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Research Update:

Coty Inc. Upgraded To 'BB-' On Continued Deleveraging, Outlook Stable

February 13, 2023

Rating Action Overview

- Coty Inc. continues to deleverage by paying down debt and expanding its EBITDA, which has caused its S&P Global Ratings-adjusted leverage to improve to the high-4x area for the 12 months ended Dec. 31, 2022.
- We expect the company will continue to increase its top-line revenue and EBITDA supported by continued momentum in both its prestige and consumer beauty divisions. Therefore, we forecast it will further improve its S&P Global Ratings-adjusted leverage to the mid-4x area by the end of fiscal year 2023.
- We raised our issuer credit rating on Coty to 'BB-' from 'B+', our issue-level rating on its senior secured debt to 'BB' from 'BB-', and our issue-level rating on its senior unsecured debt to 'BB-' from 'B+'. Our '2' recovery rating on the senior secured debt and our '3' recovery rating on the senior unsecured debt are unchanged.
- The stable outlook reflects our expectation the company will continue to expand its topline and profitability over the next year and use free operating cash flow to pay down debt such that its S&P Global Ratings-adjusted leverage declines to the mid-4x area by the end of fiscal year 2023 and to about 4x by the end of fiscal year 2024.

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Rating Action Rationale

The upgrade reflects the company's improved credit metrics, supported by its EBITDA growth and debt reduction, as well as our expectation it will further improve its leverage to the mid-4x area or below over the next year. Coty's second-quarter performance exceeded our expectations despite industry-wide constraints on the availability of key fragrance components. Beauty demand remains robust, supported by good momentum across the prestige and consumer beauty segment and across all regions and key categories, including fragrance, cosmetics, and bodycare. The company's prestige sales rose by the high-single digit percent area in the first half of fiscal year 2023 due to the success of its product innovation and consumers' return to travel retail. The consumer beauty business expanded by 10% year over year in the first half of fiscal year 2023 on market share gains and higher prices. Coty's S&P Global Ratings-adjusted EBITDA for the 12 months ended Dec. 31, 2022, increased by 5% year over year due to an expansion in its gross margin stemming from management's pricing execution in both its prestige and consumer beauty segments, supply chain improvements, and improved trade spending. Given these dynamics, the company's S&P Global Ratings-adjusted leverage for the 12 months ended Dec. 31, 2022, improved to the high-4x area from 5.4x as of the end of fiscal year 2022 (ended June 2022).

We expect the company will maintain the good momentum in both its prestige and consumer beauty businesses throughout this year as its service levels improve due to the easing of ongoing component shortages. We forecast Coty will expand its EBITDA margin on supportive pricing, cost savings, and trade investment optimization, which will be partially offset by some inflationary headwinds. Therefore, we forecast its S&P Global Ratings-adjusted leverage will improve to the mid-4x area by the end of fiscal year 2023.

Coty is focused on deleveraging toward its mid- to long-term target of 2.0x-3.5x. The company has a mid- to long-term target leverage ratio of 2.0x-3.5x based on management's calculations, which is roughly equivalent to S&P Global Ratings-adjusted leverage about 2.7x-4.2x. The company is making progress toward its target range, with company-defined leverage as of the quarter ended Dec. 31, 2022, of about 4x, and continues to target leverage in the 3x area for the end of calendar year 2023. Coty is focused on deleveraging to this target range before resuming distributions to its shareholders or repurchasing shares. Therefore, we expect management will continue to prioritize debt reduction, by using all of its free operating cash flow and asset sale proceeds for debt repayment, until it reaches its defined target leverage range. Additionally, the company currently owns a 25.9% stake in Wella, which has a book value of $1 billion. The company plans to sell its stake in this asset by calendar 2025 and will use the proceeds for debt reduction, which will help it reach its target range faster. Note that our forecast does not currently include Wella's monetization, though we believe Coty will not monetize the asset in the near-term given its good liquidity position and positive growth trajectory.

