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Research Update:

Coty Inc. Rating Affirmed On Planned Recapitalization; New Debt Ratings Assigned

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Research Update:

Coty Inc. Rating Affirmed On Planned Recapitalization; New Debt Ratings Assigned

Overview

- New York-based cosmetics manufacturer Coty Inc. has announced plans to raise a new $9.0 billion secured loan to repay its existing debt.
- We are affirming the 'BB' corporate credit rating on Coty as the transaction is leverage-neutral and the company has improved its operating performance.
- We are assigning a 'BB+' issue-level rating and '2' recovery rating to the company's proposed $9.0 billion senior secured credit facilities.
- The outlook is stable, reflecting our expectation that management will stabilize its consumer beauty segment and grow the acquired Procter & Gamble Co. (P&G) beauty assets. We forecast adjusted leverage will decline to the low-5.0x area by year-end fiscal 2018 from the mid-5.0x area at year-end fiscal 2017 and below 5.0x in fiscal 2019.

Rating Action

On March 19, 2017, S&P Global Ratings affirmed its 'BB' corporate credit rating on Coty Inc. The outlook is stable.

At the same time, we assigned 'BB+' issue-level ratings to the company's proposed $9.0 billion senior secured credit facilities, consisting of a $3.0 billion revolver due 2023, a $1.25 billion term loan A due 2023, an Euro term loan A equivalent to $2.25 billion due 2023, a $1 billion term loan B due 2025, and an Euro term loan B equivalent to $1.5 billion due 2025. The '2' recovery rating indicates our expectation of substantial recovery (70%-90% rounded estimate 75%) in the event of a payment default. Coty B.V., a subsidiary of Coty Inc., is a co-borrower of the revolver. For purposes of the ratings, we view Coty Inc. and its operating subsidiaries as a group. All ratings are based on preliminary terms and are subject to review of final documents.

The company plans to use proceeds from the debt offering to repay a portion of its existing debt, including debt that resides at Galleria Co.

The company will have $8.0 billion of funded debt at the close of the transaction.

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Rationale

The affirmation reflects our expectation that Coty will improve its operating performance, although progress could be uneven, resulting in stronger credit metrics and increases in free cash flow. The affirmation also reflects our view that the recapitilization will be leverage-neutral.

The ratings on Coty incorporate its leading market positions; its good product, channel, and geographic diversity; its participation in the large and growing cosmetics industry; and its high leverage.

Coty's operating performance showed improvement in the first half of fiscal 2018 after performing below our expectations in fiscal 2017 (ended June 30). The company has generated positive organic sale growth in its professional and luxury divisions thus far this year, which comprise 52% of its sales. Its sales trends, though still negative, are also improving in its important consumer beauty segment. Coty's consumer beauty segment's organic sales dropped 10% in fiscal 2017 because of a combination of promotional activity, loss of shelf space, and a decline in the beauty category in the mass channel. Cover Girl and Clairol were the biggest drag because of reduced shelf space. In addition, its acquisition of Hypermarcas' beauty and personal care business led to unfavorable mix shift. But in the first half of fiscal 2018, the company's adjusted EBITDA margin was 15.8% for the trailing 12 months ended Dec. 31, 2017, up from 15.1% in the year-ago period. We forecast that the company should be able to increase margins close to 18% in fiscal 2018 and in excess of 18% in fiscal 2019 as it repositions its brands, divests noncore underperforming brands, gains efficiencies from the former P&G beauty assets, and reduces costs. Adjusted leverage should decline to low-5.0x area by year-end fiscal 2018 and below 5.0x in fiscal 2019 if the company achieves our base-case forecast, from the current 5.4x.

