

Edgar Filing: ESTEE LAUDER COMPANIES INC - Form 10-Q

ESTEE LAUDER COMPANIES INC  
Form 10-Q  
January 31, 2007

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549-1004  
-----

FORM 10-Q

(Mark One)

X Quarterly Report Pursuant to Section 13 or 15(d) of the Securities  
- Exchange Act of 1934

For the quarterly period ended December 31, 2006

OR

Transition Report Pursuant to Section 13 or 15(d) of the Securities  
- Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 1-14064

The Estee Lauder Companies Inc.  
(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

11-2408943  
(IRS Employer Identification No.)

767 Fifth Avenue, New York, New York  
(Address of principal executive offices)

10153  
(Zip Code)

212-572-4200  
(Registrant's telephone number, including area code)

Not Applicable  
(Former name, former address and former fiscal year, if changed since last  
report)

Indicate by check mark whether the registrant (1) has filed all reports required  
to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during  
the preceding 12 months (or for such shorter period that the registrant was  
required to file such reports), and (2) has been subject to such filing  
requirements for the past 90 days.

Yes X No  
- -

Indicate by check mark whether the registrant is a large accelerated filer, an  
accelerated filer, or a non-accelerated filer. See definition of "accelerated  
filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check  
one):

Large accelerated filer X Accelerated filer Non-accelerated filer  
- - -

Indicate by check mark whether the registrant is a shell company (as defined in

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Rule 12b-2 of the Exchange Act). Yes No X

- -

At January 26, 2007, 124,209,228 shares of the registrant's Class A Common Stock, \$.01 par value, and 82,409,761 shares of the registrant's Class B Common Stock, \$.01 par value, were outstanding.

### THE ESTEE LAUDER COMPANIES INC.

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### THE ESTEE LAUDER COMPANIES INC.

#### PART I. FINANCIAL INFORMATION

##### Item 1. Financial Statements.

#### CONSOLIDATED STATEMENTS OF EARNINGS (Unaudited)

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	Three Months Ended December 31		Six Months Ended December 31	
	2006	2005	2006	2005
	(In millions, except per share data)			
Net Sales	\$ 1,991.1	\$ 1,783.9	\$ 3,584.6	\$ 3,200.0
Cost of Sales	499.0	458.5	927.1	850.8
Gross Profit	1,492.1	1,325.4	2,657.5	2,400.0
Operating expenses:				
Selling, general and administrative	1,159.7	1,073.1	2,224.7	2,000.0
Special charges related to cost savings initiative	--	1.6	0.5	--
	1,159.7	1,074.7	2,225.2	2,000.0
Operating Income	332.4	250.7	432.3	300.0
Interest expense, net	7.7	6.9	14.4	10.0
Earnings before Income Taxes, Minority Interest and Discontinued Operations	324.7	243.8	417.9	300.0
Provision for income taxes	113.3	90.2	146.7	100.0
Minority interest, net of tax	(2.9)	(3.2)	(4.7)	(3.0)
Net Earnings from Continuing Operations	208.5	150.4	266.5	200.0
Discontinued operations, net of tax	(0.1)	(68.7)	0.2	(100.0)
Net Earnings	\$ 208.4	\$ 81.7	\$ 266.7	\$ 100.0
Basic net earnings per common share:				
Net earnings from continuing operations	\$ 1.00	\$ .70	\$ 1.27	\$ .70
Discontinued operations, net of tax	(.00)	(.32)	.00	(.32)
Net earnings	\$ 1.00	\$ .38	\$ 1.27	\$ .38
Diluted net earnings per common share:				
Net earnings from continuing operations	\$ .99	\$ .70	\$ 1.25	\$ .70
Discontinued operations, net of tax	(.00)	(.32)	.00	(.32)
Net earnings	\$ .99	\$ .38	\$ 1.25	\$ .38
Weighted average common shares outstanding:				
Basic	208.3	214.7	209.7	214.7
Diluted	211.4	216.6	212.5	216.6

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Cash dividends declared per share \$ .50 \$ .40 \$ .50 \$

See notes to consolidated financial statements.

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THE ESTEE LAUDER COMPANIES INC.

CONSOLIDATED BALANCE SHEETS

	December 31 2006
	----- (Unaudited) (\$ in m)
ASSETS	
Current Assets	
Cash and cash equivalents	\$ 251.8
Accounts receivable, net	1,005.1
Inventory and promotional merchandise, net	783.0
Prepaid expenses and other current assets	287.1
	-----
Total current assets	2,327.0
	-----
Property, Plant and Equipment, net	807.5
	-----
Other Assets	
Investments, at cost or market value	21.9
Goodwill, net	683.9
Other intangible assets, net	79.4
Other assets, net	122.2
	-----
Total other assets	907.4
	-----
Total assets	\$ 4,041.9
	=====
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current Liabilities	
Short-term debt	\$ 189.9
Accounts payable	287.4
Accrued income taxes	180.6
Other accrued liabilities	1,059.6

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Total current liabilities	1,717.5
-----	
Noncurrent Liabilities	
Long-term debt	439.3
Other noncurrent liabilities	251.0
-----	
Total noncurrent liabilities	690.3
-----	
Minority Interest	18.6
-----	
Stockholders' Equity	
Common stock, \$.01 par value; 650,000,000 shares Class A authorized; shares issued: 169,074,012 at December 31, 2006 and 164,837,563 at June 30, 2006; 240,000,000 shares Class B authorized; shares issued and outstanding: 82,409,761 at December 31, 2006 and 85,305,915 at June 30, 2006	2.5
Paid-in capital	649.5
Retained earnings	2,524.8
Accumulated other comprehensive income	80.6
-----	
	3,257.4
Less: Treasury stock, at cost; 44,893,732 Class A shares at December 31, 2006 and 38,382,458 Class A shares at June 30, 2006	(1,641.9)
-----	
Total stockholders' equity	1,615.5
-----	
Total liabilities and stockholders' equity	\$ 4,041.9
=====	

See notes to consolidated financial statements.

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THE ESTEE LAUDER COMPANIES INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

	Six Months December
	-----
	2006
	-----
	(In mill)
Cash Flows from Operating Activities	
Net earnings	\$ 266.7
Adjustments to reconcile net earnings to net cash flows from operating activities:	

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Depreciation and amortization	103.8
Deferred income taxes	(12.4)
Minority interest, net of tax	4.7
Non-cash stock compensation	26.6
Excess tax benefits from stock-based compensation arrangements	(1.7)
Loss on disposal of fixed assets	2.7
Discontinued operations, net of tax	(0.2)
Other non-cash items	0.4
Changes in operating assets and liabilities	
Increase in accounts receivable, net	(212.5)
Decrease (increase) in inventory and promotional merchandise, net	(6.5)
Increase in other assets, net	(26.1)
Increase (decrease) in accounts payable	22.4
Increase in accrued income taxes	47.9
Increase in other accrued liabilities	101.3
Increase (decrease) in other noncurrent liabilities	(4.4)
	-----
Net cash flows provided by operating activities of continuing operations	312.7
Net cash flows used for operating activities of discontinued operations	(5.7)
	-----
Net cash flows provided by operating activities	307.0
	-----
Cash Flows from Investing Activities	
Capital expenditures	(140.5)
Capital expenditures of discontinued operations	--
Acquisition of businesses, net of cash acquired	(56.7)
Proceeds from disposition of long-term investments	--
Purchases of long-term investments	(0.4)
	-----
Net cash flows used for investing activities	(197.6)
	-----
Cash Flows from Financing Activities	
Increase in short-term debt, net	99.6
Repayments and redemptions of long-term debt	(1.2)
Net proceeds from stock-based compensation transactions	37.1
Excess tax benefits from stock-based compensation arrangements	1.7
Payments to acquire treasury stock	(254.3)
Dividends paid to stockholders	(103.6)
Distributions made to minority holders of consolidated subsidiaries	(9.5)
	-----
Net cash flows used for financing activities	(230.2)
	-----
Effect of Exchange Rate Changes on Cash and Cash Equivalents	4.0
	-----
Net Decrease in Cash and Cash Equivalents	(116.8)
Cash and Cash Equivalents at Beginning of Period	368.6
	-----
Cash and Cash Equivalents at End of Period	\$ 251.8
	=====

See notes to consolidated financial statements.

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THE ESTEE LAUDER COMPANIES INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### Note 1 - Summary of Significant Accounting Policies

#### Basis of Presentation

The accompanying consolidated financial statements include the accounts of The Estee Lauder Companies Inc. and its subsidiaries (collectively, the "Company") as continuing operations, with the exception of the operating results of its reporting unit that marketed and sold Stila brand products, which have been reflected as discontinued operations for the three and six-month periods ended December 31, 2006 and 2005. All significant intercompany balances and transactions have been eliminated.

The consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations of any interim period are not necessarily indicative of the results of operations to be expected for the fiscal year. For further information, refer to the consolidated financial statements and accompanying footnotes included in the Company's Annual Report on Form 10-K for the year ended June 30, 2006.

Certain amounts in the consolidated financial statements of prior periods have been reclassified to conform to current period presentation for comparative purposes.

#### Net Earnings Per Common Share

For the three and six-month periods ended December 31, 2006 and 2005, net earnings per common share ("basic EPS") is computed by dividing net earnings by the weighted-average number of common shares outstanding and contingently issuable shares (which satisfy certain conditions). Net earnings per common share assuming dilution ("diluted EPS") is computed by reflecting potential dilution from stock-based awards.

A reconciliation between the numerators and denominators of the basic and diluted EPS computations is as follows:

	Three Months Ended December 31		
	2006	2005	
			(Unaudited)
			(In millions, except per share amounts)
Numerator:			
Net earnings from continuing operations	\$ 208.5	\$ 150.4	\$
Discontinued operations, net of tax	(0.1)	(68.7)	
	-----	-----	
Net earnings	\$ 208.4	\$ 81.7	\$
	=====	=====	=====

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Denominator:			
Weighted average common shares outstanding - Basic	208.3	214.7	
Effect of dilutive securities: Stock options and restricted share units	3.1	1.9	
	-----	-----	
Weighted average common shares outstanding - Diluted	211.4	216.6	
	=====	=====	
Basic net earnings per common share:			
Net earnings from continuing operations	\$ 1.00	\$ .70	\$
Discontinued operations, net of tax	(.00)	(.32)	
	-----	-----	
Net earnings	\$ 1.00	\$ .38	\$
	=====	=====	
Diluted net earnings per common share:			
Net earnings from continuing operations	\$ .99	\$ .70	\$
Discontinued operations, net of tax	(.00)	(.32)	
	-----	-----	
Net earnings	\$ .99	\$ .38	\$
	=====	=====	

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THE ESTEE LAUDER COMPANIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

As of December 31, 2006 and 2005, outstanding options to purchase 13.3 million and 17.1 million shares, respectively, of Class A Common Stock were not included in the computation of diluted EPS because their inclusion would be anti-dilutive. As of December 31, 2006 and 2005, 0.2 million and 0.1 million, respectively, of Performance Share Units have been excluded from the calculation of diluted EPS because the number of shares ultimately issued is contingent on the achievement of certain performance targets of the Company, as discussed in Note 3 - Stock Programs.

