 40% of our branded sales, and as Natuzzi Italia has higher retail margin than the rest of our sales, we are very much persuaded that such a progression will continue in the fourth quarter and next year, thus helping to deliver and drive higher growth in our corporate profitability.

Anthony Lebiedzinski:

Great. Thank you.

Operator:

All right. Ladies and gentlemen, once again, that is star, one if you'd like to ask a question. We'll go back to David Kanen for a follow-up question.

David Kanen:

Yes, just a clarification, Nazzario, on terminology. So when you say like-for-like—okay, for example, 10.6% like-for-like—I'm sorry, yes, 10.6% Q3 like-for-like growth, that's the same thing as same-store sales growth, correct?

Nazzario Pozzi:

That's correct.

David Kanen:

Okay. I just wanted to qualify that. Okay, thank you

Operator:

Okay. Once last time, that is star, one if you'd like to ask a question.

Once again, ladies and gentlemen, star, one if you'd like to ask a question at this time.

With no further questions, that will conclude today's call. We thank you everyone for their participation. You may now disconnect.