The assumptions in our base-case scenario for company in fiscal years 2018 and 2019 include:

- Global GDP growth of 3.7% in 2018 and 3.6% in 2018.
- Organic sale growth of 2.5%, slightly below GDP growth, because the majority of its business is in slower-growing developed markets. Overall, revenues grows at a mid-single-digit rate in fiscal 2018, reflecting the acquisitions of Younique and Burberry in the luxury and professional beauty segments. The consumer beauty segment continues to struggle in a tough retail environment and flat shelf space along with management still attempting to integrate the P&G beauty assets. Our sales forecast does not take into account the divestment of underperforming noncore brands equaling 6%-8% of fiscal 2017 sales. In fiscal 2019, we forecast sales will be roughly in line with economic growth as we believe the company will gain shelf space in mass channels, and that consumers will respond well to its new products.
- Adjusted EBITDA margin expands to 17.8% in fiscal 2018 from 16.7% in

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fiscal 2017 and goes slightly above 18% in fiscal 2019 as margins improve from greater scale, greater efficiencies in the former P&G brands, and a focus on cost reductions. There could be some benefits from exiting some underperforming noncore brands if that occurs.

- Free operating cash flow of approximately $138 million in fiscal 2018 and roughly $950 million in fiscal 2019 after capital expenditures of roughly $510 million in fiscal 2018 and $450 in fiscal 2019.
- Dividends of about $375 million in each of the next two years.
- No material acquisitions and no share repurchases in the next two years as the company focuses on reducing leverage.

Coty, with more than $9 billion in annual sales, 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 Coty 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 a greater level of financial resources to invest in their businesses. Coty holds the No. 2 position in the professional hair salon category. 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. Due to the increasing diversity of the beauty products industry, Coty faces competition from both cosmetic bellwethers and smaller niche players with unique product propositions (i.e., fast-fashion approach, local players that use indigenous ingredients, or an experiential approach). These small niche players have been increasingly taking market share away from the well established companies whose products have high brand equity. In addition, Coty's margins are well below those of its peers. We estimate its adjusted EBITDA margin will be just under 18% in fiscal 2018, which is well below the 22% and 23% margins that L'Oreal and Estee Lauder maintain, respectively, but above Revlon's pro forma 12% depressed margins. We do not expect Coty's EBITDA margin to exceed 20% until fiscal 2020 given its need to reposition the P&G brands and invest to grow sales in the e-commerce channel.

Coty should benefit from the favorable trends in its industry. The beauty sector is one of the most attractive industries in consumer products, valued at approximately $300 billion according to Euromonitor, and it has grown at a compound annual growth rate (CAGR) of 4.7% over the last five years. Furthermore, we expect the industry will grow at almost 6.0% CAGR over the next five years. We forecast Coty will be able to stabilize and strengthen its operating performance because of its diverse portfolio of brands and products at a wide range of price points. Its luxury and professional segments have already demonstrated improvement. However, we expect it to grow its sales at a

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slower pace than its key peers and the rest of the industry because of its exposure to the mass channel and the fact that it still predominantly competes in developed markets, where growth is slower than in the emerging markets, and that it is under-indexed compared with its key peers in the skin care category.

If Coty is successful at repositioning the P&G beauty assets, it should be able to slowly close the gap between its growth rate and the growth rate of the overall industry as the P&G beauty assets provide Coty with additional expansion opportunities in faster-growing markets such as Brazil and Japan. Its acquisition of the Hypermarcas Brands should also help it grow in Brazil. Moreover, Coty now has representation in all channels.

Liquidity

We believe the company has adequate liquidity. We expect the company's liquidity sources to be at least 2x its uses over the next two years and anticipate its sources will cover its uses even if its forecasted EBITDA declines by 50%. Our view of the company's liquidity also incorporates our belief that the company has sound relationships with its banks.

Based on our quantitative analysis, Coty qualifies for a stronger liquidity assessment; however, it does not meet our qualitative requirements. Coty does not have any public bonds or other data with which to assess its standing in the credit markets. Moreover, 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 $840 million at the close of the transaction.
- Full availability under its new $3 billion revolving credit agreement due 2023.
- Funds from operations (FFO) of more $900 million in fiscal 2018 and more than $1.1 billion in fiscal 2019.