Supplemental Disclosures of Cash Flow Information

As of December 31, 2006, the Company has separately disclosed the operating and investing portion of cash flows attributable to its discontinued operations, which in the prior period was reported on a combined basis as a single amount. The Company has conformed its statement of cash flows for the six months ended December 31, 2005 to reflect the cash flows used for discontinued operations from a single line below the financing activities category into the appropriate operating activity and investing activity categories.

Supplemental cash flow information for the six months ended December 31, 2006 and 2005 were as follows:

	2006	
	-----	
Cash		(Unaudit (In milli



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Cash paid during the period for interest	\$ 18.2
	=====
Cash paid during the period for income taxes	\$ 106.7
	=====
Non-cash	
Incremental tax benefit from the exercise of stock options	\$ 3.6
	=====
Capital lease obligations incurred	\$ 1.4
	=====
Accrued dividend equivalents	\$ 0.2
	=====
Interest rate swap derivative mark to market	\$ (7.3)
	=====

### Accounts Receivable

Accounts receivable is stated net of the allowance for doubtful accounts and customer deductions of \$28.5 million and \$27.1 million as of December 31, 2006 and June 30, 2006, respectively.

### Inventory and Promotional Merchandise

Inventory and promotional merchandise includes inventory considered saleable or usable in future periods, and is stated at the lower of cost or fair-market value, with cost being determined on the first-in, first-out method. Cost components include raw materials, componentry, direct labor and overhead (e.g., indirect labor, utilities, depreciation, purchasing, receiving, inspection and warehousing) as well as inbound freight. Promotional merchandise is charged to expense at the time the merchandise is shipped to the Company's customers.

	December 31
	2006
	-----
	(Unaudited)
	(In millions)
Inventory and promotional merchandise consists of:	
Raw materials	\$ 159.5
Work in process	40.1
Finished goods	413.3
Promotional merchandise	170.1
	-----
	\$ 783.0
	=====

THE ESTEE LAUDER COMPANIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### Property, Plant and Equipment

Property, plant and equipment, including leasehold and other improvements that extend an asset's useful life or productive capabilities, are carried at cost less accumulated depreciation and amortization. The cost of assets related to

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projects in progress of \$116.0 million and \$91.9 million as of December 31, 2006 and June 30, 2006, respectively, is included in their respective asset categories in the table below. For financial statement purposes, depreciation is provided principally on the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized on a straight-line basis over the shorter of the lives of the respective leases or the expected useful life of those improvements.

		December 31 2006
		----- (Unaudited)
		(In millions)
Assets (Useful Life)		
Land	\$	13.8
Buildings and improvements (10 to 40 years)		163.6
Machinery and equipment (3 to 10 years)		882.8
Furniture and fixtures (5 to 10 years)		104.6
Leasehold improvements		856.3
		-----
		2,021.1
Less accumulated depreciation and amortization		1,213.6
		-----
	\$	807.5
		=====

Depreciation and amortization of property, plant and equipment was \$50.4 million and \$47.4 million during the three months ended December 31, 2006 and 2005, respectively, and \$99.1 million and \$92.7 million during the six months ended December 31, 2006 and 2005, respectively. Depreciation and amortization related to the Company's manufacturing process is included in cost of sales and all other depreciation and amortization is included in selling, general and administrative expenses in the accompanying consolidated statements of earnings.

### Goodwill and Other Intangible Assets

During the six months ended December 31, 2006, the Company purchased the remaining minority equity interest in Bumble and Bumble Products, LLC and Bumble and Bumble, LLC, acquired a business engaged in the wholesale distribution and retail sale of Aveda products and acquired an international distributor, all of which resulted in an increase to goodwill of \$46.5 million and other intangible assets of \$4.6 million.

### Other Accrued Liabilities

Other accrued liabilities at December 31, 2006 and June 30, 2006 were \$1,059.6 million and \$948.5 million, respectively, of which \$418.9 million and \$334.5 million, respectively, represented accruals related to advertising, merchandising and sampling.

### Operating Leases

The Company recognizes rent expense from operating leases with periods of free and scheduled rent increases on a straight-line basis over the applicable lease term. The Company considers lease renewals in the useful life of its leasehold improvements when such renewals are reasonably assured. From time to time, the Company may receive capital improvement funding from its lessors. These amounts are recorded as deferred liabilities and amortized over the remaining lease term as a reduction of rent expense.

## THE ESTEE LAUDER COMPANIES INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## Pension and Post-retirement Benefit Plans

The Company maintains pension plans covering substantially all of its full-time employees for its U.S. operations and a majority of its international operations. Certain of the Company's employees are eligible to participate in a post-retirement benefit plan which provides certain medical and dental benefits. Descriptions of these plans are discussed in the Company's Annual Report on Form 10-K for the year ended June 30, 2006.

The components of net periodic benefit cost for the three months ended December 31, 2006 and 2005 consisted of the following:

	Pension Plans				P	
	U.S.		International			P
	2006	2005	2006	2005		
(Unaudited) (In millions)						
Service cost, net	\$ 4.6	\$ 5.4	\$ 4.0	\$ 3.0	\$ 1	
Interest cost	6.2	5.3	3.2	2.4	1	
Expected return on plan assets	(7.2)	(6.2)	(3.4)	(2.8)		
Amortization of:						
Prior service cost	0.2	0.2	0.1	0.1		
Actuarial loss	0.5	1.5	1.9	2.0	0	
Net periodic benefit cost	\$ 4.3	\$ 6.2	\$ 5.8	\$ 4.7	\$ 3	

The components of net periodic benefit cost for the six months ended December 31, 2006 and 2005 consisted of the following:

	Pension Plans				P	
	U.S.		International			P
	2006	2005	2006	2005		
(Unaudited) (In millions)						
Service cost, net	\$ 9.2	\$ 10.8	\$ 7.9	\$ 6.0	\$ 2	
Interest cost	12.5	10.6	6.4	4.9	3	
Expected return on plan assets	(14.4)	(12.4)	(6.8)	(5.7)		
Amortization of						

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Prior service cost	0.3	0.4	0.1	0.1	
Actuarial loss	0.9	3.0	3.9	4.1	0
Settlements and curtailments	--	--	--	0.2	
	-----	-----	-----	-----	-----
Net periodic benefit cost	\$ 8.5	\$ 12.4	\$ 11.5	\$ 9.6	\$ 6
	=====	=====	=====	=====	=====

During the first quarter of fiscal 2007, the Pension Protection Act of 2006 was adopted into law in the United States. Certain provisions of this Act changed the calculation related to the maximum contribution amount deductible for income tax purposes. As a result of these provisions, the Company made discretionary contributions totaling \$10.0 million to its trust-based, noncontributory qualified defined benefit pension plan during the current quarter and expects to contribute an additional \$10.0 million during the remainder of fiscal 2007. As of December 31, 2006, the Company expects to make benefit payments under its non-qualified domestic noncontributory pension plan of \$10.3 million and contributions to its international pension plans of \$18.8 million during the fiscal year ending June 30, 2007, as previously disclosed.

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THE ESTEE LAUDER COMPANIES INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### Management Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses reported in those financial statements. These judgments can be subjective and complex, and consequently actual results could differ from those estimates and assumptions. The Company's most critical accounting policies relate to revenue recognition, concentration of credit risk, inventory, pension and other postretirement benefit costs, goodwill and other intangible assets, income taxes, derivatives and stock-based compensation. Descriptions of these policies are set forth in the Company's Annual Report on Form 10-K for the year ended June 30, 2006.

#### Recently Issued Accounting Standards

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 157, "Fair Value Measurements" ("SFAS No. 157") to clarify the definition of fair value, establish a framework for measuring fair value and expand the disclosures on fair value measurements. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price). SFAS No. 157 also stipulates that, as a market-based measurement, fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability, and establishes a fair value hierarchy that distinguishes between (a) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (b) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). SFAS No. 157 becomes effective for the Company in its fiscal year ending June 30, 2009. The Company is currently evaluating the impact of the provisions of SFAS No. 157 on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for

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Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 106, and 132(R) ("SFAS No. 158"). SFAS No. 158 requires employers to recognize a net liability or asset and an offsetting adjustment to accumulated other comprehensive income to report the funded status of defined benefit pension and other postretirement benefit plans. Previous standards required employers to disclose the complete funded status of its plans only in the notes to the financial statements. Additionally, SFAS No. 158 requires employers to measure plan assets and obligations at their year-end balance sheet date. The Company will adopt SFAS No. 158 prospectively, as of the end of the current fiscal year, as required.

In September 2006, the SEC issued Staff Accounting Bulletin ("SAB") No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB No. 108"), which sets forth the SEC Staff's views on the proper methods for quantifying errors when there were uncorrected errors in a prior year. Under SAB No. 108, companies should evaluate a misstatement that existed in prior years based on its impact on the current year income statement, as well as the cumulative effect of correcting such misstatements in the current year's ending balance sheet. SAB No. 108 will become effective for the Company in its fiscal year ending June 30, 2007. The Company is currently evaluating the impact of the provisions of SAB No. 108 on its consolidated financial statements.

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### THE ESTEE LAUDER COMPANIES INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

##### Note 2 - Comprehensive Income

The components of accumulated other comprehensive income ("OCI") included in the accompanying consolidated balance sheets consist of net unrealized investment gain (loss), net gain (loss) on derivative instruments designated and qualifying as cash-flow hedging instruments, net minimum pension liability adjustments and cumulative translation adjustments as of the end of each period.

Comprehensive income and its components, net of tax, are as follows:

	Three Months Ended December 31		Six M Dec
	2006	2005	2006
	(Unaudited) (In millions)		
Net earnings	\$ 208.4	\$ 81.7	\$ 266.
Other comprehensive income (loss):			
Net unrealized investment gain	0.1	--	0.
Net derivative instruments gain (loss)	(2.0)	(0.6)	(3.
Translation adjustments	18.9	(20.9)	19.
	17.0	(21.5)	15.
Other comprehensive income (loss)			

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Comprehensive income	\$ 225.4	\$ 60.2	\$ 282.
	=====	=====	=====

The accumulated net gain (loss) on derivative instruments consists of the following:

	Three Months Ended December 31		Six Mo Dece
	2006	2005	2006
	(Unaudited) (In millions)		
OCI-derivative instruments, beginning of period	\$ 9.1	\$ 12.6	\$ 10.
Gain (loss) on derivative instruments	(4.9)	2.1	(6.
Reclassification to earnings of net (gain) loss during the period	1.9	(4.8)	1.
Benefit for deferred income taxes	1.0	2.1	1.
Net derivative instruments gain (loss)	(2.0)	(0.6)	(3.
OCI-derivative instruments, end of period	\$ 7.1	\$ 12.0	\$ 7.
	=====	=====	=====

The \$7.1 million, net of tax, derivative instrument gain recorded in OCI at the end of the current period included \$9.1 million, net of tax, related to the gain on the settlement of treasury lock agreements upon issuance of the Company's 5.75% Senior Notes due October 2033, which will be reclassified to earnings as an offset to interest expense over the life of the debt. Offsetting this gain was \$2.0 million, net of tax, related to the loss on forward and option contracts, which the Company will reclassify to earnings during the next six months.

At the end of the prior period, the \$12.0 million, net of tax, derivative instrument gain recorded in OCI included \$9.3 million, net of tax, related to the gain on the settlement of treasury lock agreements upon issuance of the Company's 5.75% Senior Notes due October 2033, which will be reclassified to earnings as an offset to interest expense over the life of the debt, and \$2.7 million, net of tax, related to forward and option contracts which the Company reclassified to earnings.

