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Research Update:

Coty Inc. Downgraded On Operational Difficulties Integrating Acquired Assets And Supply Chain Issues; Outlook Negative

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Overview

- New York-based cosmetics manufacturer Coty Inc. incurred multiple supply chain disruptions and the underperformance of its consumer beauty business worsened. We forecast pro forma adjusted leverage will be in around mid-5.0x at the end of fiscal 2019.
- We believe leverage could remain high while Coty consolidates its supply chain and repositions its consumer beauty business.
- We lowered our issuer credit rating and issue rating on the unsecured debt to 'BB-' from 'BB' and the issue rating on the secured debt to 'BB' from 'BB+'. The outlook is negative.
- The negative outlook reflects the potential we will lower the rating in the next 6 months if the company's operating performance continues to be hampered by the consolidation of its supply chain or if it is unable to stabilize its consumer beauty business and leverage remains above 6x.

Rating Action

On Nov. 12, 2018, S&P Global Ratings lowered its issuer credit rating on Coty Inc. to 'BB-' from 'BB'. The outlook is negative.

At the same time, we lowered our rating on the company's senior secured debt to 'BB' from 'BB+'. The recovery rating remains a '2', indicating our expectation of substantial recovery (70%-90% rounded estimate 75%) in the event of a payment default. Coty B.V., a subsidiary of Coty, is a co-borrower of the revolver. In our rating analysis, we view Coty Inc. and its operating subsidiaries as a group.

We also lowered the rating on the senior unsecured debt to 'BB-' from 'BB'. The recovery rating remains a '4', indicating our expectation for average recovery (30%-50%; rounded estimate 35%) in the event of a payment default.

Rationale

The downgrade reflects the company's operating difficulties integrating the acquired Procter & Gamble beauty assets and the deterioration of its credit metrics. Coty's operating performance was worse than expected in first-quarter

2019 following weak operating results in fourth-quarter 2018 (which ended June 30, 2018). The company incurred both internal and external supply issues in the recent quarter, which affected all of its businesses. The consolidation of its European planning hub and warehouses in Europe and the U.S. materially hurt profits. The consolidation of its supply chain also disrupted its fourth-quarter performance. Moreover, these issues will continue to weigh on profits through the third quarter of fiscal 2019.

Coty also incurred component shortages from some of its suppliers and the hurricane in North Carolina disrupted receipts and shipments from its manufacturing plant there in the first quarter. In addition, the company's consumer beauty segment, which accounts for 41% of its sales, remains under pressure due to ongoing weakness in the mass segment of the industry. The confluence of the above significantly hurt credit metrics. We estimate leverage increased to 6.6x in the trailing 12 months ending Sept. 30, 2018, up from 5.4x in the year before and 5.9x in fiscal 2018. We expect the company to focus on stabilizing the consumer beauty business this year and to begin repaying debt in fiscal 2020. We believe the company will not be able to reduce leverage below 4.0x until fiscal 2021; previously, we had expected the company to delever below 4.0x in fiscal 2020.

Coty has struggled to revive its consumer beauty business. This is partly because of weakness in the mass channel, competition from consumer-savvy independent brands, consumer preference for prestige products, and intense competition from its key competitor L'Oréal. The business has also underperformed because the execution of its integration plan has not gone smoothly. The company needs to accelerate product innovation, strengthen its online business, and shorten its product cycles. We believe it will take time for Coty to reposition this business, which also suffered while owned by Procter & Gamble. Furthermore, it is likely the company will need to be more promotional to move product and maintain shelf space for at least the next year. We expect Coty will be able to grow its luxury and professional beauty businesses as both businesses operate in healthy channels.

Coty's EBITDA margins are well below its peers. We estimate its adjusted EBITDA margin was just above 15% in the trailing 12 months ending Sept. 30, 2018, which is well below the 22.6% and 23% margins that L'Oreal and Estee Lauder maintain, respectively. We do not expect Coty's EBITDA margin to exceed 20% until fiscal 2021 given its need to reposition the consumer beauty business and invest to grow sales in the e-commerce channel, as well as expand in developing markets and skin care.

Coty has made management and board changes given the execution issues it has had. The company announced today that is has replaced its CEO and Chairman of the Board and is adding two new independent Board members. Last quarter its CFO resigned. It is too soon to determine if these changes will result in better operating performance or changes in financial policy.

