Natuzzi SpA

Second Quarter and First Half 2018 Financial Results Conference Call

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CORPORATE PARTICIPANTS

Piero Direnzo, *Investor Relations Manager*

Vittorio Notarpietro, *Chief Financial Officer*

Pasquale Natuzzi, *Chief Executive Officer*

Gianni Tucci, *Chief Officer, Softaly Division*

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CONFERENCE CALL PARTICIPANTS

David Kanen, *Kanen Wealth Management*

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PRESENTATION

Operator:

Good morning, ladies and gentlemen, and thank you for standing by. Welcome to the Natuzzi Second Quarter and First Half 2018 Financial Results Conference Call. At this time, all participants are in a listen-only mode. Following the introduction, we will conduct the 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, then the Chief Financial Officer, Mr. Vittorio Notarpietro, Mr. Ed Teplitz, President of Natuzzi Americas, Mr. Nazzario Pozzi, Chief Officer of the Natuzzi Division, Mr. Gianni Tucci, Chief Officer of the Softaly Division, and Mr. Piero Direnzo, Investor Relations.

As a reminder today’s call is being recorded, I would now like to turn the call over to Piero. Please go ahead.

Piero Direnzo:

Thank you. Good morning to our listeners in the United States and good afternoon to those of you connecting from Europe. Welcome to the Natuzzi's second quarter and first half of 2018 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 Financial Officer. Please, Vittorio.

Vittorio Notarpietro:

Thank you so much, Piero. As announced, we have recently concluded the partnership with Kuka Group for the expansion of the Group retail presence in Greater China, mainly China and Hong Kong. The operations have just started but let me give you an update of these financial impacts that will be recognized in the third quarter 2018 financial statement deriving from the conclusion of this agreement.

First, a recap of the transaction as foreseen by the partnership:
1) the capital increase of €35 million in Natuzzi Trading Shanghai, afterwards the Chinese legal entity subscribed and paid by Kuka;
2) the transfer of some Chinese legal entity shares from Natuzzi SpA to Kuka for a gross amount of €30 million; and
3) the sale of the Natuzzi brand distribution license in Greater China by Natuzzi SpA to the Chinese legal entity for a gross amount of €15 million.

At the end of the day, the capital increase and the share purchase let Kuka achieve the majority stake 51% in the partnership. The above mentioned steps generated for the Group, at total, extraordinary income of about €48 million that will be reported in the third quarter 2018. As a consequence, the Group has already collected a total amount of about €40 million already net of any taxes. In fact, during the third quarter 2018, Natuzzi already paid a total amount of taxes equal to almost €5 million.

In executing the agreement, the parties have contributed to the Chinese partnership vehicle a total amount of €25 million in order to support the investments needed for the retail expansion in Greater China. This partnership has been in force from August 1, 2018. And therefore, starting from that date, the Group will consolidate this partnership vehicle by the equity method as affiliated company and no longer by integral method as full controlled subsidiary. This means that we will consolidate only 49% of the net equity of this partnership vehicle.

Further, in the future financial statements, we will not consolidate line-by-line the Chinese legal entity financial statements, rather we recognize an investment asset in the financial statements, which will be estimated equal to 49% of the entity's net equity, net of intergroup figures. In other terms, we will not consider integrally the entire revenues such as the sell-out, sell-in and other revenues and all the operating costs that now pertain entirely to the vehicle of this partnership. In fact, we will include in the consolidated statement of operations only the change in value of the 49 stake in the partnership. This change in value will be accounted for in the non-operating part of the income statement, I mean, in the future.

Of course, the Group will continue to manufacture and provide this legal entity with products at the selling price or sale price, if you prefer, taking advantage of the retail development plan, which is the goal of the partnership. For 2018 full year result, we will consolidate integrally the numbers up to July 31, 2018, whereas the 49% stake in the Chinese vehicle will be considered with the equity method from August 3, 2018 onward.