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As of December 31, 2006, the Company has three active equity compensation plans which include the Amended and Restated Fiscal 2002 Share Incentive Plan, the Fiscal 1999 Share Incentive Plan and the Non-Employee Director Share Incentive Plan (collectively, the "Plans"). These Plans currently provide for the issuance of 32,894,400 shares, which consist of shares originally provided for and shares transferred to the Plans from a previous plan and employment agreement, to be granted in the form of stock-based awards to key employees, consultants and non-employee directors of the Company. As of December 31, 2006, approximately 8,428,200 shares of Class A Common Stock were reserved and available to be granted pursuant to these Plans. The Company may satisfy the obligation of its stock-based compensation awards with either new or treasury shares. The Company's stock compensation awards outstanding at December 31, 2006 include stock options, Performance Share Units ("PSU"), Restricted Stock Units ("RSU") and share units.

Stock-based compensation expense is attributable to the granting of, and the remaining requisite service periods of, stock options, PSUs, RSUs and share units, net of estimated forfeitures. Compensation expense attributable to net stock-based compensation during the three months ended December 31, 2006 and 2005 was \$11.7 million and \$10.4 million, respectively. Compensation expense attributable to net stock-based compensation during the six months ended December 31, 2006 and 2005 was \$26.5 million and \$23.6 million, respectively. As of December 31, 2006 and 2005, the total unrecognized compensation cost related to nonvested stock-based awards was \$47.7 and \$55.2 million, respectively and the related weighted-average period over which it is expected to be recognized is approximately 2.2 and 2.6 years, respectively.

### Stock Options

A summary of the Company's stock option programs as of December 31, 2006 and changes during the six-month period then ended, is presented below:

(Unaudited) (Shares in thousands)	Shares	Weighted-Average Exercise Price	Aggregate Intrinsic Value (1) (in millions)
Outstanding at June 30, 2006	26,215.7	\$ 39.53	
Granted at fair value	1,659.8	39.58	
Exercised	(1,306.8)	28.42	
Expired	(117.7)	41.91	
Forfeited	(72.8)	39.16	
Outstanding at December 31, 2006	26,378.2	40.07	\$ 99.3
Exercisable at December 31, 2006	20,736.1	40.44	\$ 83.7

(1) The intrinsic value of a stock option is the amount by which the current market value of the underlying stock exceeds the exercise price of the option.

The exercise period for all stock options generally may not exceed ten years from the date of grant. Stock option grants to individuals generally become exercisable in three substantively equal tranches over a service period of up to

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four years.

The weighted-average grant date fair value of stock options granted for the three months ended December 31, 2006 and 2005 was \$14.71 and \$10.69, respectively. The weighted-average grant date fair value of stock options granted for the six months ended December 31, 2006 and 2005 was \$13.67 and \$11.61, respectively. The total intrinsic value of stock options exercised during the three months ended December 31, 2006 and 2005 was \$14.0 million and \$3.0 million, respectively. The total intrinsic value of stock options exercised during the six months ended December 31, 2006 and 2005 was \$15.9 million and \$22.4 million, respectively.

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### THE ESTEE LAUDER COMPANIES INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	Three Months Ended December 31
(Unaudited)	2006
Weighted-average expected stock-price volatility	24%
Weighted-average expected option life	9 years
Average risk-free interest rate	4.7%
Average dividend yield	1.2%

	Six Months Ended December 31
(Unaudited)	2006
Weighted-average expected stock-price volatility	24%
Weighted-average expected option life	8 years
Average risk-free interest rate	4.7%
Average dividend yield	1.2%

In addition to awards made by the Company, stock options were assumed as part of the October 1997 acquisition of the companies that sold jane brand products. There were 4,100 options to acquire shares of the Company's Class A Common Stock outstanding as of June 30, 2006, all of which were exercised as of December 31, 2006.

#### Performance Share Units

During the six months ended December 31, 2006, the Company issued approximately 119,000 PSUs, which will be settled in stock subject to the achievement of the Company's net sales and net earnings per share goals for the three years ending June 30, 2009. Settlement will be made pursuant to a range of opportunities relative to the net sales and earnings per share targets of the Company and, as such, the compensation cost of the PSUs is subject to adjustment based upon the



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attainability of these target goals. No settlement will occur for results below the minimum threshold and additional shares shall be issued if performance exceeds the targeted performance goals. PSUs are accompanied by dividend equivalent rights that will be payable in cash upon settlement of the PSU. These awards are subject to the provisions of the agreement under which the PSUs are granted. The PSUs were valued at \$39.56, representing the closing market value of the Company's Class A Common Stock on the date of grant, and generally vest at the end of the performance period.

The following is a summary of the status of the Company's PSUs as of December 31, 2006 and activity during the six months then ended:

(Unaudited) (Shares in thousands)	Shares	Weighted- Grant Fair V
Nonvested at June 30, 2006	111.1	\$
Granted	119.0	
Vested	--	
Forfeited	--	
Nonvested at December 31, 2006	230.1	

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### THE ESTEE LAUDER COMPANIES INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

##### Restricted Stock Units

The Company granted approximately 593,400 RSUs during the six months ended December 31, 2006, of which 326,400 are scheduled to vest on October 31, 2007, 171,300 on October 31, 2008 and 95,700 on November 2, 2009, all subject to the continued employment or retirement of the grantees. Certain RSUs are accompanied by dividend equivalent rights that will be payable in cash upon settlement of the RSU and as such were valued at \$39.56 representing the closing market value of the Company's Class A Common Stock on the date of grant. Other RSUs are not accompanied by dividend equivalent rights, and as such were valued at the closing market value of the Company's Class A Common Stock on the date of grant less the discounted present value of the dividends expected to be paid on the shares during the vesting period.

The following is a summary of the status of the Company's RSUs as of December 31, 2006 and activity during the six months then ended:

(Unaudited) (Shares in thousands)	Shares	Weighted- Grant Fair V
Nonvested at June 30, 2006	111.1	\$
Granted	593.4	
Vested	(37.0)	

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Forfeited	(4.1)
	-----
Nonvested at December 31, 2006	663.4
	=====

Share Units

The Company grants share units to certain non-employee directors under the Non-Employee Director Share Incentive Plan. The share units are convertible into shares of Class A Common Stock as provided for in that plan. Share units are accompanied by dividend equivalent rights that are converted to additional share units when such dividends are paid. The following is a summary of the status of the Company's share units as of December 31, 2006 and activity during the six months then ended:

(Unaudited) (Shares in thousands)	Shares	Weighted- Grant Fair V
	-----	-----
Outstanding at June 30, 2006	13.1	\$
Granted	4.3	
Dividend equivalents	0.2	
Converted	--	
	-----	
Outstanding at December 31, 2006	17.6	
	=====	

Cash Units

Certain non-employee directors defer cash compensation in the form of cash payout share units, which are not subject to the Plans. These share units are classified as liabilities and, as such, their fair value is adjusted to reflect the current market value of the Company's Class A Common Stock. The Company recorded \$0.2 million and \$0.1 million as compensation expense to reflect the change in the market value for the three months ended December 31, 2006 and 2005, respectively. The Company recorded \$0.4 million as compensation expense to reflect the change in the market value for the six months ended December 31, 2006 while the same expense for the six months ended December 31, 2005 was de minimis.

THE ESTEE LAUDER COMPANIES INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 4 - Discontinued Operations

On September 30, 2005, the Company committed to a plan to sell and on April 10, 2006, completed the sale of certain assets and operations of the reporting unit that marketed and sold Stila brand products. As such, \$0.1 million of loss and \$0.2 million of income, both net of tax, for the three and six months ended December 31, 2006, are reflected as discontinued operations in the accompanying consolidated statements of earnings. The current year operating results included

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income from providing certain transitional distribution and online services as well as the manufacture and sale to the purchaser of a limited range of products. Also included were charges for transitional services related to certain information systems, accounting and other back office services provided to the purchaser in exchange for monthly service fees designed to recover the estimated costs of providing these transition services. Transitional services are expected to conclude in fiscal 2007. During the prior year, the Company recorded a charge of \$68.7 million (net of \$14.2 million tax benefit) and \$72.0 million (net of \$16.2 million tax benefit) as discontinued operations for the three and six months ended December 31, 2005, respectively. The charge reflected the anticipated loss on the sale of the business of \$65.5 million, net of tax, and the operating loss of \$3.2 million, net of tax, and \$6.5 million, net of tax, for the three and six months ended December 31, 2005, respectively. Net sales associated with the discontinued operations were \$12.1 million and \$25.7 million for the three and six months ended December 31, 2005, respectively.

### Note 5 - Cost Savings Initiative

During fiscal 2006, the Company recorded special charges associated with a cost savings initiative that was designed to support its long-term financial objectives. As part of this multi-faceted initiative, the Company identified savings opportunities that included streamlined processes and organizational changes. Substantially all employees designated for separation under the cost savings initiative have been separated as of December 31, 2006.

During the six months ended December 31, 2006, the Company incurred an additional \$0.5 million under this program primarily related to facility closings. At December 31, 2006, the accrued liability related to the cost savings initiative was \$41.9 million of which \$27.0 million and \$14.9 million was reflected as other accrued liabilities and other noncurrent liabilities, respectively, in the accompanying consolidated balance sheet.

THE ESTEE LAUDER COMPANIES INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### Note 6 - Segment Data and Related Information

Reportable operating segments include components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker (the "Chief Executive") in deciding how to allocate resources and in assessing performance. Although the Company does business in one operating segment, beauty products, management also evaluates performance on a product category basis. Performance is measured based upon net sales and operating income. Operating income represents earnings before income taxes, minority interest, net interest expense and discontinued operations. The accounting policies for the Company's reportable segment are substantially the same as those for the consolidated financial statements, as described in the segment data and related information footnote included in the Company's Annual Report on Form 10-K for the year ended June 30, 2006. The assets and liabilities of the Company are managed centrally and are reported internally in the same manner as the consolidated financial statements; thus, no additional information is produced for the Chief Executive or included herein. There has been no significant variance in the total or long-lived asset value associated with the Company's segment data since June 30, 2006. Special charges related to the Company's cost savings initiative of \$1.6 million for the three and six months ended December 31, 2005 have been reclassified to conform to current period

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presentation for comparative purposes. These charges were previously reported in the Americas region and in each of the product categories.

