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Research Update:

Beauty Company Coty Inc. Rating Raised To 'B+' On Improved Credit Metrics Due To Strategic Initiatives; Outlook Positive

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Rating Action Overview

- Coty Inc. continues to execute its strategic plans, resulting in better credit metrics. We forecast S&P Global Ratings-adjusted-leverage improving to 4.8x in 2022 and 4.5x in 2023, which is better than our previous forecast of low-5x in fiscal 2022 and below 5x in 2023.
- In addition, we expect the company to make voluntary debt repayments over the next few quarters from proposed transactions, thereby supporting further deleveraging.
- We raised our issuer credit rating to 'B+' from 'B'. We also raised the issue-level ratings on the company's senior secured debt to 'BB-' from 'B+' and on its senior unsecured debt to 'B+' from 'B'. The recovery ratings on the senior secured debt and the senior unsecured debt are '2' and '3', respectively.
- The positive outlook reflects that we could raise the rating over the coming quarters if the company achieves mid-single-digit revenue growth while maintaining its operating margins, demonstrating consistent operating performance.

Rating Action Rationale

Credit metrics have improved with debt reduction, and we expect leverage to remain below 5x in fiscal 2022 as the company makes progress toward its 2x-3.5x financial policy targets. Leverage for 12 months ended March 2022 fell to 4.7x after peaking in the double-digits during the pandemic. We forecast leverage to stay in the mid-4x range through the end of fiscal 2023 driven by debt repayment of about $400 million and supported by its financial policy. We expect Coty's management team to continue prioritizing debt reduction, with all potential excess cash proceeds from several real estate divestitures and applying distributions from its Wella stake to debt repayment, thus bringing leverage below 5x. The conversion of KKR's former convertible preferred shares into common equity has also reduced leverage, as we included the preferred balance in our debt calculation. The company has reiterated its target to reduce leverage below 3.5x (based on management's calculations, and approximately 4x S&P adjusted leverage depending on our adjustments) by the end of 2024 and its commitment to suspend shareholder distributions until it hits its targets.

Coty has addressed its former 2023 maturity wall, improving its overall liquidity position. In 2021 and 2022 Coty successfully tapped the capital markets to extend the 2023 maturities of about $3.2 billion of long-term debt and extend the maturity of its revolving credit facility. The 4% euro note due 2023 was repaid in April 2022, utilizing cash on the balance sheet. The revolver was reduced to $2 billion from $2.75 billion and its maturity was extended to 2025. The company's next maturities are about $1.5 billion of term loans and notes maturing in 2025 and $2.4 billion of notes maturing in 2026. The company has about $148 million cash on the balance sheet (after the euro note repayment), which we forecast will increase to $300 million at year end as it generates free operating cash flow in the fourth quarter.

Coty's growth in prestige cosmetics is fueling expansion and higher gross margins. Coty has continued to deliver on its strategic initiatives, with brand repositioning, reduced low-margin sales, increased portfolio premiumization, product innovations across both of its segments, and developments in digital. Coty's prestige segment has grown significantly over the past few quarters, driven by fragrance sales in Gucci Beauty, Chloe, Burberry, and Hugo Boss, as well as cosmetics sales in Gucci Beauty, Burberry, and Kylie Cosmetics. Total segment revenues for the third quarter ended March 31, 2022, grew 21% compared to the previous year. The company launched numerous product innovations in fragrances over the past few quarters including Gucci Flora Gorgeous Gardenia, Burberry Hero, Burberry Her EDT, and Hugo Boss The Scent Le Parfum. Additionally, on June 21, 2022, Coty, in partnership with Kim Kardashian, will launch SKKN BY KIM, a skincare collection offering cleansers, toners, exfoliators, and other facial creams.

Coty's Consumer Beauty Segment also has performed well over the past few quarters, with third-quarter revenues up 8% over the previous year, driven by demand in color cosmetics as consumers returned to social gatherings and to the office and restarted using mass fragrances and body care. In Europe, Rimmel, driven by its Kind & Free Cosmetics line, and Max Factor, driven by its cosmetics line, have both gained market share in the EMEA markets, especially via e-commerce. In the U.S., Sally Hansen, and Covergirl both recorded share gains for the quarter, despite challenging supply chain constraints with Covergirl's Lash Blast mascara. The company has continued to navigate the challenging inflationary environment, expanding gross margin in the third quarter of fiscal 2022 through cost savings initiatives and strategic marketing investments helping to fuel revenue and sell-out growth.