Notwithstanding the struggles with its consumer beauty segment, Coty has more than $9 billion in annual sales and is a formidable player in the cosmetics industry. The company holds the no. 1 position in the global fragrance market, with almost twice the market share of its next-largest competitor, L'Oreal. In the color cosmetics market, the company holds the no. 3 positon, though we expect it will gain additional market share from its competitors such as Avon, Shiseido, and Revlon. However, it will be hard for Coty to gain market share from L'Oreal and Estee Lauder, which have solid positions in most of their categories, a history of strong brand management, and greater financial resources to invest in their businesses. Coty holds the no. 2 position in the professional hair salon category, in which its market share is about half that of L'Oreal but twice the size of Henkel's. We believe it could be difficult for Coty to take market share away from L'Oreal and Henkel given their financial and marketing strength; however, Coty's salon business is significantly larger than Kao's, Estee Lauder's, Shiseido's, and Revlon's, and we believe it has the potential to gain share from these players.

The assumptions in our base-case scenario for company in fiscal years 2019 and 2020 include:

- Global GDP growth of 3.7% in 2018 and 3.6 in 2019.
- Organic sale growth declines about 4% in fiscal 2019, well below GDP growth, because it will not be able to recapture all of the lost sales from the supply disruptions and needs to reposition its consumer beauty segment. In fiscal 2020, we forecast sales will grow more in-line with economic growth as its supply chain issues should be resolved and it should benefit from its luxury and professional beauty segments.
- Adjusted EBITDA margin expands to approximately 18% in fiscal 2019 from 16.3% in fiscal 2018 because of synergies and its cost savings initiatives. It expands to almost 20% in fiscal 2020 because of the absence of supply chain disruptions, continued good performance in its luxury and professional beauty segments, and some recovery in its consumer beauty business.
- Free operating cash flow (FOCF) of approximately $390 million in fiscal 2019 and more than $1.0 billion in fiscal 2020 after capital expenditures of roughly $445 million in fiscal 2019 and $345 million in fiscal 2020. FOCF in 2019 strengthens because of fewer restructuring costs, and operating performance improves.
- Dividends of about approximately $375 million annually each year.
- No material acquisitions and no share repurchases over the next two years.

Liquidity

We believe the company has adequate liquidity. We expect the company's liquidity sources to exceed its uses by more than 1.9x over the next two years and anticipate its sources will cover its uses even if its forecasted EBITDA declines by 30%. Our view of the company's liquidity also incorporates our belief that the company has sound relationships with its banks and generally satisfactory standing in credit markets. Based on our quantitative analysis, Coty qualifies for a stronger liquidity assessment; however, it does not meet our qualitative requirements. Coty may not be able to comply with its leverage covenant if forecasted EBITDA declines by 15% and we do not believe the company has the ability to absorb high-impact, low probability events (such as market turbulence, sovereign risk, or the activation of material adverse change clauses) without refinancing. In addition, it is too soon to assess whether the company is committed to maintaining its current high level of liquidity.

Principal liquidity sources:

- Cash balances of approximately $423.3 million at Sept. 31, 2018;
- Revolver availability of $1.5 billion,taking into account its covenants, under its $3.25 billion revolving credit agreement due 2023;
- Funds from operations of about $808 million in fiscal 2019 and more than $1.25 billion in fiscal 2020.

Principal liquidity uses:

- Capital spending of approximately $420 million in fiscal 2019 and $360 million fiscal 2020;
- Seasonal working capital requirements of $500 million per year;
- Dividends of about $375 million per year;
- Mandatory debt amortization of approximately $200 million per year; and
- No share repurchases for the next two years.

Outlook

The negative outlook on Coty reflects the potential for a lower rating over the next 6 months if Coty is unable to strengthen credit metric and leverage remains above 6.0x or if we believe it will not delever below 5.0x in fiscal 2020.

Downside scenario

We could lower the rating if Coty does not increase EBITDA year-over-year in each quarter for the remainder of fiscal 2019. This could occur if it does not reduce the impact of its supply chain consolidation on its operations or it is unable to improve the consumer beauty business. We could also lower the rating if its luxury or professional beauty segments begin to underperform or if other integration issues arise and it is unable to expand margins. We could also lower the rating if the recent management and Board changes results in a more aggressive financial policy including additional acquisitions or increased shareholder payments prior to de-leveraging.

