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Research Update:

Coty Inc. Outlook Revised To Positive From Negative On Improved Credit Measures And Debt Reduction; Ratings Affirmed

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Rating Action Overview

- Coty Inc.'s recently announced sale of about 9% stake in Wella AG and redemption of a portion of preferred equity owned by financial sponsor KKR has improved its credit measures.
- We expect that the company will continue to benefit from higher sales volumes and successful implementation of its transformation plan, resulting in a significant improvement in adjusted leverage from the high levels at year-end fiscal 2021.
- In addition, we expect the company to make voluntary debt repayments and refinance its revolving credit facility over the next few months, thereby supporting liquidity.
- Therefore, we affirmed our 'B-' issuer credit rating on Coty and revised the outlook to positive from negative.
- At the same time, we affirmed our 'B' issue-level rating on its senior secured debt, and our 'B-' issue-level rating on its senior unsecured debt. The '2' recovery rating on the company's senior secured debt reflects our expectation for substantial (70%-90%; rounded estimate: 75%) recovery in the event of payment default. The '4' recovery rating on the company's senior unsecured debt reflects our expectation for average (30%-50%; rounded estimate: 45%) recovery for lenders in the event of payment default.
- The positive outlook reflects the potential that we will raise our rating on Coty if it continues to successfully execute its transformation plan, increases sales and profitability, and uses proceeds from asset sales and the Brazilian IPO for debt repayment, resulting in leverage declining to the low-6x area by the end of fiscal 2022.

Rating Action Rationale

The positive outlook reflects our expectation that Coty's credit measures will improve on a sustained basis due to capital structure changes and improved operating efficiency. Coty recently announced that it has entered into an agreement to sell about 9% of its stake in Wella AG

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to KKR in exchange for redemption of about 50% of KKR's convertible shares and accrued dividends. This will lead to a reduction in the value of the total preferred equity owned by KKR to about $278 million, equivalent to 5.2% of Coty's outstanding class A common equity on an as-converted basis compared to $1.1 billion or 18% equivalent at the end of fiscal 2021 (ended June 2021). We expect future annual dividend payouts to preferred equity holders to decrease by about $26 million to about $45 million. In addition, this transaction reduces our measure of consolidated leverage by about 0.5x, given our treatment of the company's preferred equity as a debt-like obligation.

Coty's stake in Wella AG has declined to 30.6% following the transaction. We believe this transaction is an important step toward simplifying the company's business further and allowing it to focus more intently on its core cosmetics and fragrance businesses, while also looking to expand in skincare. It also reiterates the company's commitment and disciplined approach towards asset sales and debt reduction. The sale of a portion of Coty's stake signals that further sell-downs are possible, which we believe could help reduce the company's leverage further. Coty's remaining stake in Wella is valued at $1.4 billion.

We expect new management to remain committed to its leverage target of 5x (low-6x with S&P Global Ratings' adjustments), which we believe is achievable in fiscal 2022. Pro forma leverage for the last 12 months ended June 30, 2021, declined to about 9.9x as a result of the recent redemptions of KKR's preferred convertible shares. We believe Coty will continue to use cash proceeds from its Brazilian IPO and additional sales of its stake in Wella toward debt repayment, which we estimate will exceed $500 million in fiscal 2022. The reduction in consolidated debt levels, combined with strong EBITDA growth, should result in leverage declining to the low-6x area, compared to our previous forecast of 7.3x. We expect Coty to allocate capital prudently and continue to look for opportunities for potential asset dispositions to further streamline its portfolio. We do not expect the company to resume dividend payments to equity holders or undertake share repurchases before leverage is lower than its targets. Moreover, we expect voluntary debt repayments to help improve the cushion under the company's net leverage covenant over the next few quarters to around 15%.

Coty has $114 million outstanding balance on the term loan A maturing in April 2023 that we expect to be repaid by the end of 2021. Its largest upcoming maturity is the €550 million senior unsecured euro notes in April 2023 that we assume will be refinanced at satisfactory terms. The company also has a balance of $2.1 billion of its revolving credit facility maturing in April 2023. We believe the company's ability to receive a broad syndication for its $700 million extended tranche of the revolving credit facility reflects Coty's access to multiple sources of capital and well-established and solid relationships with its banks. We expect the company to complete the refinancing of majority of the remaining revolver facility by the end of 2021. Coty has about $250 million cash on the balance sheet that we believe includes some cushion due to the uncertain macro environment amid the pandemic and persistent supply chain disruptions from inflation and port congestion. We will continue to monitor its performance against these trends.

We expect tailwinds in the fragrances and cosmetics segments and Coty's transformation plan to contribute to sales and profitability growth in 2021 and 2022. Coty's performance at the point-of-sales channels in the U.S. mass cosmetics segment has improved markedly since the fourth quarter of fiscal 2021, after facing many periods of weak performance. We view the steps taken by the management to refocus CoverGirl's advertising as positive and expect the brand to continue to grow profitably. We also recognize the brand repositioning efforts undertaken by Coty for its owned brands Rimmel and MaxFactor as key to support strong organic growth in the mass

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segment of the company's business.

