Moody's

Rating_Action: Moody's upgrades Coty's CFR to Ba3; outlook stable

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New York, February 16, 2023 -- Moody's Investors Service ("Moody's") today upgraded Coty Inc.'s ("Coty") Corporate Family Rating ("CFR") to Ba3 from B1, its Probability of Default Rating to Ba3-PD from B1-PD, and the company's senior secured first lien credit facility ratings to Ba2 from Ba3, consisting of a revolving credit facility and term loan. At the same time, Moody's upgraded the company's senior secured notes rating to Ba2 from Ba3 and its unsecured notes rating to B2 from B3. Coty's speculative grade liquidity rating was upgraded to SGL-1 from SGL-2. The rating outlook is stable.

The ratings upgrade reflects Coty's continued progress in reducing financial leverage and strengthening its balance sheet as well as liquidity, fueled by earnings growth and debt repayment funded from free cash flow and asset sales. Moody's expects that the company's debt-to-EBITDA leverage will improve to a low 4x range in fiscal 2024 ending June 30, 2024, supported by further growth in revenue and earnings as well as voluntarily debt repayment. Coty's commitment to continue de-leveraging is a key factor in the upgrade. Coty is targeting to reduce net debt-to-EBITDA (based on the company's calculation) towards 3.0x by the end of calendar year 2023 from 4.1x as of December 31, 2022, with a further target to reduce this leverage metric towards roughly 2.0x exiting calendar year 2025. Coty has executed its business transformation well in the past two and a half years, and generated healthy growth in both its prestige and mass portfolios. As a result, Moody's views the likelihood of the company achieving its leverage target has significantly increased. Coty has achieved higher revenue and gross margins by focusing on product premiumization and innovation, brand repositioning, and investment in marketing and brand support. In the next 12-18 months, Coty will benefit from continued strong growth and higher penetration in prestige fragrance globally, a further recovery in travel retail, and expansions in skincare and prestige cosmetics at a time when China pivoted its covid-related policy and reopened its border. Moody's expects Coty will generate at least $400 million free cash flow annually, supported by earnings growth, disciplined capital spending, working capital management, and further cost saving initiatives. Coty's plan to monetize its remaining 25.9% stake in Wella should ultimately provide cash to reinvest or further reduce financial leverage.

The upgrade of the speculative grade liquidity rating to SGL-1 from SGL-2 reflects that the company's improved free cash flow and near full availability on the $2 billion revolver provides very good coverage of cash needs including minimal maturities over the next 12 months.

The following ratings are affected by today's action:

Upgrades:

..Issuer: Coty Inc.

.... Corporate Family Rating, Upgraded to Ba3 from B1

.... Probability of Default Rating, Upgraded to Ba3-PD from B1-PD

.... Speculative Grade Liquidity Rating, Upgraded to SGL-1 from SGL-2

....Senior Secured First Lien Bank Credit Facility (revolver and term loan), Upgraded to Ba2 (LGD3) from Ba3 (LGD3)

....Senior Secured Regular Bond/Debenture, Upgraded to Ba2 (LGD3) from Ba3 (LGD3)

....Senior Unsecured Regular Bond/Debenture, Upgraded to B2 (LGD5) from B3 (LGD5)

Outlook Actions:

..Issuer: Coty Inc.

....Outlook, Remains Stable

RATINGS RATIONALE

Coty's Ba3 CFR reflects the company's good market position and improved operating performance that is leading to sizable annual free cash flow, and the company's commitment to continue to delever. Moody's anticipates debt-to-EBITDA to improve to a low 4.0x level in the next 12-18 months from 4.9x as of December 31, 2022 primarily due to earnings improvement as well as further debt repayment funded by free cash flow and asset sales. Coty's earnings growth is supported by a recovery and expansion from color cosmetics and travel retail, healthy demand and higher penetration in prestige fragrance, product premiumization and innovation, continued focus on marketing and brand support, as well as well-timed expansion in skincare and China. The rating also reflects Moody's view that the company will generate at least $400 million free cash flow over the next year as a result of good earnings growth, disciplined capital spending, additional cost savings, and working capital management. Moody's believes Coty's commitment to deleverage is in part motivated by a desire to improve financial flexibility to restart the dividend, which would weaken free cash flow. Moody's assumes that any dividend resumption would be to a level that preserves significant annual free cash flow.

Coty's product portfolio has a concentration in fragrance and color cosmetics, the two categories that Moody's views as more exposed to earnings volatility in an economic downturn compared to skincare and haircare, which was evidenced by significant category revenue declines in 2020. Nevertheless, recent strong sector growth and higher penetration in prestige fragrance compared to the pre-pandemic level is helping to expand Coty's gross margin. The free cash flow provides the company further financial flexibility to invest in marketing and product development, as well as other strategic pillars such as skincare. Coty is more concentrated than its primary competitors in mature developed markets in the US and western Europe. Moreover, Coty relies more heavily on licenses to support its prestige brands relative to greater ownership of its mass beauty brands. That said, lower exposure to China benefited the company in the last two years when China was under strict covid lock-down and certain of Coty's competitors were much more negatively impacted. China expansion is one of Coty's strategic pillars, and Moody's views it a well-timed opportunity for Coty to launch a Lancaster ultra-premium skincare line in China as the country reopens, along with its prestige fragrance and cosmetics push. As there are no major licenses up for renew in the next six years, brand licensors switching partners is a longer-term risk. The risk is somewhat mitigated by Coty's good manufacturing, distribution and marketing capabilities, and successful prestige product launches. The top six licensing brands are also owned by different organizations, which creates some diversification. Coty's ratings are also supported by the company's large scale, its portfolio of well-recognized brands, and good product and geographic diversification.