Coty continues to execute across all strategic growth pillars. The company has continued to deliver on its strategic initiatives, including its brand repositionings, increased portfolio premiumization, product innovations across both prestige and consumer beauty, and digital developments. In consumer beauty, Coty delivered market share gains over the past year due to the repositioning of its brands, which has supported a mid- to high-single digit percent increase in its revenue (faster than the mid-single digit percent pace in its consumer beauty marketing). In the prestige business, it continues to expand the fragrance category and premiumize its portfolio through premium launches, such as Burberry Hero and Her, Gucci Flora Gorgeous Jasmine and Gorgeous Gardenia, and Boss Bottled Parfum and Chloe Atelier des Fleurs. The fragrance market continues to grow at the high-single-digit percent pace in both North America and Europe, exceeding the historical low- to mid-single digit percent rate. Coty's prestige makeup sales in the U.S. are expanding at almost 3x the speed of the broader market, fueled by its launches of new Gucci and Kylie products. The company also has plans to accelerate its skincare business, including the upcoming launch of Lancaster's ultra-premium skincare line Ligne Princiere in China. The company's travel retail revenue rose by about 40% year over year in the first half of fiscal year 2023 and we expect global travel will continue to recover from the pandemic.

Outlook

The stable outlook reflects our expectation Coty will continue to expand its topline and profitability and use its free operating cash flow to pay down debt over the next year such that its S&P Global

Ratings-adjusted leverage declines to the mid-4x area by the end of fiscal year 2023 and to about 4x by the end of fiscal year 2024.

Upside scenario

We could raise our ratings if we believed the company would sustain leverage below 4x along with:

- Sustained organic growth and market share gains combined with improved cost structure leading to EBITDA margin improvement;
- Continuing to execute its strategy of utilizing all excess cash proceeds from future asset sales for debt reduction; and
- It demonstrates conservative financial policies by refraining from large, debt-financed dividends or acquisitions.

Downside scenario

We could lower our ratings on Coty if its operating performance starts to deteriorate and we expect adjusted leverage to sustain above 5x, which could occur due to:

- A worsening macroeconomic environment, heightened competition, an operational misstep, higher inflation, or consumer trade down, which lead to lower demand for the company's products; or
- The company pursues a more aggressive financial policy that entails debt-funded share repurchases and acquisitions.

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 53% stake in the company as of Dec. 31, 2022.

Our Base-Case Scenario

- S&P Global economists expect U.S. GDP will contract by 0.1% in calendar 2023 and expand by 1.4% in calendar year 2024, Europe GDP will increase by 0.5% in calendar year 2023 and 2.0% in calendar year 2024, and Chinese GDP will expand by 4.8% in calendar year 2023 and 4.7% in calendar year 2024;
- Revenue increases by about the mid-single digit percent range in both fiscal years 2023 and 2024 because of good momentum across the prestige and consumer beauty segments and across all regions and key categories, including fragrance, cosmetics, and bodycare;
- EBITDA margin improves by 30 basis points in fiscal year 2023 on higher volumes, a favorable product mix, pricing actions and cost-savings initiatives, and trade investment optimization, which are partially offset by inflationary headwinds. EBITDA margin remains stable at similar levels in fiscal year 2024 because we believe it will reinvest its increased profitability in enhanced marketing;
- Capital expenditure (capex) of about $200 million annually over the next two years, mainly due

to maintenance capital spending requirements to support its higher sales volumes;

- Free operating cash flow in the $580 million range in fiscal year 2023; and
- Share repurchases of about $200 million in fiscal year 2024 after the company reaches its target leverage range.

Based on these assumptions, we project following metrics:

- Debt to EBITDA in the mid-4x area in fiscal year 2023, improving to about the 4x area in fiscal year 2024; and
- EBITDA interest coverage in the low-4x area in fiscal years 2023 and 2024.

Liquidity

We continue to assess Coty's liquidity as adequate despite our view that its sources will likely be at least 3x its uses over the next 12 months and remain positive even if its EBITDA declines by 30%. We believe the company has well-established and solid relationships with its banks--demonstrated by its ability to secure large, committed credit facilities--and a satisfactory standing in the credit markets. However, we continue to believe it will need to refinance if it experiences a high-impact, low-probability event (such as severe market turbulence, sovereign risk, or the activation of materially adverse change clauses).