	Three Months Ended December 31		Six Month Decemb
	2006	2005	2006
	(Unaudited) (In millions)		
<b>PRODUCT CATEGORY DATA</b>			
Net Sales:			
Skin Care	\$ 701.1	\$ 644.1	\$ 1,268.1
Makeup	716.8	642.3	1,363.6
Fragrance	465.1	407.9	754.4
Hair Care	93.9	79.2	176.3
Other	14.2	10.4	22.2
	\$ 1,991.1	\$ 1,783.9	\$ 3,584.6
	=====	=====	=====
Operating Income:			
Skin Care	\$ 148.8	\$ 133.3	\$ 191.7
Makeup	128.6	92.5	178.5
Fragrance	37.4	17.9	42.5
Hair Care	15.6	7.5	19.5
Other	2.0	1.1	0.6
Special charges related to cost savings initiative	--	(1.6)	(0.5)
	332.4	250.7	432.3
Reconciliation:			
Interest expense, net	7.7	6.9	14.4
	\$ 324.7	\$ 243.8	\$ 417.9
	=====	=====	=====
<b>GEOGRAPHIC DATA</b>			
Net Sales:			
The Americas	\$ 944.0	\$ 878.8	\$ 1,844.5
Europe, the Middle East & Africa	761.7	658.9	1,233.6
Asia/Pacific	285.4	246.2	506.5
	\$ 1,991.1	\$ 1,783.9	\$ 3,584.6
	=====	=====	=====
Operating Income:			
The Americas	\$ 109.9	\$ 79.6	\$ 183.0
Europe, the Middle East & Africa	170.8	132.0	189.1
Asia/Pacific	51.7	40.7	60.7
Special charges related to cost savings initiative	--	(1.6)	(0.5)
	\$ 332.4	\$ 250.7	\$ 432.3
	=====	=====	=====

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## THE ESTEE LAUDER COMPANIES INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

### Results Of Operations

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We manufacture, market and sell beauty products including those in the skin care, makeup, fragrance and hair care categories which are distributed in over 130 countries and territories. The following is a comparative summary of operating results from continuing operations for the three and six months ended December 31, 2006 and 2005, and reflects the basis of presentation described in Note 1 of Notes to Consolidated Financial Statements - Summary of Significant Accounting Policies for all periods presented. Sales of products and services that do not meet our definition of skin care, makeup, fragrance or hair care have been included in the "other" category. Special charges related to our cost savings initiative of \$1.6 million for the three and six months ended December 31, 2005 have been reclassified to conform to current period presentation for comparative purposes. These charges were previously reported in the Americas region and in each of our product categories.

	Three Months Ended December 31		Six Months December
	2006	2005	2006
	-----		
	(In millions)		
<b>NET SALES</b>			
By Region:			
The Americas	\$ 944.0	\$ 878.8	\$ 1,844.5
Europe, the Middle East & Africa	761.7	658.9	1,233.6
Asia/Pacific	285.4	246.2	506.5
	\$ 1,991.1	\$ 1,783.9	\$ 3,584.6
	=====	=====	=====
By Product Category:			
Skin Care	\$ 701.1	\$ 644.1	\$ 1,268.1
Makeup	716.8	642.3	1,363.6
Fragrance	465.1	407.9	754.4
Hair Care	93.9	79.2	176.3
Other	14.2	10.4	22.2
	\$ 1,991.1	\$ 1,783.9	\$ 3,584.6
	=====	=====	=====
<b>OPERATING INCOME (LOSS)</b>			
By Region:			
The Americas	\$ 109.9	\$ 79.6	\$ 183.0
Europe, the Middle East & Africa	170.8	132.0	189.1
Asia/Pacific	51.7	40.7	60.7
Special charges related to cost savings initiative	--	(1.6)	(0.5)

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	----- \$ 332.4 =====	----- \$ 250.7 =====	----- \$ 432.3 =====
By Product Category:			
Skin Care	\$ 148.8	\$ 133.3	\$ 191.7
Makeup	128.6	92.5	178.5
Fragrance	37.4	17.9	42.5
Hair Care	15.6	7.5	19.5
Other	2.0	1.1	0.6
Special charges related to cost savings initiative	--	(1.6)	(0.5)
	----- \$ 332.4 =====	----- \$ 250.7 =====	----- \$ 432.3 =====

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THE ESTEE LAUDER COMPANIES INC.

The following table presents certain consolidated earnings data as a percentage of net sales:

	Three Months Ended December 31		Six M De
	2006	2005	2006
	-----	-----	-----
Net sales	100.0%	100.0%	100
Cost of sales	25.1	25.7	25
Gross profit	74.9	74.3	74
Operating expenses:			
Selling, general and administrative	58.2	60.1	62
Special charges related to cost savings initiative	--	0.1	
	----- 58.2	----- 60.2	----- 62
Operating income	16.7	14.1	12
Interest expense, net	0.4	0.4	0
Earnings before income taxes, minority interest and discontinued operations	16.3	13.7	11
Provision for income taxes	5.7	5.1	4
Minority interest, net of tax	(0.1)	(0.2)	(0)
Net earnings from continuing operations	----- 10.5	----- 8.4	----- 7
Discontinued operations, net of tax	--	(3.8)	
Net earnings	----- 10.5%	----- 4.6%	----- 7

=====

In order to meet the demands of consumers, we continually introduce new products, support new and established products through advertising, sampling and merchandising and phase out existing products that no longer meet the needs of our consumers. The economics of developing, producing and launching these new products influence our sales and operating performance each period. The introduction of new products may have some cannibalizing effect on sales of existing products, which we take into account in our business planning.

Second Quarter Fiscal 2007 as Compared with Second Quarter Fiscal 2006

#### Net Sales

Net sales increased 12% or \$207.2 million to \$1,991.1 million, reflecting net sales growth in all major product categories within each geographic region. Europe, the Middle East & Africa led the growth in our fragrance and skin care product categories, while hair care growth was primarily in the Americas. Makeup product category growth was strong in all regions. The Americas region and the skin care, makeup and fragrance categories were adversely impacted by fewer department store doors resulting from the merger of Federated Department Stores, Inc. ("Federated") and The May Department Stores Company (the "Federated/May Merger"). We also experienced weakness in our business at those Federated doors affected by the national nameplate change to Macy's in the United States. Prior-year period net sales in the Americas reflected an incremental provision of approximately \$13 million for returns that were anticipated at that time as a result of then-announced store closings related to these retailer consolidations. Excluding the impact of foreign currency translation, net sales increased 9%.

#### Product Categories

##### Skin Care

Net sales of skin care products increased 9% or \$57.0 million to \$701.1 million. Most of this growth occurred outside of the United States. Net sales in the United States were adversely impacted by retailer consolidation. The recent launches of Repairwear Lift and All About Eyes Rich from Clinique and Advanced Night Repair Concentrate Recovery Boosting Treatment and new Perfectionist products from Estee Lauder contributed incremental sales of approximately \$36 million, combined. Net sales increases of approximately \$17 million from Resilience Lift Extreme Ultra Firming products and Advanced Night Repair Eye Recovery Complex by Estee Lauder also contributed to growth in this product category. These improvements were partially offset by approximately \$13 million of lower sales of certain other Resilience Lift products from Estee Lauder and Repairwear Deep Wrinkle Concentrate for Face and Eye by Clinique. Excluding the impact of foreign currency translation, skin care net sales increased 6%.

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THE ESTEE LAUDER COMPANIES INC.

##### Makeup

Makeup net sales increased 12% or \$74.5 million to \$716.8 million, primarily reflecting growth from our makeup artist brands of approximately \$57 million. The recent launches of Resilience Lift Extreme Ultra Firming Makeup SPF 15 and High Gloss Lip Gloss from Estee Lauder and High Definition Lashes from Clinique contributed incremental sales of approximately \$17 million, combined. Approximately \$21 million of higher sales of Double Wear Foundation and Pure Color EyeShadow by Estee Lauder and Perfectly Real Makeup from Clinique was

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offset by lower sales of existing makeup products. Excluding the impact of foreign currency translation, makeup net sales increased 9%.

### Fragrance

Net sales of fragrance products increased 14% or \$57.2 million to \$465.1 million, driven by the recent launches of DKNY Red Delicious, Sean John Unforgivable, Pure White Linen from Estee Lauder, DKNY Red Delicious Men and Youth Dew Amber Nude from Tom Ford for Estee Lauder, which collectively contributed approximately \$58 million to the category. Higher net sales of DKNY Be Delicious Men, Tommy and Tommy Girl by Tommy Hilfiger and the Clinique fragrance franchises contributed approximately \$18 million, collectively, to the growth in net sales. Partially offsetting these increases were lower sales of True Star and True Star Men by Tommy Hilfiger, Estee Lauder Beyond Paradise and DKNY Be Delicious of approximately \$30 million, collectively. While current period sales levels compared favorably to the prior-year period's lower launch activity, we anticipate continued challenges in this product category, particularly in the United States. Excluding the impact of foreign currency translation, fragrance net sales increased 11%.

### Hair Care

Hair care net sales increased 19% or \$14.7 million to \$93.9 million, primarily due to growth from Aveda and Bumble and bumble products. Aveda net sales increases benefited from the acquisition of an independent distributor, the initial shipments of Be Curly Shampoo & Conditioner and the recent international launches of Damage Remedy hair care products. Bumble and bumble net sales benefited from growth in its existing salon distribution and new points of distribution. Excluding the impact of foreign currency translation, hair care net sales increased 17%.

### Geographic Regions

Net sales in the Americas increased 7% or \$65.2 million to \$944.0 million. The increase was led by growth in the United States of approximately \$48 million from our makeup artist brands, the recent launch of the Unforgivable fragrance by Sean John, our hair care business and from our internet distribution. Partially offsetting this growth was approximately \$22 million related to weaknesses in our core brands in the United States as a result of competitive pressures and retailer consolidation. We expect these factors, including weakness in our business at those Federated doors affected by the national nameplate change to Macy's in the United States, to continue to affect sales, with the impact of retailer consolidations easing during the second half of fiscal 2007. Net sales growth in Canada, Latin America and Mexico contributed an additional \$13 million to the increase. In addition, the prior-year period results reflected an incremental provision of approximately \$13 million for returns that were anticipated at that time as a result of then-announced store closings related to retailer consolidations.

In Europe, the Middle East & Africa, net sales increased 16% or \$102.8 million to \$761.7 million, including approximately \$42 million in exchange rate benefit due to the weakening of the U.S. dollar. Including the exchange rate benefit, net sales growth throughout the region was led by the United Kingdom, our travel retail business, Russia and Germany of approximately \$70 million, collectively. The balancing of inventory levels at certain retailers and changes in our distribution policy in the Benelux countries (Belgium, the Netherlands and Luxembourg), Austria and Spain had a negative impact on net sales. As a result, net sales in those countries remained relatively flat as compared with the prior-year period. On a local currency basis, net sales in Europe, the Middle East & Africa increased 9%.

Net sales in Asia/Pacific increased 16% or \$39.2 million to \$285.4 million. Higher net sales of approximately \$27 million in Korea, China, Japan, Australia and Hong Kong generally reflected a strong economic environment during this period as well as new points of distribution. Excluding the impact of foreign



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currency translation, Asia/Pacific net sales increased 13%.

We strategically stagger our new product launches by geographic market, which may account for differences in regional sales growth.

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### THE ESTEE LAUDER COMPANIES INC.

#### Cost of Sales

Cost of sales as a percentage of total net sales decreased to 25.1% as compared with 25.7% in the prior period. Cost of sales as a percentage of net sales reflected a decrease in the level and timing of promotions of approximately 40 basis points. Also contributing to the favorability was a decrease in obsolescence charges, a change in the mix of our business, improvement in the gross margin of our travel retail and distributor businesses and the effect of exchange rate translation of approximately 10 basis points each. Partially offsetting these improvements by approximately 20 basis points were unfavorable changes in manufacturing variances. Overall cost of sales reflected savings achieved during the current period from our cost savings initiative, which commenced during fiscal 2006.

Since certain promotional activities are a component of sales or cost of sales and the timing and level of promotions vary with our promotional calendar, we have experienced, and expect to continue to experience, fluctuations in the cost of sales percentage. In addition, future cost of sales mix may be impacted by the inclusion of new brands which have margin and product cost structures different from those of our existing brands.