The company's recent strategic and operational initiatives should support sustained above-pre-pandemic profitability over the medium term. Given increased EBITDA margins due to its improved product mix and cost optimization initiatives, as well as our expectation of cash inflows through better working capital management, we expect Coty to generate annual free cash flow of $450 million-$500 million in fiscal 2022 and fiscal 2023. Our expectation for higher EBITDA is partly due to strong revenue growth and lower restructuring spend. Coty generated EBITDA margins of 21.6% in the third quarter of fiscal 2022, compared with negative 0.1% and 10.3% for the same period in 2021 and 2020, respectively, which were hampered by the pandemic onset and a pause in consumer spending on cosmetics.

The company has successfully navigated through the inflation and supply chain headwinds that have plagued the industry. Most of the company's freight is under contract over the next 12 months and doesn't depend on spot-based pricing. The company had secured these contracts in advance, which shielded it from significant freight headwinds. In addition, most of the company's inventory is manufactured locally within its various global markets, making transportation and logistics simpler. We do expect sustained inflationary pressures and supply chain bottlenecks to partially offset profitability gains through the remainder of the year. In addition, Coty announced it would continue to increase its marketing spend and reinvest proceeds from efficiency gains into its key strategic initiatives. However, we expect cost base optimization and other initiatives to boost EBITDA margins 50 basis points relative to fiscal 2019 over the medium term.

Outlook

The positive outlook reflects that we could raise the rating over the coming quarters.

Upside scenario

We could raise our rating on Coty if we believe the company will sustain leverage below 4.5x along with:

- Organic growth and a track record of retaining its market shares and improved cost structure;
- Executing its strategy of utilizing all excess cash proceeds, including from future asset sales and distributions from its stake in Wella for debt reduction; and
- Demonstrating conservative financial policies by not making large, debt-financed dividends or acquisitions.

Downside scenario

We could revise the outlook to stable on Coty if we expect adjusted leverage to approach 5x, which could occur due to:

- A revision to the company's asset sale plans that leads to lower-than-forecast debt reduction;
- An operational misstep, worse macro environment, heightened competition, higher inflation, or additional restructuring charges lead to underperformance; or
- A resurgence of COVID-19 variants causes increased mask-wearing or reimposition of restrictions on consumer mobility, weakening demand for the company's products and resulting in material organic revenue declines.

Company Description

Coty develops, manufactures, markets, and distributes fragrances, cosmetics, skin care and body care products worldwide. JAB Holding Co. is Coty's largest shareholder, with 55% ownership in the company as of March, 31, 2022.

Our Base-Case Scenario

- S&P Global Ratings economists expect U.S. GDP will expand 2.4% in calendar 2022 and 2.0% in calendar 2023, Europe GDP will increase 2.7% in calendar 2022 and 2.2% in calendar 2023, and China GDP will expand 4.2% in calendar 2022 and 5.3% in calendar 2023.
- Revenue increases about 16% in fiscal 2022 to $5.4 billion, backed by a rebound in overall

regional sales because of pent-up demand and successful product launches. For fiscal 2023, we expect a mid-single-digit sales increase amid a more normalized consumer environment.

- EBITDA margin improves to 21.6% in fiscal 2022 from 14.1% in 2021 on higher volumes, favorable mix, pricing actions, realization of benefits from the company's transformation plan, and lower restructuring charges. This is somewhat offset by reinstatement of employee bonuses and reinvestment into the company's operational priorities. We expect EBITDA margin in the following years to remain stable as we believe the company will reinvest its increased profitability to enhance marketing spend.
- Capital expenditures (capex) of about $200 million annually over the next two years, mainly driven by maintenance capital spending requirements to support the higher sales volumes.
- Free operating cash flow of $430 million-$460 million in fiscal 2022 and fiscal 2023, considerably above $123 million in fiscal 2021.
- Dividends of about $63 million in fiscal 2022 and $13 million in fiscal 2023.
- No share repurchases or acquisitions over the next 12 months.

Based on these assumptions, we project following metrics:

- Debt to EBITDA in the high-4x area in fiscal 2022, improving to the mid-4x area in fiscal 2023.
- EBITDA interest coverage in the low-4x area in fiscal 2022 and fiscal 2023.