Now, let's go a bit deeper into 2018 second quarter and first half numbers. As anticipated in our previous conference calls, the strengthening of euro versus major currencies continued to play an important role also in second quarter. In second quarter 2018, net sales were €108 million, minus 7.1% versus second quarter last year, or minus 3.4% if we consider constant exchange rates. Gross profit was 32.8% of net sales or 34.2% under constant exchange rates, almost the same as 34.1% in Q2 2017 and notwithstanding a price increase experienced in raw materials.

Our effort in rationalizing the SG&A cost has continued also in second quarter of this year and indeed, we reached a reduction in such costs both in absolute terms from €26.2 million last year second quarter to €23.9 million this quarter, and as a percentage of sales from 22.5% to 22.1%. As a result, the operating result has been negative by €5 million or negative by €3.3 million under constant exchange rates versus minus €4.5 million in Q2 last year.

Let's have a look to the six months. As for the six month period ended on June 30, 2018, total consolidated net sales were €225.7 million, down 2.7% from €232.1 million in the same period last year. Excluding the currency effects, sales for the period would have been higher by €12 million and consequently would have increased by 2.4%.

Sales for the Natuzzi Division, which includes Natuzzi Italia, Natuzzi Editions and Divani&Divani, increased by 1% or by 7% under constant exchange rate.

Within the Natuzzi Division, the wholesale business decreased by 1.5%, but it would have increased by 4.7% under constant exchange rate. The Natuzzi directly operated stores, DOS Division, grew by 13.3% or 18.2% under constant exchange rates. On a same-store basis, that is considering only those stores that were operating throughout the first half of 2018 and first half of 2017, increased by 2.2% or 5.5% under constant exchange rates.

In a nutshell, our direct control of the distribution is starting delivering positive results. You might recall that we acquired some business in Mexico and in Florida. We needed first to restructure those stores. Now, we have completed turnaround and the upgrade of the DOS in Florida and Mexico, and these stores are now profitable. We will also open three new stores in USA. between the end of 2017 and first half of this year. Now such stores are quickly getting closer to their full sales potential. Nazzario will surely add more flavor on this during the Q&A session.

The DOS network is improving its profitability, especially if we consider the network on same-store basis. The 58 DOS existing during the first six months last year and this year generated an operating result positive of €0.8 million from €0.2 million during the same period last year. As of today, the entire DOS network consists of 64 directly operated stores and 20 concessions in United Kingdom and Mexico. And we plan to open three new DOS by the end of this year, two in the United States and one in France. This rollout number does not include the plan in China.

As far as private label business is concerned, Softaly reported disappointing sales of €49.7 million, down 13.6% in the first half. The decrease was concentrated mainly in the North American market, while shifted sales from the EMEA and Asia-Pacific region increased by 5.6% and 5.9%, respectively.

Gross margin for the first six month period of 2018 was equal to 31.9%, negatively affected by currency movements. It could have been 33.6% under constant exchange rate. For the first half last year, we reported a 30.7% gross margin or 34.7% excluding the €9.3 million accrual made last year for labor related risks. During the period, gross margin was affected also by increased price of some raw materials. We had an increase in the labor costs as compared to the first half of last year, net of the €9.3 million accrued. Following some extra work required to speed up the production, especially towards the end of June production and shipments, especially towards the end of June and meet the delivery time required by our customers.

On the SG&A side, which was the biggest financial issue last year, our costs reduction program continues to deliver savings in absolute terms and as a percentage on net sales. During the first half of this year, other SG&A was €46.6 million or 20.6% on sales improving from €50.1 million or 21.6% of net sales reported last year. We achieved these improvements notwithstanding the further investments made this year in expanding our U.S. network. As said, in 2017 first half, we reported an operating loss of €14.7

million, of which €9.3 million for the said accrual versus an operating loss of €8 million this year. Thus, under constant exchange rates and excluding the extraordinary accrual of last year, 2018 first half operating results would have been minus €3.5 million better than the €5.4 million loss last year.

Gianni, Nazzario, Edward and, of course, Mr. Natuzzi will be pleased to answer, and later an introduction of Mr. Natuzzi. Mr. Natuzzi, please?