#### Operating Expenses

Operating expenses improved to 58.2% of net sales as compared with 60.2% of net sales in the prior-year period. Although we have increased the total dollars spent on advertising, merchandising and sampling, we have generated an improvement of approximately 200 basis points related to net sales growth from businesses with a lower mix of advertising, merchandising and sampling and disciplined spending at our core brands. An improvement of approximately 40 basis points was attributable to the prior-year period's incremental provision for sales returns that were anticipated at that time as a result of then-announced store closings related to retailer consolidations. Partially offsetting these improvements was an increase of approximately 20 basis points in selling expenses reflecting higher demonstration, field selling and training costs in support of our business, as well as investments in new channel initiatives. Overall operating expenses reflected savings achieved during the current period from our cost savings initiative, which commenced during fiscal 2006.

Changes in advertising, merchandising and sampling spending result from the type, timing and level of activities related to product launches and rollouts, as well as the markets being emphasized.

#### Operating Results

Based on the growth in net sales and the decreases in our cost of sales and operating expense margins as previously discussed, operating income increased 33%, or \$81.7 million, to \$332.4 million as compared with the prior-year period. Operating margins improved to 16.7% of net sales as compared with 14.1% in the prior-year period.

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### Product Categories

Fragrance operating results increased over 100%, or \$19.5 million to \$37.4 million, reflecting our ongoing effort to rationalize continued spending in support of our fragrances at the point of sale. Hair care operating results also increased over 100% or \$8.1 million to \$15.6 million as the increase in sales outpaced increased spending in support of new distribution points and product launches. Operating results increased 39% or \$36.1 million to \$128.6 million in makeup, primarily as a result of higher net sales from our makeup artist brands, which more than offset challenges among certain core brands and the impact of retailer consolidation in the United States. Skin care operating results increased 12% or \$15.5 million to \$148.8 million, also reflecting higher net sales fueled by recent product launches.

### Geographic Regions

Operating income in the Americas increased 38% or \$30.3 million to \$109.9 million. Our efforts to balance advertising, merchandising and sampling spending with our net sales levels related to our core brands, as well as other planned company-wide cost containment efforts, resulted in the improvement in operating income in this region. Net sales growth from our hair care business and our internet distribution also contributed improved results during the current-year period. Operating income in this region was negatively impacted in the prior-year period by \$10 million as a result of an incremental provision for then-anticipated returns as a result of retailer consolidations. Investment spending behind new and developing brands partially offset these improvements.

In Europe, the Middle East & Africa, operating income increased 29% or \$38.8 million to \$170.8 million primarily due to improved results in the United Kingdom, our travel retail business and Russia of approximately \$30 million, collectively. Slightly offsetting these increases were lower results in the Benelux countries, France and Italy of approximately \$1 million, collectively.

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### THE ESTEE LAUDER COMPANIES INC.

In Asia/Pacific, operating income increased 27% or \$11.0 million to \$51.7 million. Improved results in Hong Kong, China, Australia and Taiwan contributed approximately \$9 million, collectively. Slightly offsetting the increase were lower contributions of approximately \$1 million, combined, from Japan and New Zealand.

### Interest Expense, Net

Net interest expense was \$7.7 million as compared with \$6.9 million in the prior period. This change primarily resulted from reduced interest income generated from lower average investment balances, partially offset by lower interest expense reflecting lower average debt balances and the capitalization of interest expenses on internally developed software in connection with the upgrade of our information systems.

### Provision for Income Taxes

The provision for income taxes represents Federal, foreign, state and local income taxes. The effective rate differs from statutory rates due to the effect of state and local taxes, tax rates in foreign jurisdictions and certain nondeductible expenses. Our effective tax rate will change from quarter to quarter based on non-recurring and recurring factors including, but not limited to, the geographical mix of earnings, the timing and amount of foreign dividends, enacted tax legislation, state and local taxes, tax audit settlements and the interaction of various global tax strategies. The effective rate for

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income taxes for the three months ended December 31, 2006 was 34.9% as compared with 37.0% in the prior period. The decrease in the effective income tax rate of 210 basis points primarily reflected the positive impact attributable to the tax effect of our foreign operations (150 basis points) and an increase in tax credits (60 basis points).

### Discontinued Operations

On September 30, 2005, we committed to a plan to sell and on April 10, 2006, we completed the sale of certain assets and operations of our reporting unit that marketed and sold Stila brand products. As such, \$0.1 million and \$68.7 million of operating losses, both net of tax, for the three months ended December 31, 2006 and 2005, respectively, are reflected as discontinued operations in the accompanying consolidated statements of earnings. The prior period charge reflected the anticipated loss on the sale of the business of \$65.5 million, net of tax, and the operating loss of \$3.2 million, net of tax. Current period operating results reflected transitional services related to certain information systems, accounting and other back office services provided to the purchaser in exchange for monthly service fees designed to recover the estimated costs of providing these transition services. Partially offsetting these costs was operating income generated from providing certain transitional distribution and online services as well as the manufacture and sale to the purchaser of a limited range of products. Transitional services are expected to conclude in fiscal 2007.

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## THE ESTEE LAUDER COMPANIES INC.

### Six Months Fiscal 2007 as Compared with Six Months Fiscal 2006

#### Net Sales

Net sales increased 9% or \$303.6 million to \$3,584.6 million reflecting net sales growth in all major product categories within each geographic region. The increases in our skin care, makeup and fragrance product categories were led by Europe, the Middle East & Africa while the increase in hair care net sales was predominantly in the Americas. The Americas region and the skin care, makeup and fragrance categories were adversely impacted by fewer department store doors resulting from the Federated/May Merger. We also experienced weakness in our business at those Federated doors affected by the national nameplate change to Macy's in the United States. Prior-year period net sales in the Americas reflected an incremental provision of approximately \$13 million for returns that were anticipated at that time as a result of then-announced store closings related to these retailer consolidations. Excluding the impact of foreign currency translation, net sales increased 7%.

#### Product Categories

##### Skin Care

Net sales of skin care products increased 9% or \$100.6 million to \$1,268.1 million. Most of this growth occurred outside of the United States. Net sales in the United States were adversely impacted by retailer consolidation. The recent launches of Advanced Night Repair Concentrate Recovery Boosting Treatment and new Perfectionist products from Estee Lauder and Repairwear Lift and All About Eyes Rich from Clinique contributed incremental sales of approximately \$61 million, combined. Net sales increases from Resilience Lift Extreme Ultra Firming products and Advanced Night Repair Eye Recovery Complex from Estee Lauder, along with products in the Clinique 3-Step System, totaled approximately \$51 million. These improvements were partially offset by approximately \$27

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million of lower sales from certain other Resilience Lift products and Perfectionist [CP+] from Estee Lauder. Excluding the impact of foreign currency translation, skin care net sales increased 6%.

### Makeup

Makeup net sales increased 9% or \$116.4 million to \$1,363.6 million reflecting growth from our makeup artist brands of approximately \$104 million. This increase was supported by sales from new points of distribution and new product launches as well as M.A.C Viva Glam lip products, the proceeds of which are donated to AIDS-related charities. Higher sales of approximately \$35 million of Double Wear Foundation by Estee Lauder and Perfectly Real Makeup by Clinique was substantially offset by lower sales of approximately \$25 million of Individualist Finish Makeup and Pure Color Lip Gloss by Estee Lauder and Repairwear Anti-Aging Makeup SPF 15 by Clinique. Excluding the impact of foreign currency translation, makeup net sales increased 8%.

### Fragrance

Net sales of fragrance products increased 8% or \$53.3 million to \$754.4 million primarily driven by the recent launches of DKNY Red Delicious, Sean John Unforgivable, Pure White Linen from Estee Lauder, DKNY Red Delicious Men, Youth Dew Amber Nude from Tom Ford for Estee Lauder and Donna Karan Gold which collectively contributed approximately \$104 million to the category. Lower sales of approximately \$51 million of True Star Men and True Star by Tommy Hilfiger, Estee Lauder Beyond Paradise and DKNY Be Delicious partially offset the growth in this product category. While current period sales levels compared favorably to the prior-year period's lower launch activity, we anticipate continued challenges in this product category, particularly in the United States. Excluding the impact of foreign currency translation, fragrance net sales increased 5%.

### Hair Care

Hair care net sales increased 18% or \$26.7 million to \$176.3 million, primarily due to sales growth from Aveda and Bumble and bumble products. Bumble and bumble sales benefited from sales growth in its existing salon distribution and new points of distribution. Aveda net sales increased as a result of the acquisition of an independent distributor, sales of professional color products, the initial shipments of Be Curly Shampoo & Conditioner and the recent international launch of Damage Remedy hair care products. Excluding the impact of foreign currency translation, hair care net sales increased 17%.

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THE ESTEE LAUDER COMPANIES INC.

### Geographic Regions

Net sales in the Americas increased 5% or \$84.7 million to \$1,844.5 million. The increase was led by growth in the United States of approximately \$91 million from our makeup artist brands, our hair care business, the recent launch of the Unforgivable fragrance by Sean John and from our internet distribution. Partially offsetting this growth was approximately \$44 million related to weaknesses in certain of our core brands as a result of competitive pressures and retailer consolidation. We expect these factors, including weakness in our business at those Federated doors affected by the national nameplate change to Macy's in the United States, to continue to affect sales, with the impact of retailer consolidations easing during the second half of fiscal 2007. Net sales growth in Canada, Latin America and Mexico contributed an additional \$17 million to the increase. The prior-year period results reflected an incremental provision of approximately \$13 million for returns that were anticipated at that time as a result of then-announced store closings from retailer consolidations.

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In Europe, the Middle East & Africa, net sales increased 15% or \$157.2 million to \$1,233.6 million, including approximately \$54 million in exchange rate benefit due to the weakening of the U.S. dollar. Including the exchange rate benefit, this increase reflected higher net sales of approximately \$104 million in the United Kingdom, our travel retail business, Russia and Germany. In the prior-year period, net sales in certain markets were adversely impacted by temporary disruptions due to the transition to a new regional inventory center in Belgium. On a local currency basis, net sales in Europe, the Middle East & Africa increased 10%.

Net sales in Asia/Pacific increased 14% or \$61.7 million to \$506.5 million. Higher net sales of approximately \$41 million in Korea, China, Hong Kong and Australia generally reflected an improved economy across the region. We also experienced modest sales growth in Japan, our largest market in this region. Excluding the impact of foreign currency translation, Asia/Pacific net sales increased 12%.

We strategically stagger our new product launches by geographic market, which may account for differences in regional sales growth.

### Cost of Sales

Cost of sales as a percentage of total net sales decreased to 25.9% as compared with 26.8% in the prior period. Cost of sales as a percentage of net sales reflected a decrease in the level and timing of promotions of approximately 50 basis points, a favorable change in the mix of our business of approximately 40 basis points, a decrease in obsolescence charges of approximately 20 basis points and the effect of exchange rate translation of approximately 10 basis points. Partially offsetting these improvements by approximately 30 basis points were unfavorable changes in manufacturing variances. Overall cost of sales reflected savings achieved during the current period from our cost savings initiative, which commenced during fiscal 2006.

Since certain promotional activities are a component of sales or cost of sales and the timing and level of promotions vary with our promotional calendar, we have experienced, and expect to continue to experience, fluctuations in the cost of sales percentage. In addition, future cost of sales mix may be impacted by the inclusion of new brands which have margin and product cost structures different from those of our existing brands.

