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Ratings

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Research Update:

Coty Inc. Ratings Affirmed On Modest Debt Reduction; Outlook Remains Negative

September 14, 2021

Rating Action Overview

- Coty Inc. recently announced the conversion of a portion of preferred equity owned by financial sponsor KKR into common equity, resulting in a reduction in pro forma S&P Global Ratings-adjusted debt to EBITDA to 10.5x as of June 30, 2021.
- However, the company faces some refinancing risk related to the upcoming maturities of a portion of its revolving credit facility, remaining outstanding balance on its term loan A (after successfully refinancing $1.7 billion of its outstanding term loan A balances earlier this year) and senior unsecured euro notes, all of which mature in April 2023.
- The company's profitability has improved over the past few quarters from higher sales volumes and successful implementation of its transformation plan. However, its leverage remained elevated, and we estimate that the headroom under the company's maximum net leverage covenant will remain tight over the next 12 months.
- We affirmed our 'B-' issuer credit rating on Coty, our 'B' rating on its senior secured debt, and our 'B-' 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. Subsidiary Coty B.V. is a co-borrower under the revolving credit facility. In our rating analysis, we view Coty Inc. and its operating subsidiaries as a group. The '3' recovery rating on the company's senior unsecured debt reflects our expectation for meaningful (50%-70%; rounded estimate: 50%) recovery for lenders in the event of payment default.
- The negative outlook reflects the risk of a lower rating over the next 12 months if Coty's capital structure becomes unsustainable. This could occur if the company is unable to refinance its upcoming debt maturities before they become current or if leverage remains elevated and there is minimal cushion under the company's covenants.

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Rating Action Rationale

Coty could face refinancing risk over the next 12 months due to upcoming maturities. Coty recently refinanced $1.7 billion of its outstanding term loan A balances that were scheduled to mature in 2023 with new senior secured notes that mature in 2026 and extended $700 million of its revolving commitment to April 2025. We viewed these transactions as credit positive reflecting the company's access to multiple sources of capital and well-established and solid relationships with its banks.

The remaining $2.1 billion revolving credit facility and $114 million outstanding balance on the term loan A mature in April 2023. The company's €550 million senior unsecured euro notes also mature in April 2023. We view the refinancing of the 2023 maturities as essential to provide the company with additional time to continue to turn around its operations.

The conversion of a portion of KKR's ownership in Coty from preferred equity into common equity has improved the company's capital structure. Coty recently announced that KKR sold about 50 million shares of the company's common equity through a secondary market offering as a result of conversion of a portion of the convertible preferred stock held by KKR. This will lead to a reduction in the value of the total preferred equity owned by KKR to about $762 million, equivalent to 10.9% 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).

In our view, this transaction improves the sustainability of the company's capital structure and results in our measure of Coty's pro forma consolidated leverage for fiscal 2021 declining from 11x to 10.5x. Although we treat Coty's preferred equity as a debt-like obligation, we note that the security has a mandatory conversion mechanism after a 3-year period depending on the stock price. We also recognize that the preferred equity holders do not have redemption rights, and that Coty has the option to either accrue or pay dividends in cash. In combination, these characteristics mitigate liquidity risks derived from the security. In addition, we expect future dividend payouts to preferred equity holders to decrease by about $30 million annually, thereby supporting the company's liquidity.

Although we do not incorporate any incremental preferred equity conversion into our base-case forecast, we would view any further potential conversion favorably.

Coty's leverage remains elevated, but we expect management to continue prioritizing debt reduction. Leverage for the 12 months ended June 30, 2021, is about 10.5x, pro forma for the preferred shares conversion by KKR (about 9.3x excluding remaining preferred stock). This is higher than our previous expectations of leverage declining to below 10x. The company reduced its debt burden to $7.2 billion as of June 2021 from $9.6 billion in June 2020 largely through debt repayment from asset sales. We expect an improvement in free operating cash flow to about $450 million in fiscal 2022 as the company benefits from its initiatives of better working capital management, significantly reducing excess and obsolete inventory, and realizes higher profitability. We also recognize that the company remains committed to identifying opportunities for potential asset dispositions to further streamline its portfolio, including the monetization of its 40% stake in Wella AG. The company has also commenced the process of a public listing of a portion of its stake in its Brazilian business. Management has reiterated that it will continue to prioritize debt reduction over shareholder returns until Coty's credit profile improves and we believe the company will continue to use all of its excess cash proceeds toward debt reduction, striving to reduce company-adjusted net leverage to 5x (equivalent to S&P Global Ratings-adjusted debt to EBITDA of about 7.5x) by the end of 2021.