We expect the U.S. prestige fragrance market to continue to grow strongly compared to the same period in 2019 supported by strong consumer demand. Coty also has a strong innovation pipeline with key fragrance launches under the brands Gucci, Burberry and Calvin Klein. In addition, we expect the international expansion of Kylie Cosmetics to further support sales and profitability growth. We believe that the continuation of the company's recent good performance is highly dependent upon its ability to maintain recent market share gains and leverage strategic and operational improvements. Given the short operating track record of its current management team, which is handling the execution of its transformation strategies, we believe there are inherent risks associated with the company's ongoing transformation strategy.

Outlook

The positive outlook reflects the potential that we will raise our rating on Coty if the company continues to successfully execute its transformation plan and increases sales and profitability resulting in leverage declining to the low-6x area by the end of fiscal 2022.

Upside scenario

We could raise our rating on Coty if:

- It builds on its current operating momentum with revenue and EBITDA margins in line with our forecast and we believe it has established a successful record of retaining its market shares and sustaining its improved cost structure; and
- It successfully executes its strategy of utilizing all excess cash proceeds, including from future asset sales and the Brazilian IPO, for debt reduction that supports reducing and sustaining leverage below the mid-6x area.

Downside scenario

We could revise the outlook to stable if we expect adjusted leverage to remain above 6.5x, which could occur due to:

- A resurgence of COVID-19 variants causes reimposition of restrictions on consumer mobility leading to demand for the company's products remaining weak, resulting in material organic revenue declines; or
- An operational misstep, a worsening macro environment, heightened competition, higher inflation or additional restructuring charges stall sales and profit recovery prospects.

Company Description

Coty Inc., together with its subsidiaries, develops, manufactures, markets, and distributes fragrances, cosmetics, skin care and body care products worldwide. JAB Holding Co. is Coty's largest shareholder, with a 61% ownership in the company as of June 30, 2021.

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Our Base-Case Scenario

- S&P Global Ratings economists expect U.S. GDP will expand 5.7% in 2021 and 4.1% in 2022, Europe GDP will increase 5.1% in 2021 and 4.5% in 2022, and Asia-Pacific GDP will expand 6.7% in 2021 and 5.2% in 2022.
- Revenue increases about 16% in fiscal 2022 to $5.4 billion, backed by a rebound in overall regional sales because of an improving economy and continued growth in e-commerce sales. For 2023, we expect sales to increase by a mid-single-digit percentage amid a more normalized consumer environment.
- We expect EBITDA margin to improve to 16.1% in fiscal 2022 from 14.1% in 2021 on higher volumes, realization of benefits from the company's transformation plan and lower restructuring charges. This is somewhat offset by material cost inflation, reinstatement of employee bonuses and reinvestment into the company's operational priorities. We expect EBITDA margin to further improve to 17.8% in fiscal 2023 on continued benefits from sales growth and cost structure initiatives.
- Capex of about $200 million annually over the next two years are mainly driven by maintenance capital spend requirements to support the higher sales volumes.
- Mandatory debt amortization of $23 million per year.
- Discretionary cash flow of about $500 million in fiscal 2022 and fiscal 2023, meaningfully above $89 million in fiscal 2021.
- No share repurchases or material acquisitions over the next 12 months.

Based on these assumptions, we project following metrics:

- Debt to EBITDA in the low-6x area in fiscal 2022, improving to 5x in 2023 (excluding preferred stock: 5.7x and 4.5x respectively); and
- EBITDA interest coverage of about 2.9x in fiscal 2022, improving to the mid-3x area in 2023.

Liquidity

We continue to assess Coty's liquidity as adequate despite our view that its sources will likely be at least 2.6x its uses over the next 12 months and remain positive even if EBITDA declines by 30%. We believe Coty has well-established and solid relationships with its banks--demonstrated by its ability to secure large, committed credit facilities--and satisfactory standing in credit markets. However, we continue to believe the company will need to refinance if it experiences a high-impact, low-probability event (such as severe market turbulence, sovereign risk, or the activation of material-adverse-change clauses).

Principal liquidity sources

- About $254 million cash as of June 30, 2021;
- Availability of $2.1 billion under the revolving credit facility due 2023; and
- Annual cash FFO of about $470 million over the next 12 months.

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Principal liquidity uses

- Debt repayment of more than $500 million in fiscal 2022 from the proceeds of Brazil IPO, sale of Wella stake and other dispositions
- Mandatory scheduled debt amortization of approximately $23 million per year;
- Capital spending of about $200 million over the next 12 months;
- Working capital (including seasonal peak) requirements of about $500 million; and
- No dividends paid to common equity shareholders or share repurchases over the next 12 months.

Covenants

Compliance expectations

We expect Coty to remain in compliance with all applicable covenants under the revolving credit agreement and term loan agreement for the respective periods over the next 12 months. We expect the company to have sufficient headroom over the next 12 months under our base case forecast.