Liquidity

We continue to assess Coty's liquidity as adequate despite our view that its sources will likely be at least 3.2x its uses over the next 12 months and remain positive even if EBITDA declines 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 the credit markets. However, given its high debt burden, we continue to believe the company will need to refinance if it experiences a high-impact, low probability event such as market turbulence or a material decline in market share that leads to margin erosion.

Principal liquidity sources:

- About $670 million cash as of March 31, 2022;
- Availability of $1.2 billion under the revolving credit facility due 2025; and
- Cash funds from operations of about $620 million over the next 12 months.

Principal liquidity uses:

- Debt maturities of $92 million, including 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

Covenants

Coty's credit agreement contains a maximum 4.75x total net leverage ratio maintenance financial covenant requirement through on June 30, 2022, stepping down to 4.50x on Sept. 30, 2022, 4.25x on Dec. 31, 2022, and to 4.00x March 31, 2023 through June 30, 2023. The company's credit agreement allows it to add back 36 months of forward cost savings and excludes some restructuring costs.

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 headroom over 20% over the next 12 months under our base-case forecast.

Issue Ratings - Recovery Analysis

Key analytical factors

The company's debt structure is composed of:

- A $2.0 billion revolving credit facility (with $0 outstanding as of March 31, 2022) maturing in April 2025;
- Term B facility with $1.3 billion outstanding as of March 31, 2022 maturing in April 2025;
- 2026 senior secured dollar notes with $900 million outstanding as of March 31, 2022, maturing in April 2026;
- 2026 senior secured euro notes with $793 million outstanding as of March 31, 2022, maturing in April 2026;
- 2029 senior secured notes with $500 million outstanding as of March 31, 2022, maturing in April 2029;
- 2026 senior unsecured dollar notes with $550 million outstanding as of March 31, 2022, maturing in April 2026; and
- 2026 senior unsecured euro notes with $283 million outstanding as of March 31, 2022, maturing in April 2026.

Both the term loan A (due in April 2023) and euro senior unsecured notes (due in April 2023) were repaid in fiscal 2022.

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's debt is incurred in the U.S. (except for 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 $5.39 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 $1.0 billion combined discrete asset value (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 $675 million that results in an estimate gross recovery value of $4.39 billion. To determine net recovery value available for distribution to creditors, we reduced our estimate of total gross recovery value of $5.39 billion 5% to account for estimated bankruptcy administrative expenses. This results in a total net recovery value of about $5.12 billion.

Simulated default assumptions

Our simulated default scenario contemplates a default in 2026, primarily due to missteps 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: $403 million (default year interest plus amortization)
- Maintenance capex: $137.5 million
- Default EBITDA proxy: $540 million
- Operational adjustment: $135.1 million (25% of preliminary emergence EBITDA)

Simplified waterfall

- Emergence EBITDA: $675 million
- Multiple: 6.5x
- Gross recovery value: $4.39 billion
- Gross asset value: $1.6 billion
- Realization rate: 60%
- DAV: $1.0 billion
- Total gross recovery value: $5.39 billion
- Net recovery value for waterfall after administrative expenses (5%): $5.12 billion

- Valuation split (obligor/nonobligors): 21%/55%/18%/6%
- Collateral for secured creditors: $1.09 billion
- First-lien claims: $5.4 billion
- --Recovery expectation: 70%-90%; rounded estimate: 80%
- Collateral for unsecured creditors: $1.9 billion
- Unsecured claims: $3.1 billion
- --Recovery expectation: 50%-70%; rounded estimate: 60%

Note: All debt amounts at default include six months accrued pre-petition interest.

Ratings Score Snapshot

Issuer credit rating: B+/Positive/--

Business risk: Fair

- Industry risk: Low
- Country 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 impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

The negative one notch comparable rating analysis modifier indicates our view that Coty has a short operating track-record of good operating performance.

ESG credit indicators: E-2, S-2, G-2

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

Upgraded; Outlook Action

	To	From
Coty Inc.		
Issuer Credit Rating	B+/Positive/--	B/Stable/--
Issue-Level Ratings Raised; Recovery Expectations Revised		
Coty Inc.		
Coty B.V.		
Senior Secured	BB-	B+
Recovery Rating	2(80%)	2(85%)
Coty Inc.		
Senior Unsecured	B+	B
Recovery Rating	3(60%)	3(55%)
Issue-Level Ratings Raised; Recovery Ratings Unchanged		
Coty Inc.		
Senior Secured	BB-	B+
Recovery Rating	2(80%)	2(80%)