However, we anticipate economic conditions to remain uncertain as the return to normalcy and improvements in consumer mobility vary amid renewed concerns about the spread of COVID-19 variants, which could curb consumers' recent spending on cosmetics and fragrances. Additionally, inflationary pressures could pressure margins more than we expect. These challenges pose risks to the sustainability of the company's recent operating trends and could lengthen the recovery of company's credit metrics.

We expect the company's covenant headroom to improve but remain tight. Coty amended its credit agreement in March 2020, including obtaining a waiver on its leverage covenants for its fiscal third-quarter 2020 (ended March 31, 2020) through its fiscal third-quarter 2021. Subsequently, the company's maximum net leverage ratio covenant was applicable in the fourth fiscal quarter of fiscal 2021. We estimate that the company had minimal cushion (less than 5%) under its maximum permitted leverage covenant of 5.25x. Although the covenant steps down to 5x in March 2022 and 4.75x in June 2022, the company expects covenant headroom to improve to 15%-20% range over the next 12 months. We expect the company to prudently manage its cash flow for additional debt repayment and forecast that the covenant headroom will improve--but remain tight under 15%. The company has strong relationships with its banks, and we believe it would likely be able to secure covenant relief if the company experiences material declines in its profitability. This could occur if the demand for the company's products remains weak or if the company encounters some operational missteps while continuing to execute its transformation plan.

Coty's transformation plan and simplification efforts improved its products and cost structure, albeit execution risks remain. Coty embarked on various large restructuring initiatives in the past few years to reduce its cost structure. The company has sold assets to reduce its debt burden including its sale of a 60% stake in Wella AG to KKR in 2020, significantly reduced its stock-keeping units (SKU) count and packaging formats, streamlined its brand portfolio, closed manufacturing facilities, reduced headcount, repurposed its marketing investments, and integrated the remaining businesses it acquired from the Procter & Gamble Co. in 2016. Coty has reduced its material costs significantly and improved operating productivity. The cleaner portfolio also makes it easier for management to better plan for demand and manage inventory and reduce excess and obsolete inventory. In addition, the company has expanded into the e-commerce channel, leveraged the social media platform, and strengthened its position in the fast-growing Chinese beauty and skincare market.

The benefits from these initiatives have resulted in a significant improvement in Coty's profitability with the company achieving S&P Global Ratings-adjusted EBITDA margin of 14.1% in fiscal 2021. However, we believe the company's profitability was depressed due to lower fixed-cost absorption on lower volumes because of the COVID-19 pandemic and restructuring costs associated with the company's turnaround actions. We expect EBITDA margins to further improve to about 16% in fiscal 2022.

The company's transformation strategy remains underway and we expect the company to incur incremental restructuring costs of about $200 million over the next two years. We also recognize that there are inherent risks associated with the continued execution of the turnaround plan.

We expect Coty will increase its revenues and profitability in fiscal 2022. Coty posted 90% sales growth in the fourth quarter of fiscal 2021 as it lapped its hardest-hit quarter from the pandemic but it still remains 30% below 2019 levels for the same period on a proforma basis. The company's prestige brands portfolio grew by 160% compared to the same period in fiscal 2020 (24% lower than 2019 levels for the same period) driven by strong prestige fragrance demand in the U.S. and China and continued expansion of the company's prestige cosmetics footprint. The company's mass beauty segment performance remained below our expectations with sales increasing by 44.4% in the fourth quarter of fiscal 2021, but remaining 35% below 2019 levels for the same period. We believe the new management has better positioned the company's product portfolio to expand. The company has significantly reduced its prestige brands' exposure to low-quality sales channels and expanded its presence in fast-growing prestige skincare and cosmetics categories. The company introduced several product innovations focused on clean and sustainable ingredients. We believe these trends will continue in fiscal 2022 and expect revenue and profitability to continue to improve, albeit at a slower pace. We revised our base-case forecast and expect low-teens-percentage sales growth and S&P Global Ratings-adjusted EBITDA of about $840 million for fiscal 2022 compared to $655 million in fiscal 2021.