### Operating Expenses

Operating expenses improved to 62.0% of net sales as compared with 62.4% of net sales in the prior-year period. Although we have increased the total dollars spent on advertising, merchandising and sampling, we have generated an improvement of approximately 50 basis points related to growth in brands from businesses with a lower mix of advertising, merchandising and sampling and disciplined spending at our core brands. An improvement of approximately 30 basis points was attributable to the prior-year period's incremental provision for sales returns that were anticipated at that time as a result of then-announced store closings related to retailer consolidations. Partially offsetting these improvements was an increase of approximately 30 basis points in selling expenses reflecting higher demonstration, field selling and training costs in support of our business, as well as investments in new channel initiatives. Also offsetting operating expense margin improvements was approximately 20 basis points attributable to the combination of a charge related to the settlement of an employment matter, incremental spending related to our strategic modernization initiative and stock-based compensation. Overall operating expenses reflected savings achieved during the current period from our cost savings initiative, which commenced during fiscal 2006.

Changes in advertising, merchandising and sampling spending result from the

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type, timing and level of activities related to product launches and rollouts, as well as the markets being emphasized.

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### THE ESTEE LAUDER COMPANIES INC.

#### Operating Results

Due to the growth in net sales and the decreases in our cost of sales and operating expense margins as previously discussed, operating income increased 22%, or \$76.5 million, to \$432.3 million as compared with the prior-year period. Operating margins improved to 12.1% of net sales as compared with 10.8% in the prior-year period.

#### Product Categories

Fragrance operating results increased over 100% or \$25.6 million to \$42.5 million, reflecting our ongoing effort to rationalize continued spending in support of our fragrances at the point of sale. Hair care operating results increased 52% or \$6.7 million to \$19.5 million as the increase in sales outpaced increased spending in support of new distribution points and product launches. Operating results increased 17% or \$25.5 million to \$178.5 million in makeup, primarily as a result of higher net sales from our makeup artist brands, which more than offset challenges among certain core brands and the impact of retailer consolidation in the United States. Skin care operating results increased 11% or \$19.6 million to \$191.7 million, also reflecting higher net sales fueled by recent product launches.

#### Geographic Regions

Operating income in the Americas increased 14% or \$23.0 million to \$183.0 million. Our efforts to balance advertising, merchandising and sampling spending with our net sales levels related to our core brands, as well as other planned company-wide cost containment efforts, resulted in the improvement in operating income in this region. Operating income in this region was negatively impacted in the prior-year period by approximately \$10 million as a result of an incremental provision for then-anticipated returns as a result of retailer consolidations. Investment spending behind new and developing brands partially offset these improvements.

In Europe, the Middle East & Africa, operating income increased 22% or \$34.7 million to \$189.1 million primarily due to higher results of approximately \$35 million in the United Kingdom, our travel retail business, Russia and Germany. Lower results in France, the Benelux countries and Switzerland partially offset these improvements by approximately \$5 million, combined. Operating results in the prior-year period were tempered in continental Europe due to disruptions resulting from the transition to a new regional inventory center in Belgium.

In Asia/Pacific, operating income increased 41% or \$17.7 million to \$60.7 million. This increase reflected improved results of approximately \$15 million in China, Australia, Hong Kong and Korea, partially offset by lower results in Japan and New Zealand of approximately \$1 million, combined.

#### Interest Expense, Net

Net interest expense was \$14.4 million as compared with \$12.5 million in the prior period. This change primarily resulted from reduced interest income generated from lower average investment balances, partially offset by lower interest expense reflecting lower average debt balances and the capitalization of interest expenses on internally developed software in connection with the upgrade of our information systems.

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### Provision for Income Taxes

The provision for income taxes represents Federal, foreign, state and local income taxes. The effective rate differs from statutory rates due to the effect of state and local taxes, tax rates in foreign jurisdictions and certain nondeductible expenses. Our effective tax rate will change from quarter to quarter based on non-recurring and recurring factors including, but not limited to, the geographical mix of earnings, the timing and amount of foreign dividends, enacted tax legislation, state and local taxes, tax audit settlements and the interaction of various global tax strategies. The effective rate for income taxes for the six months ended December 31, 2006 was 35.1% as compared with 36.7% in the prior period. The decrease in the effective income tax rate of 160 basis points primarily reflected the positive impact attributable to the tax effect of our foreign operations (130 basis points) and an increase in tax credits (30 basis points).

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### THE ESTEE LAUDER COMPANIES INC.

### Discontinued Operations

On September 30, 2005, we committed to a plan to sell and on April 10, 2006, we completed the sale of certain assets and operations of our reporting unit that marketed and sold Stila brand products. As such, \$0.2 million of operating income and \$72.0 million of operating loss, both net of tax, for the six months ended December 31, 2006 and 2005, respectively, are reflected as discontinued operations in the accompanying consolidated statements of earnings. The prior-year charge reflected the anticipated loss on the sale of the business of \$65.5 million, net of tax, and the operating loss of \$6.5 million, net of tax. The current year operating income resulted from us providing certain transitional distribution and online services as well as the manufacture and sale to the purchaser of a limited range of products. Partially offsetting this income were costs incurred from transitional services related to certain information systems, accounting and other back office services provided to the purchaser in exchange for monthly service fees designed to recover the estimated costs of providing these transition services. Transitional services are expected to conclude in fiscal 2007.

### Financial Condition

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### Liquidity and Capital Resources

Our principal sources of funds historically have been cash flows from operations and borrowings under commercial paper, borrowings from the issuance of long-term debt and committed and uncommitted credit lines provided by banks and other lenders in the United States and abroad. At December 31, 2006, we had cash and cash equivalents of \$251.8 million compared with \$368.6 million at June 30, 2006.

At December 31, 2006, our outstanding borrowings of \$629.2 million included: (i) \$237.4 million of 6% Senior Notes due January 2012 consisting of \$250.0 million principal, unamortized debt discount of \$0.6 million and a \$12.0 million adjustment to reflect the fair value of an outstanding interest rate swap; (ii) \$197.4 million of 5.75% Senior Notes due October 2033 consisting of \$200.0 million principal and unamortized debt discount of \$2.6 million; (iii) \$147.2 million of outstanding short-term commercial paper payable through January 2007 at an average interest rate of 5.27%; (iv) a 0.8 billion yen short-term

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borrowing under a revolving credit facility (approximately \$6.8 million at the exchange rate at December 31, 2006); (v) a 15.2 million Turkish lira borrowing under an overdraft borrowing facility (approximately \$10.6 million at the exchange rate at December 31, 2006); (vi) \$7.4 million of capital lease obligations and (vii) \$22.4 million of other short-term and long-term borrowings.

We have a \$750.0 million commercial paper program under which we may issue commercial paper in the United States. Our commercial paper is currently rated A-1 by Standard & Poor's and P-1 by Moody's. Our long-term credit ratings are A+ with a stable outlook by Standard & Poor's and A1 with a stable outlook by Moody's. At December 31, 2006, we had \$147.2 million of commercial paper outstanding, which we may refinance on a periodic basis as it matures at then prevailing market interest rates. We also have an effective shelf registration statement covering the potential issuance of up to an additional \$300.0 million in debt securities and \$169.2 million in additional uncommitted credit facilities, of which \$31.0 million was used as of December 31, 2006.

We have an unused \$600.0 million senior revolving credit facility that expires on May 27, 2010. The facility may be used for general corporate purposes, including financing working capital, and also as credit support for our commercial paper program. Up to the equivalent of \$250 million of the facility is available for multi-currency loans. The interest rate on borrowings under the credit facility is based on LIBOR or on the higher of prime, which is the rate of interest publicly announced by the administrative agent, or 1/2% plus the Federal funds rate. The credit facility has an annual fee of \$0.4 million, payable quarterly, based on our current credit ratings. As of December 31, 2006, we were in compliance with all related financial and other restrictive covenants, including limitations on indebtedness and liens.

We have a fixed rate promissory note agreement with a financial institution pursuant to which we may borrow up to \$150.0 million in the form of loan participation notes through one of our subsidiaries in Europe. The interest rate on borrowings under this agreement is at an all-in fixed rate determined by the lender and agreed to by us at the date of each borrowing. At December 31, 2006, no borrowings were outstanding under this agreement. Debt issuance costs incurred related to this agreement were de minimis.

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### THE ESTEE LAUDER COMPANIES INC.

We have an overdraft borrowing agreement with a financial institution pursuant to which our subsidiary in Turkey may be credited to satisfy outstanding negative daily balances arising from its business operations. The total balance outstanding at any time shall not exceed 20.0 million Turkish lira. The interest rate applicable to each such credit shall be 40 basis points per annum above the spot rate charged by the lender or the lender's floating call rate agreed to by us at each borrowing. There were no debt issuance costs incurred related to this agreement. The outstanding balance at December 31, 2006 (\$10.6 million at the exchange rate at December 31, 2006) is classified as short-term debt on our consolidated balance sheet.

We have a 3.0 billion yen revolving credit facility that expires on March 24, 2009. The interest rate on borrowings under the credit facility is based on TIBOR (Tokyo Interbank Offered Rate) and a 10 basis point facility fee is incurred on the undrawn balance. The outstanding balance at December 31, 2006 (\$6.8 million at the exchange rate at December 31, 2006) is classified as short-term debt on our consolidated balance sheet.



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Our business is seasonal in nature and, accordingly, our working capital needs vary. From time to time, we may enter into investing and financing transactions that require additional funding. To the extent that these needs exceed cash from operations, we could, subject to market conditions, issue commercial paper, issue long-term debt securities or borrow under the revolving credit facility.

Total debt as a percent of total capitalization was 28% at December 31, 2006 and 24% at June 30, 2006.

The effects of inflation have not been significant to our overall operating results in recent years. Generally, we have been able to introduce new products at higher selling prices or increase selling prices sufficiently to offset cost increases, which have been moderate.

We believe that cash on hand, cash generated from operations, available credit lines and access to credit markets will be adequate to support currently planned business operations and capital expenditures on both a near-term and long-term basis.

### Cash Flows

Net cash provided by operating activities from continuing operations was \$312.7 million during the six months ended December 31, 2006 compared with \$388.7 million in the prior period. The net decrease in operating cash flows reflected higher accounts receivable balances, primarily related to significant sales growth from our international operations, which generally carry longer payment terms, coupled with the extension of credit to some international customers resulting from our efforts to strategically expand our business in certain markets. Partially offsetting this deterioration was an improvement in net earnings from continuing operations.

Net cash used for investing activities was \$197.6 million during the six months ended December 31, 2006 compared with \$150.7 million in the prior period. The change in cash flows used for investing activities during the fiscal 2007 quarter primarily reflected increases in capital expenditures related to our continuing company-wide initiative to upgrade our information systems. Current period investing activities also reflected the cash payment related to the acquisition of the remaining minority equity interest in the Bumble & bumble business, and to a lesser extent, distributor acquisitions. Prior period investing activities reflected the earn-out payment related to the fiscal 2000 acquisition of Jo Malone Limited.

Net cash used for financing activities was \$230.2 million during the six months ended December 31, 2006 compared with \$414.7 million in the prior period. Increases in short-term debt primarily reflected an increase in commercial paper borrowings during the current period and, to a lesser extent, drawings under the 20.0 million Turkish lira overdraft borrowing facility, partially offset by payments of outstanding loan participation notes and payments of short-term borrowings under the 3.0 billion yen revolving credit facility. The improvement in cash used for financing activities also reflected the October 2005 redemption of the 2015 Preferred Stock and less cash used for share repurchases. The improvement was partially offset by the increase in dividends paid to common stockholders.