Requirements

Coty's credit agreements contain a maximum 5.25x total net leverage ratio maintenance financial covenant requirement through Dec. 31, 2021, that steps down to 5.00x on March 31, 2022, 4.75x on June 30, 2022, 4.50x on Sept. 30, 2022, 4.25x on Dec. 31, 2022, and to 4.00x March 31, through June 30, 2023. The company's credit agreement does not include the preferred equity as debt and allows it to add back 36 months of forward cost savings and excludes some restructuring costs.

Issue Ratings - Recovery Analysis

Key analytical factors

- The company's debt structure is composed of:
- --A $2.1 billion revolving credit facility (with $670 million outstanding as of June 30, 2021) maturing in April 2023;
- --A $700 million revolving credit facility (with full availability as of June 30, 2021) maturing in April 2025;
- --Term A facility with $114 million outstanding as of Jun. 30, 2021, maturing in April 2023;
- --Term B facility with $1.5 billion outstanding as of Jun. 30, 2021, maturing in April 2025;
- --2026 senior secured dollar notes with $900 million outstanding as of June 30, 2021, maturing in April 2026;
- --2026 senior secured euro notes with $833 million outstanding as of June 30, 2021, maturing

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in April 2026;

- 2023 senior unsecured euro notes with $655 million outstanding as of June 30, 2021, maturing in April 2023;
- 2026 senior unsecured dollar notes with $550 million outstanding as of June 30, 2021 maturing in April 2026; and
- 2026 senior unsecured euro notes with $298 million outstanding June 30, 2021, maturing in April 2026.

- Coty Inc. is the borrower/issuer of all the debt. Coty BV is a co-borrower under the revolver. We continue to value the company on a going concern basis. 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.) The unsecured notes are guaranteed direct and indirect wholly owned domestic subsidiaries (U.S. and euro notes cross-guaranteed).
- The company has operations globally, with approximately 35% of its EBITDA generated in the U.S. and 65% overseas. The company's debt is incurred in the U.S. (with the exception of Coty BV 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 case and would incur additional bankruptcy-related costs, resulting in lower recovery prospects.
- 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.
- We estimate $5.5 billion in gross recovery value at the time of default under our projected scenario. We base this on assumptions of the realization rates for Coty's ownership stakes in Wella and King Kylie as well as an assumption of an EBITDA multiple applied against the company's distressed emergence EBITDA under our hypothetical default scenario. Our analysis considers a 60% realization rate on the company's investments in Wella and King Kylie, resulting in a $1.1 billion combined DAV at default. We have valued the company's base business based on an enterprise value to gauge recovery and apply a 6.5x multiple on an assumed distressed emergence EBITDA of $667 million that results in an estimate gross recovery value of $4.3 billion. To determine net recovery value available for distribution to creditors, we reduced our estimate of total gross recovery value of $5.5 billion by 5% to account for estimated bankruptcy administrative expenses. This results in a total net recovery value of about $5.2 billion.

Simulated default assumptions

Our simulated default scenario contemplates a default in 2023, primarily due to missteps in executing its restructuring plan or due to a steep decline in demand for the company's products. We believe that in a distressed situation, funds from the company's operations would not be adequate to support the interest burden and cash needs for its operations.

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Calculation of EBITDA at emergence

- Debt service: $473.4 million (default year interest plus amortization)
- Maintenance capex: $133.3 million
- Default EBITDA proxy: $606.6 million
- Operational adjustment: $60.7 million (10% of preliminary emergence EBITDA)

Simplified waterfall

- Emergence EBITDA: $667.3 million
- Multiple: 6.5x
- Gross recovery value: $4.3 billion
- Gross asset value: $1.1 billion
- Realization rate: 60%
- DAV: $1.1 billion
- Total gross recovery value: $5.5 billion
- Net recovery value for waterfall after administrative expenses (5%): $5.2 billion
- Valuation split (obligor/nonobligors): 21%/55%/18%/6%
- Collateral for secured creditors: $3.3 billion
- First-lien claims: $5.8 billion
- --Recovery expectation: 70%-90%; rounded estimate: 75%
- Collateral for unsecured creditors: $1.9 billion
- Unsecured claims: $4.1 billion
- --Recovery expectation: 30%-50%; rounded estimate: 45%

All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating: B-/Positive/--

Business risk: Fair

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

Financial risk: Highly leveraged

- Cash flow/leverage: Highly leveraged

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Anchor: b

Modifiers

- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Coty Inc.		
Issuer Credit Rating	B-/Positive/--	B-/Negative/--
Issue-Level Ratings Affirmed; Recovery Ratings Unchanged		
Coty Inc.		
Coty B.V.		
Senior Secured	B	B
Recovery Rating	2(75%)	2(75%)

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Issue-Level Ratings Affirmed; Recovery Ratings Revised

Coty Inc.		
Senior Unsecured	B-	B-
Recovery Rating	4(45%)	3(50%)

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