Outlook

The negative outlook reflects the risk of a lower rating over the next 12 months if Coty's capital structure becomes unsustainable. This could occur if the company is unable to refinance its upcoming debt maturities before they become current or if leverage remains elevated and there is minimal cushion under the company's covenants.

Downside scenario

We could lower our ratings on Coty if we believe the company's capital structure will become unsustainable or it will face a liquidity crisis because it cannot refinance its 2023 debt maturities before becoming current in April 2022. We believe this could occur if:

- 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
- A worsening macro environment, heightened competition, higher inflation, additional restructuring charges, or an operational misstep stall sales and profit recovery prospects.

Upside scenario

We could revise the outlook to stable if we are confident it can refinance its 2023 debt maturities before they become current in early 2022. In addition, an outlook revision to stable would require the company to:

- Continue to demonstrate progress in improving its profitability such that EBITDA margin improves to more than 15%;
- Sustain leverage below 10x; and
- Maintain at least 15% cushion under the covenants in its credit facility over the next 12 months.

Company Description

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

Our Base-Case Scenario

- S&P Global Ratings economists expect U.S. GDP will expand 6.7% in 2021 and 3.7% in 2022, Europe GDP will increase 4.6% in 2021 and 4.1% in 2022, and Asia-Pacific GDP will expand 6.7% in 2021 and 4.9% in 2022.
- Revenue increases about 13% in fiscal 2022 to $5.2 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.
- Capital expenditures (capex) of about $200 million annually over the next two years are mainly driven by maintenance capital spending requirements to support the higher sales volumes.
- Mandatory debt amortization of $23 million per year.
- Discretionary cash flow of about $450 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 mid-7x area in fiscal 2022, improving to 6x in 2023 (excluding preferred stock: 6.5x and low-5x area, respectively); and
- EBITDA interest coverage of about 2.7x in fiscal 2022, improving to the 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 4.2x 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 funds from operations of about $430 million over the next 12 months.

Principal liquidity uses:

- 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 asset-based loan revolving credit agreement and term loan agreement for the respective periods over the next 12 months. We estimate that the company had minimal cushion (less than 5%) under its maximum net leverage ratio covenant as of June 30, 2021. We expect the covenant headroom to improve but remain tight (less than 15%) 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 5x on March 31, 2022, 4.75x on June 30, 2022, 4.5x on Sept. 30, 2022, 4.25x on Dec. 31, 2022, and to 4x 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 comprises:

- 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 June 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 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 $5.7 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 $1.4 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 $5.7 billion by 5% to account for estimated bankruptcy administrative expenses. This results in a total net recovery value of about $5.4 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.

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: $1.4 billion
- Realization rate: 60%
- DAV: $1.4 billion
- Total gross recovery value: $5.7 billion
- Net recovery value for waterfall after administrative expenses (5%): $5.4 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: $3.9 billion
- Recovery expectation: 50%-70% (rounded estimate 50%)

All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating: B-/Negative/--

Business risk: Fair

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

Financial risk: Highly leveraged

- Cash flow/leverage: Highly leveraged

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: Hybrid Capital: Methodology And Assumptions, July 1, 2019
- General Criteria: Group Rating Methodology, 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
- 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
- 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	
Coty Inc.	
Issuer Credit Rating	B-/Negative/--
Issue-Level Ratings Affirmed; Recovery Ratings Unchanged	
Coty Inc.	
Senior Unsecured	B-
Recovery Rating	3(50%)

Issue-Level Ratings Affirmed; Recovery Expectations Revised

	To	From
Coty Inc.		
Coty B.V.		
Senior Secured	B	B
Recovery Rating	2(75%)	2(80%)

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.