### Dividends

During the current period, we paid dividends on the Class A and Class B Common Stock of \$.50 per share (or an aggregate of \$103.6 million) as compared with \$.40 per share (or an aggregate of \$85.4 million) in the prior-year period. For the six months ended December 31, 2005, dividends on the 2015 Preferred Stock were \$0.4 million and were characterized as interest expense in the accompanying consolidated statements of earnings. The 2015 Preferred Stock was redeemed in October 2005.

## THE ESTEE LAUDER COMPANIES INC.

## Share Repurchase Program

We are authorized by the Board of Directors to repurchase up to 48.0 million shares of Class A Common Stock in the open market or in privately negotiated transactions, depending on market conditions and other factors. As of December 31, 2006, the cumulative total of acquired shares pursuant to the authorization was 45.1 million, reducing the remaining authorized share repurchase balance to 2.9 million. During the first six months of fiscal 2007, we purchased approximately 6.5 million shares for \$254.3 million as outlined in the following table:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Program(1)
July 2006	--	--	--
August 2006	1,655,000	35.83	1,655,000
September 2006	1,344,800	38.11	1,344,800
October 2006	266,974 (2)	39.93	251,000
November 2006	1,752,000	40.73	1,752,000
December 2006	1,498,000	41.22	1,498,000
Year-to-date	6,516,774	39.02	6,500,800

- (1) The publicly announced repurchase program was last increased by 20.0 million shares on May 18, 2005. The initial program covering the repurchase of 8.0 million shares was announced in September 1998 and increased by 10.0 million shares on both May 11, 2004 and October 30, 2002.
- (2) Includes 15,974 shares that were repurchased by the Company in connection with shares withheld to satisfy tax obligations upon the vesting of restricted stock units.

## Commitments and Contingencies

During the first quarter of fiscal 2007, we purchased the remaining minority equity interest in Bumble and Bumble Products, LLC and Bumble and Bumble, LLC.

## Contractual Obligations

Since June 30, 2006, we made additional commitments pursuant to employment agreements of approximately \$29 million, which are expected to be paid through fiscal 2010.

## Pension Plan Funding

During the first quarter of fiscal 2007, the Pension Protection Act of 2006 was adopted into law in the United States. Certain provisions of this Act changed the calculation related to the maximum contribution amount deductible for income tax purposes. As a result of these provisions, we made discretionary contributions totaling \$10.0 million to our trust-based, noncontributory qualified defined benefit pension plan during the current quarter and expect to contribute an additional \$10.0 million during the remainder of fiscal 2007. We previously disclosed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006, that we did not expect to make any contributions to this plan during fiscal 2007.

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### Derivative Financial Instruments and Hedging Activities

There have been no significant changes to our derivative financial instruments and hedging activities as discussed in our Annual Report on Form 10-K for the year ended June 30, 2006.

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### THE ESTEE LAUDER COMPANIES INC.

#### Foreign Exchange Risk Management

We enter into forward exchange contracts to hedge anticipated transactions, as well as receivables and payables denominated in foreign currencies, for periods consistent with our identified exposures. The purpose of the hedging activities is to minimize the effect of foreign exchange rate movements on our costs and on the cash flows that we receive from foreign subsidiaries. Almost all foreign currency contracts are denominated in currencies of major industrial countries and are with large financial institutions rated as strong investment grade by a major rating agency. We also enter into foreign currency options to hedge anticipated transactions where there is a high probability that anticipated exposures will materialize. The forward exchange contracts and foreign currency options entered into to hedge anticipated transactions have been designated as cash-flow hedges. Hedge effectiveness of forward exchange contracts is based on a hypothetical derivative methodology and excludes the portion of fair value attributable to the spot-forward difference which is recorded in current-period earnings. Hedge effectiveness of foreign currency option contracts is based on a dollar offset methodology. The ineffective portion of both forward exchange and foreign currency option contracts is recorded in current-period earnings. For hedge contracts that are no longer deemed highly effective, hedge accounting is discontinued and gains and losses accumulated in other comprehensive income are reclassified to earnings when the underlying forecasted transaction occurs. If it is probable that the forecasted transaction will no longer occur, then any gains or losses accumulated in other comprehensive income are reclassified to current-period earnings. As of December 31, 2006, these cash-flow hedges were highly effective, in all material respects.

As a matter of policy, we only enter into contracts with counterparties that have at least an "A" (or equivalent) credit rating. The counterparties to these contracts are major financial institutions. We do not have significant exposure to any one counterparty. Our exposure to credit loss in the event of nonperformance by any of the counterparties is limited to only the recognized, but not realized, gains attributable to the contracts. Management believes risk of loss under these hedging contracts is remote and in any event would not be material to the consolidated financial results. The contracts have varying maturities through the end of June 2007. Costs associated with entering into such contracts have not been material to our consolidated financial results. We do not utilize derivative financial instruments for trading or speculative purposes. At December 31, 2006, we had foreign currency contracts in the form of forward exchange contracts and option contracts in the amount of \$682.6 million and \$36.0 million, respectively. The foreign currencies included in forward exchange contracts (notional value stated in U.S. dollars) are principally the Euro (\$202.4 million), British pound (\$90.2 million), Swiss franc (\$84.6 million), Japanese yen (\$62.4 million), Australian dollar (\$50.0 million) and Canadian dollar (\$46.9 million). The foreign currencies included in the option contracts (notional value stated in U.S. dollars) are principally the Canadian dollar (\$13.5 million), Euro (\$11.8 million), Japanese yen (\$7.2 million) and British pound (\$3.5 million).

#### Interest Rate Risk Management

We enter into interest rate derivative contracts to manage the exposure to fluctuations of interest rates on our funded indebtedness and anticipated

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issuance of debt, as well as cash investments, for periods consistent with the identified exposures. All interest rate derivative contracts are with large financial institutions rated as strong investment grade by a major rating agency.

We have an interest rate swap agreement with a notional amount of \$250.0 million to effectively convert fixed interest on the existing \$250.0 million 6% Senior Notes to variable interest rates based on LIBOR. We designated the swap as a fair-value hedge. As of December 31, 2006, the fair-value hedge was highly effective, in all material respects.

### Market Risk

Using the value-at-risk model, as discussed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006, our average value-at-risk, calculated for the most recent twelve months, is \$11.1 million related to our foreign exchange contracts. As of December 31, 2006, our average value-at-risk related to our interest rate contracts for the twelve month period for which these contracts were outstanding was \$6.6 million. There have been no significant changes in market risk since June 30, 2006 that would have a material effect on our calculated value-at-risk exposure, as disclosed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006.

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### Off-Balance Sheet Arrangements

We do not maintain any off-balance sheet arrangements, transactions, obligations or other relationships with unconsolidated entities that would be expected to have a material current or future effect upon our financial condition or results of operations.

### Critical Accounting Policies

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As disclosed in our Annual Report on Form 10-K for the fiscal year ended June 30, 2006, the discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in conformity with U.S. generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses reported in those financial statements. These judgments can be subjective and complex, and consequently actual results could differ from those estimates and assumptions. Our most critical accounting policies relate to revenue recognition, concentration of credit risk, inventory, pension and other postretirement benefit costs, goodwill and other intangible assets, income taxes, derivatives and stock-based compensation. Since June 30, 2006, there have been no significant changes to the assumptions and estimates related to those critical accounting policies.

### Recently Issued Accounting Standards

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In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 157, "Fair Value Measurements" ("SFAS No. 157") to clarify the definition of fair value, establish a framework for measuring fair value and expand the disclosures on fair value measurements. SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price).

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SFAS No. 157 also stipulates that, as a market-based measurement, fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability, and establishes a fair value hierarchy that distinguishes between (a) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (b) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). SFAS No. 157 becomes effective for us in our fiscal year ending June 30, 2009. We are currently evaluating the impact of the provisions of SFAS No. 157 on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 106, and 132(R)" ("SFAS No. 158"). SFAS No. 158 requires employers to recognize a net liability or asset and an offsetting adjustment to accumulated other comprehensive income to report the funded status of defined benefit pension and other postretirement benefit plans. Previous standards required employers to disclose the complete funded status of its plans only in the notes to the financial statements. Additionally, SFAS No. 158 requires employers to measure plan assets and obligations at their year-end balance sheet date. We will adopt SFAS No. 158 prospectively, as of the end of our current fiscal year, as required.

In September 2006, the SEC issued Staff Accounting Bulletin ("SAB") No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB No. 108"), which sets forth the SEC Staff's views on the proper methods for quantifying errors when there were uncorrected errors in a prior year. Under SAB No. 108, companies should evaluate a misstatement that existed in prior years based on its impact on the current year income statement, as well as the cumulative effect of correcting such misstatements in the current year's ending balance sheet. SAB No. 108 will become effective for us in our fiscal year ending June 30, 2007. We are currently evaluating the impact of the provisions of SAB No. 108 on our consolidated financial statements.

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### Forward-Looking Information

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We and our representatives from time to time make written or oral forward-looking statements, including statements contained in this and other filings with the Securities and Exchange Commission, in our press releases and in our reports to stockholders. The words and phrases "will likely result," "expect," "believe," "planned," "may," "should," "could," "anticipate," "estimate," "project" or similar expressions are intended to identify "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include, without limitation, our expectations regarding sales, earnings or other future financial performance and liquidity, product introductions, entry into new geographic regions, information systems initiatives, new methods of sale and future operations or operating results. Although we believe that our expectations are based on reasonable assumptions within the bounds of our knowledge of our business and operations, actual results may differ materially from our expectations. Factors that could cause actual results to differ from expectations include, without limitation:

- (1) increased competitive activity from companies in the skin care,

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makeup, fragrance and hair care businesses, some of which have greater resources than we do;

(2) our ability to develop, produce and market new products on which future operating results may depend and to successfully address challenges in our core brands, including gift with purchase, and in our fragrance business;

(3) consolidations, restructurings, bankruptcies and reorganizations in the retail industry causing a decrease in the number of stores that sell our products, an increase in the ownership concentration within the retail industry, ownership of retailers by our competitors or ownership of competitors by our customers that are retailers;

(4) destocking by retailers;

(5) the success, or changes in timing or scope, of new product launches and the success, or changes in the timing or the scope, of advertising, sampling and merchandising programs;

(6) shifts in the preferences of consumers as to where and how they shop for the types of products and services we sell;

(7) social, political and economic risks to our foreign or domestic manufacturing, distribution and retail operations, including changes in foreign investment and trade policies and regulations of the host countries and of the United States;

(8) changes in the laws, regulations and policies (including the interpretations and enforcement thereof) that affect, or will affect, our business, including those relating to our products, changes in accounting standards, tax laws and regulations, trade rules and customs regulations, and the outcome and expense of legal or regulatory proceedings, and any action we may take as a result;

(9) foreign currency fluctuations affecting our results of operations and the value of our foreign assets, the relative prices at which we and our foreign competitors sell products in the same markets and our operating and manufacturing costs outside of the United States;

(10) changes in global or local conditions, including those due to natural or man-made disasters, real or perceived epidemics, or energy costs, that could affect consumer purchasing, the willingness or ability of consumers to travel and/or purchase our products while traveling, the financial strength of our customers or suppliers, our operations, the cost and availability of capital which we may need for new equipment, facilities or acquisitions, the cost and availability of raw materials and the assumptions underlying our critical accounting estimates;

(11) shipment delays, depletion of inventory and increased production costs resulting from disruptions of operations at any of the facilities that manufacture nearly all of our supply of a particular type of product (i.e., focus factories) or at our distribution or inventory centers;

(12) real estate rates and availability, which may affect our ability to increase the number of retail locations at which we sell our products and the costs associated with our other facilities;

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- (13) changes in product mix to products which are less profitable;
- (14) our ability to acquire, develop or implement new information and distribution technologies, on a timely basis and within our cost estimates;
- (15) our ability to capitalize on opportunities for improved efficiency, such as publicly-announced cost-savings initiatives and the success of Stila under new ownership, and to integrate acquired businesses and realize value therefrom;
- (16) consequences attributable to the events that are currently taking place in the Middle East, including terrorist attacks, retaliation and the threat of further attacks or retaliation;
- (17) the timing and impact of acquisitions and divestitures, which depend on willing sellers and buyers, respectively; and
- (18) additional factors as described in our filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K for the fiscal year ended June 30, 2006.