The SGL-1 speculative grade liquidity rating reflects Coty's very good liquidity with a cash balance of $281 million and over $1.9 billion availability under the $2 billion revolver as of December 31, 2022. The revolver expires in April 2025. Moody's expects the company to generate at least $400 million free cash flow over the next year (CFO minus capital spending and dividends), and there are no debt maturities until April 2025. The total net leverage covenant steps down to 4.0x in March 2023 from 4.25x currently, and Moody's expects Coty will maintain good EBITDA cushion within the covenant.

ENVIRONMENTAL SOCIAL AND GOVERNANCE CONSIDERATIONS

Coty's exposure to environmental risks is moderately negative (E-3). The company has neutral to low exposure to physical climate risk, carbon transition, water management, and use of natural capital risks. Waste and pollution risk is moderately negative reflecting the waste created from consumer products and packaging material that often cannot be recycled. The company is addressing those risks by using less and simplified packaging, exploring packaging reuse through at-home or in-store refills, and increasing the amount of recycled materials in its product packaging. Coty also pioneered using carbon captured ethanol to produce fragrances in early 2022.

Coty's exposure to social risks is moderately negative (S-3). The company has neutral-to-low exposure to human capital, and demographic and societal trends. While consumer facing and focused on beauty, the company's customer relations risk exposure is largely mitigated by its status as a large global player that is well diversified across color cosmetics, skincare and fragrance, as well as in both mass and prestige markets. The company has over 60% of revenue earned from prestige products, which Moody's views as higher growth. Health and safety and responsible production risk are moderately negative given the company has direct manufacturing and its products use natural ingredients including palm oil derivatives. The company is committed towards fully sustainable and certified ingredients, including to purchase 100% certified palm oil which partially mitigates that risk.

Coty's governance risk is moderately negative (G-3) as a result of high leverage and concentrated ownership risks. Coty's past strategies include building its beauty business with a number of large and expensive debt-funded acquisitions including P&G Beauty and Younique. The acquisitions contribute to high leverage that remains a drag on the current credit rating. Coty is controlled by JAB Holding Company S.a.r.l. (JAB), who holds approximately 53% of the stock. Moreover, the company's board of directors has limited independence given that four of the twelve board members are related to JAB. Moody's views Coty's financial policies as improved, including a plan to reduce the company's net debt-to-EBITDA leverage towards 3.0x by calendar 2023, and towards 2.0x by calendar 2025. The company also demonstrated a continued focus on lowering leverage and governance risk, including the partial debt redemption of its 2026 senior unsecured in November 2022.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

The stable outlook reflects Moody's expectation that Coty will continue to generate strong earnings and use free cash flow and proceeds from asset sales to repay debt and reduce debt-to-EBITDA leverage to a low 4x by fiscal 2024. The stable outlook also reflects Moody's expectation that the company will only resume dividend payments after the company meets its mid to long-term target leverage ratio of 2.0x-3.5x and the company will maintain at least good liquidity.

The ratings could be downgraded if Coty's operating performance deteriorates due to market share losses, revenue declines or an inability to mitigate cost increases. Coty's ratings could also be downgraded if it fails to reduce debt-to-EBITDA to below 4.5x, free cash flow-to-debt is below

7% or if the company pursues material debt funded acquisitions or shareholder distributions. A deterioration in liquidity could also lead to a downgrade.

The ratings could be upgraded if the company sustains good operating performance including organic revenue growth while at least maintaining the EBITDA margin. Coty would also need to sustain debt-to-EBITDA below 4.0x and retained cash flow to net debt above 12% factoring in a potential dividend reintroduction to be considered for an upgrade. The company would also need to maintain financial policies that sustain these credit metrics.

The principal methodology used in these ratings was Consumer Packaged Goods published in June 2022 and available at https://ratings.moodys.com/api/rmc-documents/389866. Alternatively, please see the Rating Methodologies page on https://ratings.moodys.com for a copy of this methodology.

Coty Inc., a public company headquartered in New York, NY, is a manufacturer and marketer of fragrance, color cosmetics, and skin and body care products. The company's products are sold in over 150 countries. The company generated roughly $5.3 billion in revenue for the twelve-month ending December 31, 2022. Coty is 53% owned by a German based investment firm, JAB Holding Company S.a.r.l. (JAB), with the rest publicly traded or owned by management.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on https://ratings.moodys.com/rating-definitions.

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