Principal Liquidity Uses:

- Working capital needs of about $500 million per year.
- Capital spending of approximately $510 million in fiscal 2018 and $450 million fiscal 2018.
- Dividends of about $375 million per year.
- Mandatory debt amortization of almost $200 million per year.
- No share repurchases for the next two years.

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Outlook

The stable outlook on Coty reflects our expectation that management will stabilize the performance of the consumer beauty segment and grow the acquired P&G beauty assets. In addition, we expect the company to realize greater efficiencies from the former P&G brands, and achieve cost reductions in its fiscal 2018. We forecast adjusted leverage will decline to the low-5.0x area by year-end fiscal 2018 from the mid-5.0x area at year-end fiscal 2017 and below 5.0x in fiscal 2019.

Upside scenario

We could raise our rating on Coty if it gains traction in rebuilding the P&G brands, stems its decline in market share, maintains its strong market position in the beauty category, and improves its profitability such that its EBITDA margin expands to 20% or above, resulting in it being able to sustain adjusted leverage below 4.0x. We believe this is unlikely over the next year given its current level of operating performance.

Downside scenario

We could lower our rating on Coty if it continues to encounter difficulty in repositioning its consumer beauty business, resulting in the company not being able to expand its EBITDA margin and reduce leverage. If this were to occur, we could reconsider the business risk. We could also lower the rating if the company's financial policy becomes more aggressive such that it makes additional debt-financed acquisitions and sustains adjusted leverage above 5.0x.

Ratings Score Snapshot

Corporate Credit Rating: BB/Stable/--
Business risk: Satisfactory

- Country risk: Low
- Industry risk: Low
- Competitive position: Satisfactory

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)

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- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Issue Ratings--Recovery Analysis

We are assigning issue-level and recovery ratings to Coty Inc.'s credit facility. The credit facility is composed of:

- $3.0 billion revolver due 2023 (Coty B.V. is a co-borrower);
- $1.25 billion term loan A due 2023;

Euro Term loan A equivalent to $2.25 billion due 2023;

- $1 billion term loan B due 2025; and
- Euro term loan B equivalent to $1.5 billion due 2025.

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 assets of the borrower and each subsidiary guarantor, 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 generated in the U.S. and 70% overseas. The company's debt is incurred in the U.S. (with the exception of 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: 2023

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- EBITDA at emergence: more than $1,020 mil.
- Implied EV multiple: 7.0x

Calculation of EBITDA at emergence:

- Debt service assumption: almost $600 mil.
- Capex assumption: more than $220 mil.
- Default year amortization: roughly $200 mil.
- Emergence EBITDA: $1,020 mil.

Simulated default assumptions

Our simulated default scenario contemplates a default in 2023, primarily due to missteps in integrating the P&G beauty assets.

Simplified waterfall

- Net recovery value (after 5% admin. costs): $6,790 mil.
- Valuation split in % (Obligor/non-obligors): 30%/70%
- Collateral for secured creditors: $5,125 mil.
- First-lien claims: $7,855 mil.
- Recovery expectation: 70%-90% (rounded estimate 75%)
- Collateral for unsecured creditors: $1,665 mil.

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

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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

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Ratings Affirmed

Coty Inc.
 Corporate Credit Rating                  BB/Stable/--

New Rating

Coty Inc.
Coty B.V.
 Senior Secured
  US$3 bil revolver bank ln due 2023     BB+
   Recovery Rating                        2(75%)

Coty Inc.
 Senior Secured
  EUR0 mil term B bank ln due 2025       BB+
   Recovery Rating                        2(75%)
  US$1 bil term B bank ln due 2025       BB+
   Recovery Rating                        2(75%)
  US$1.25 bil term A bank ln due 2023    BB+
   Recovery Rating                        2(75%)
  US$3 bil revolver bank ln due 2023     BB+
   Recovery Rating                        2(75%)
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