We assume no responsibility to update forward-looking statements made herein or otherwise.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk.

The information required by this item is set forth in Item 2 of this Quarterly Report on Form 10-Q under the caption "Liquidity and Capital Resources - Market Risk" and is incorporated herein by reference.

### Item 4. Controls and Procedures.

Our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) are designed to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission. The Chief Executive Officer and the Chief Financial Officer, with assistance from other members of management, have reviewed the effectiveness of our disclosure controls and procedures as of December 31, 2006 and, based on their evaluation, have concluded that the disclosure controls and procedures were effective as of such date.

There have been no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) that occurred during the second quarter of fiscal 2007 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

THE ESTEE LAUDER COMPANIES INC.

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## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings.

We are involved, from time to time, in litigation and other legal proceedings incidental to our business. Management believes that the outcome of current litigation and legal proceedings will not have a material adverse effect upon our results of operations or financial condition. However, management's assessment of our current litigation and other legal proceedings could change in light of the discovery of facts with respect to legal actions or other proceedings pending against us not presently known to us or determinations by judges, juries or other finders of fact which are not in accord with management's evaluation of the possible liability or outcome of such litigation or proceedings.

On March 30, 2005, the United States District Court for the Northern District of California entered into a Final Judgment approving the settlement agreement we entered into in July 2003 with the plaintiffs, the other Manufacturer Defendants (as defined below) and the Department Store Defendants (as defined below) in a consolidated class action lawsuit that had been pending in the Superior Court of the State of California in Marin County since 1998. On April 29, 2005, notices of appeal were filed by representatives of two members of the purported class of consumers. One of those appeals has since been withdrawn. If the appeal is resolved satisfactorily, the Final Judgment will result in the plaintiffs' claims being dismissed, with prejudice, in their entirety in both the Federal and California actions. There has been no finding or admission of any wrongdoing by us in this lawsuit. We entered into the settlement agreement solely to avoid protracted and costly litigation. In connection with the settlement agreement, the defendants, including the Company, will provide consumers with certain free products and pay the plaintiffs' attorneys' fees. To meet its obligations under the settlement, we took a special pre-tax charge of \$22.0 million, or \$13.5 million after-tax, equal to \$.06 per diluted common share in the fourth quarter of fiscal 2003. At December 31, 2006, the remaining accrual balance was \$16.3 million. The charge did not have a material adverse effect on our consolidated financial condition. In the Federal action, the plaintiffs, purporting to represent a class of all U.S. residents who purchased prestige cosmetics products at retail for personal use from eight department stores groups that sold such products in the United States (the "Department Store Defendants"), alleged that the Department Store Defendants, the Company and eight other manufacturers of cosmetics (the "Manufacturer Defendants") conspired to fix and maintain retail prices and to limit the supply of prestige cosmetics products sold by the Department Store Defendants in violation of state and Federal laws. The plaintiffs sought, among other things, treble damages, equitable relief, attorneys' fees, interest and costs.

In 1999, the Office of the Attorney General of the State of New York (the "State") notified the Company and ten other entities that they had been identified as potentially responsible parties ("PRPs") with respect to the Blydenburgh landfill in Islip, New York. Each PRP may be jointly and severally liable for the costs of investigation and cleanup, which the State estimated in 2006 to be approximately \$19.7 million for all PRPs. In 2001, the State sued other PRPs (including Hickey's Carting, Inc., Dennis C. Hickey and Maria Hickey, collectively the "Hickey Parties"), in the U.S. District Court for the Eastern District of New York to recover such costs in connection with the site, and in September 2002, the Hickey Parties brought contribution actions against the Company and other Blydenburgh PRPs. These contribution actions seek to recover, among other things, any damages for which the Hickey Parties are found liable in the State's lawsuit against them, and related costs and expenses, including attorneys' fees. In June 2004, the State added the Company and other PRPs as defendants in its pending case against the Hickey Parties. In April 2006, the Company and other defendants added numerous other parties to the case as third-party defendants. The Company and certain other PRPs have engaged in



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settlement discussions which to date have been unsuccessful. Settlement negotiations with the new third-party defendants, the State, the Company and other defendants began in July 2006. We have accrued an amount which we believe would be necessary to resolve our share of this matter. If settlement discussions are not successful, we intend to vigorously defend the pending claims. While no assurance can be given as to the ultimate outcome, management believes that the resolution of the Blydenburgh matters will not have a material adverse effect on our consolidated financial condition.

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THE ESTEE LAUDER COMPANIES INC.

### PART II. OTHER INFORMATION

On March 30, 2006, a purported securities class action complaint captioned Thomas S. Shin, et al. v. The Estee Lauder Companies Inc., et al., was filed against the Company and certain of our officers and directors (collectively the "Defendants") in the United States District Court for the Southern District of New York. The complaint alleged that the Defendants made statements during the period April 28, 2005 to October 25, 2005 in press releases, the Company's public filings and during conference calls with analysts that were materially false and misleading and that artificially inflated the price of the Company's stock. The complaint alleged claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The complaint also asserted that during the class period, certain executive officers and the trust for the benefit of a director sold shares of our Class A Common Stock at artificially inflated prices. Three additional purported securities class action complaints were subsequently filed in the United States District Court for the Southern District of New York containing similar allegations. On July 10, 2006, the Court consolidated these actions under the caption In re: Estee Lauder Companies Securities Litigation, appointed lead plaintiff, and approved the selection of lead counsel. A consolidated amended complaint addressing the same issues as the original complaint was filed on September 8, 2006. The Defendants filed a motion to dismiss the amended complaint on November 7, 2006 and the plaintiff responded to the motion on January 5, 2007. Defendants plan to reply to plaintiff's response on or before February 5, 2007. The Defendants believe that the claims asserted in the consolidated amended complaint are without merit and they intend to defend the consolidated action vigorously.

On April 10, 2006, a shareholder derivative action complaint captioned Miriam Loveman v. Leonard A. Lauder, et al., was filed against certain of our officers and all of our directors as of that date (collectively the "Derivative Action Defendants") in the United States District Court for the Southern District of New York. The complaint alleges that the Derivative Action Defendants breached their fiduciary duties to the Company based on the same alleged course of conduct identified in the complaint described above. On May 4, 2006, the derivative action was reassigned to the judge assigned to the consolidated securities action. On September 1, 2006, the Derivative Action Defendants filed a motion to dismiss. The plaintiff responded to the Derivative Action Defendants' motion to dismiss on December 11, 2006. The Derivative Action Defendants replied to plaintiff's response on January 29, 2007. The defendants believe that this complaint is without merit and intend to defend the action vigorously.

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## PART II. OTHER INFORMATION

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

#### Sales of Unregistered Securities

Shares of Class B Common Stock may be converted immediately into Class A Common Stock on a one-for-one basis by the holder and are automatically converted into Class A Common Stock on a one-for-one basis upon transfer to a person or entity that is not a "Permitted Transferee" or soon after a record date for a meeting of stockholders where the outstanding Class B Common Stock constitutes less than 10% of the outstanding shares of Common Stock of the Company. There is no cash or other consideration paid by the holder converting the shares and, accordingly, there is no cash or other consideration received by the Company. The shares of Class A Common Stock issued by the Company in such conversions are exempt from registration under the Securities Act of 1933, as amended, pursuant to Section 3(a)(9) thereof.

During the three months ended December 31, 2006, the holders set forth in the table converted shares of Class B Common Stock into Class A Common Stock on the dates set forth in the table below:

Stockholder That Converted Class B Common Stock to Class A Common Stock	Date of Conversion	Number of Shares Converted/ Received
----- Lauder & Sons LP	October 27, 2006	1,896,154
Trust f/b/o Aerin and Jane Lauder u/a/d 12/15/76 by Estee and Joseph Lauder, grantors	October 31, 2006	500,000

#### Share Repurchase Program

Information required by this item is set forth in Part I Item 2 of this Quarterly Report on Form 10-Q under the caption "Liquidity and Capital Resources - Share Repurchase Program" and is incorporated herein by reference.

### Item 4. Submission of Matters to a Vote of Security Holders

- (a) The Annual Meeting of Stockholders of the Company was held on October 31, 2006.
- (b) The following directors were re-elected at the Annual Meeting of Stockholders: Rose Marie Bravo, CBE, Paul J. Fribourg, Mellody Hobson, Irvine O. Hockaday, Jr., and Barry S. Sternlicht as Class I Directors for a term expiring at the 2009 Annual Meeting. The Class II Directors, whose terms expire at the 2007 Annual Meeting, are Aerin Lauder, William P. Lauder, Richard D. Parsons and Lynn Forester de Rothschild. The Class III Directors, whose terms expire at the 2008 Annual Meeting are Charlene Barshefsky, Leonard A. Lauder and Ronald S. Lauder.
- (c) (i) Each person re-elected as a director at the Annual Meeting received

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the number of votes (shares Class B Common Stock are entitled to ten votes per share) indicated beside his or her name:

Name	Votes For	Votes Withheld
Rose Marie Bravo, CBE	959,104,967	2,304,245
Paul J. Fribourg	958,773,137	2,636,075
Mellody Hobson	958,908,379	2,500,833
Irvine O. Hockaday, Jr.	958,525,900	2,888,312
Barry S. Sternlicht	909,114,910	52,294,302

(ii) 960,495,914 votes (shares of Class B Common Stock are entitled to ten votes per share) were cast for and 209,344 votes were cast against the ratification of the appointment of KPMG LLP as independent auditors of the Company for the 2007 fiscal year. There were 703,954 abstentions and no broker nonvotes.

(d) Not applicable

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THE ESTEE LAUDER COMPANIES INC.

### PART II. OTHER INFORMATION

Item 6. Exhibits.

Exhibit Number	Description
31.1	Certification pursuant to Rule 13a-14(a) (CEO).
31.2	Certification pursuant to Rule 13a-14(a) (CFO).
32.1	Certification pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (CEO). (furnished)
32.2	Certification pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (CFO). (furnished)

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### SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by

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the undersigned thereunto duly authorized.

THE ESTEE LAUDER COMPANIES INC.

Date: January 31, 2007

By: /s/ RICHARD W. KUNES

-----  
Richard W. Kunes  
Executive Vice President  
and Chief Financial Officer  
(Principal Financial and  
Accounting Officer)

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INDEX TO EXHIBITS

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