Upside scenario

We could revise the outlook to stable if the company can resolve its supply chain issues, stabilize its consumer beauty segment, and achieve synergies resulting in its EBITDA margin expanding to the high-teens and leverage falling to the low-5.0x area. For leverage to decline to 5.0x, EBITDA would need to increase by almost 40% from current levels.

Ratings Score Snapshot

Issuer credit rating: BB-/Negative/--

Business risk: Fair
- Country risk: Low
- Industry risk: Low
- Competitive position: Fair

Financial risk: Aggressive
- Cash flow/leverage: Aggressive

Anchor: bb-

Modifiers
- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no additional impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Issue Ratings--Recovery Analysis

Security and guarantee package

The bank loans are guaranteed by the borrower and its direct and indirect wholly owned domestic subsidiaries and secured by perfected first-priority security interest in substantially all of the borrower's and each subsidiary guarantor's assets, subject to certain exceptions, whether owned on the closing date or thereafter acquired. (All facilities are cross-guaranteed.)

Jurisdictional/insolvency regime issues

The company has operations globally, with approximately 30% of its EBITDA is generated in the U.S. and 70% overseas. The company's debt is incurred in the U.S. (except for Coty B.V. being a co-borrower on the revolving credit facility), and each of the secured facilities are cross-guaranteed and cross-collateralized. In the event of an insolvency proceeding, the company would most likely file for bankruptcy protection under the auspices of the U.S. federal bankruptcy court system; even though it has significant foreign operations, we do not assume any filings in foreign jurisdictions. The company could file for bankruptcy protection in foreign jurisdictions as well, but in such a case, it would add complexity to the administration of the bankruptcy and would incur additional bankruptcy-related costs, resulting in lower recovery prospects.

Key analytical factors

We believe the company would be reorganized rather than liquidated under a default scenario, given Coty's portfolio of well-recognized brand names with strong market shares and its geographic diversity. Therefore, in evaluating the recovery prospects for debt holders, we have valued the company on a going-concern basis using a 7x multiple of our projected emergence EBITDA value.

- Year of default is 2022
- Emergence EBITDA: $1.046 billion
- Implied EV multiple: 7.0x

Calculation of EBITDA at emergence:

- Debt service assumption: $615 million
- Capital expenditures assumption: more than $230 million
- Default year amortization: roughly $200 million

Capital Structure consists of senior secured and unsecured:

- $3.250 billion revolving credit facility due in 2023
- $1 billion team loan A due in 2023,
- Euro-denominated term loan A due in 2023 equivalent to $2.5 billion,
- $1.4 billion term loan B due in 2025,
- €850 million term loan B due 2025 equivalent to $1.046 billion,
- €550 million senior unsecured notes due in 2023 equivalent to $687.5 million,
- €250 million senior unsecured notes due in 2026 equivalent to $312.5 million, and
- $550 million senior unsecured notes due in 2026.

Simulated default assumptions

Our simulated default scenario contemplates a default in 2022, primarily due to missteps in integrating the Procter & Gamble beauty assets.

Simplified waterfall

- Net recovery value (after 5% administrative costs): $6.960 billion
- Valuation split (obligor/nonobligors): 30%/70%
- Collateral for secured creditors: $5.255 billion

- First-lien claims: $8.280 billion
- Recovery expectation: 70%-90% (rounded estimate 75%)
- Collateral for unsecured creditors: $1.750 billion
- Unsecured claims: $4.614 billion
- Recovery expectation: 30%-50% (rounded estimate 35%)

Note: All debt amounts at default include six months accrued prepetition interest.

Related Criteria

- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria - Corporates - Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria - Corporates - Industrials: Key Credit Factors For The Branded Nondurables Industry, May 7, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded; Outlook Action

	To	From
Coty Inc.		
Issuer Credit Rating	BB-/Negative/--	BB/Stable/--

Ratings Lowered; Recovery Rating Unchanged

Coty Inc.

Senior Secured	BB	BB+
Recovery Rating	2(75%)	
Senior Unsecured	BB-	BB-
Recovery Rating	4(35%)	
Coty B.V.		
Senior Secured	BB	BB+
Recovery Rating	2(75%)	

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.