Pasquale Natuzzi:

Thank you, Vittorio, and good afternoon to everybody. Today, I would like just to give everyone an overview of the furniture business, primarily the upholstery business. The global upholstery market, according to the recent market research conducted by an independent company, total global upholstery sales are growing. Some markets are growing faster than others, with China and the United States responsible together considered for more than 50% of the total worldwide upholstery sales. China is the fastest growing market in the world and thus consistently growing by double-digit percentage over the last several years. United States is also growing but at a lower single-digit pace annually.

Natuzzi has a strong presence in China, including the manufacturing, retail, marketing and commercial organization. More importantly, we have, as Vittorio said, just finalized the partnership with the Kuka Group, which will allow us to expand at a much quicker pace. Prior to our partnership with Kuka, we had about 160 stores there in China, of which 50 are Natuzzi Italia and 110 are Natuzzi Editions, of which 20 have been opened this year in China and we expect to open an additional 30 stores by the end of this year and hundreds of stores over the next several years; that's the plan.

United States is another key market for us. We have been in the marketplace for more than 30-years—I would say 35 years furnishing the homes of several millions consumers; we have been publically traded on the New York Stock Exchange for 25 years and enjoy strong awareness as the preferred brand. We currently have 12 directly owned stores that are performing well, both in terms of sales and profitability. We believe that growing this footprint of directly controlled retail is an important strategy moving forward.

I want to now touch upon our other global business. As you just heard from Vittorio, our overall business and profitability in our controlled retail distribution continue to grow. This is currently approximately one-third of our total turnover distribution. This controlled distribution is currently for Natuzzi Italia globally and primarily in China and Brazil for Natuzzi Edition. We continue to be committed to investing in and growing our directly operating store network, as Vittorio just highlighted.

Total direct operating store sales were 13.3% over the prior year or 18.2% increase under constant exchange rates. We will continue to grow our direct operating store and our franchising retailer footprint for mono-brand Natuzzi Italia and Editions stores. Based on the experience and success of developing the Natuzzi Editions mono-brand store network in China and Brazil, we are now planning to move forward with a small test of opening a Natuzzi Editions store in United States and in United Kingdom.

Over the last several years, we have invested in upgrading Natuzzi Editions product styling, marketing, store display, store experience and overall brand messaging. We now believe Natuzzi Edition is a lifestyle brand and be able to compete and be successful as a mono-brand concept. We believe that through the combination of direct-to-consumer, and continue to work with our stronger retailer partnership, will allow us to leverage on the assets and grow our Natuzzi Editions sales and profitability.

Let me now touch upon the challenges that we are currently facing and discussing with you our strategy for overcoming them. Private label in North America is challenging with extreme price sensitivity and competition. All the China manufacturers are there in America, they're fighting for price and margin. Competing only on price is not the solution for us, certainly. We are focusing on increasing efficiency and production by reducing the complexity of our offering.

We are using the knowledge we have learned from our recent private-label success in Europe and focusing on improving the process and manufacturing efficiency in order to build demand and maintain profitability and fulfill the factory
That's the main reason why we have private label because we have the factory, we are global, we have a factory and we needed to fulfill the production.

Tariffs have just been imposed today on all private label and Natuzzi Edition products entering in the United States that we manufacture in our factory in China. In particular, the tariff rate is currently 10% and we have announced a short-term solution to overcome this.

This will in the short-term negatively impact our margin. However, there is a threat of 25% tariff beginning in January 2019. Fortunately, Natuzzi is a global manufacturer with a manufacturing facility also in Italy, in Romania and in Brazil, and we are taking actions and planning on how to move the production to other facilities in order to avoid the tariff and the negative impact it would have on our business. That's in general just an overview for you shareholders and analysts who understand that we are strongly committed to overcome our current situation.

I thank you very much for listening, and obviously, I'm here open and available to answer to any questions. Today, we have here with us Edward Teplitz, which is the President of Natuzzi America, and because in America, as I said before, we have good brand awareness with the business in the 35-years, we satisfied a lot of customers there, we have an organization, we have the people, our Natuzzi Italia stores are performing well and are becoming profitable, we are confident. We are confident that even in the presence of balance sheets that are not certainly pleasant for any one.

Thank you for listening.