Principal liquidity sources:

- Cash of $280 million as of Dec. 31, 2022;
- Availability of $1.9 billion under the revolving credit facility due 2025; and
- Cash funds from operations of about $670 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; and

Covenants

Coty's credit agreements contain a maximum 4.75x total net leverage ratio maintenance financial covenant requirement through June 30, 2022, which steps down to 4.50x as of Sept. 30, 2022, 4.25x as of Dec. 31, 2022, and 4.00x as of 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 will remain in compliance with all of the applicable covenants under the asset-based lending (ABL) revolving credit agreement and term loan agreement over the next 12 months. We also expect the company will sustain sufficient headroom of about 20% under its covenants over the next 12 months.

Issue Ratings - Recovery Analysis

Key analytical factors

- The company's debt structure comprises a $2.0 billion revolving credit facility (with $75 million outstanding as of Dec 31, 2022) maturing in April 2025; a term loan B facility with $1.2 billion outstanding as of Dec. 31, 2022, maturing in April 2025; 2026 senior secured dollar notes with $900 million outstanding as of Dec. 31, 2022, maturing in April 2026; 2026 senior secured euro notes with $746 million outstanding as of Dec. 31, 2022, maturing in April 2026; 2029 senior secured notes with $500 million outstanding as of Dec. 31, 2022, maturing in January 2029; 2026 senior unsecured dollar notes with $473 million outstanding as of Dec. 31, 2022, maturing in April 2026; and 2026 senior unsecured euro notes with $192 million outstanding as of March 31, 2022, maturing in April 2026. It also has Brazilian credit facilities totaling $42.4 million outstanding as of Dec. 31, 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 a perfected first-priority security interest in substantially all of the 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 by Coty's direct and indirect wholly-owned domestic subsidiaries (U.S. and euro notes cross-guaranteed).
- 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. However, in such a case, it would add complexity to the administration of the bankruptcy and 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 geographic diversity.
- We estimate $5.13 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 stake in Wella as well as by applying an EBITDA multiple to our measure of the company's distressed emergence EBITDA under our hypothetical default scenario. Our analysis considers a 60% realization rate on the company's investment in Wella, resulting in a $700 million discrete asset value (DAV) at default. We have valued the company's base business, which includes its 51% ownership in Kylie, based on an enterprise value approach and applied a 6.5x multiple on to an assumed distressed emergence EBITDA of $681 million, which results in an estimated gross recovery value of $4.4 billion. To determine the net recovery value available for distribution to creditors, we reduced our estimated total gross recovery value of $5.13 billion by 5% to account for estimated bankruptcy administrative expenses. This results in a total net recovery value of about $4.87 billion.

Simulated default assumptions

- Our simulated default scenario contemplates a default occurring in 2027 primarily due to a steep decline in the demand for the company's products or operational missteps. We believe that in a distressed situation, the funds from the company's operations would not be adequate to support its interest burden and cash needs.

- Debt service: $372.1 million (default year interest plus amortization)
- Maintenance capital expenditure: $132.6 million
- Default EBITDA proxy: $540.7 million
- Operational adjustment: $176.7 million (35% of preliminary emergence EBITDA)

Simplified waterfall

- Emergence EBITDA: $681.4 million
- Multiple: 6.5x
- Gross recovery value: $4.4 billion
- Gross asset value: $1.1 billion
- Realization rate: 60%
- DAV: $699 million
- Total gross recovery value: $5.13 billion
- Net recovery value for waterfall after administrative expenses (5%): $4.87 billion
- Valuation split (obligor/nonobligors): 30.2%/56.1%/13.6%
- Collateral for secured creditors: $3.2 billion
- First-lien claims: $5.1 billion
- --Recovery expectations: 70%-90% (rounded estimate: 85%)
- Collateral for unsecured creditors: $1.6 billion
- Unsecured claims: $2.6 billion
- --Recovery expectations: 50%-70% (rounded estimate: 60%)

Note: All debt amounts at default include six months of accrued prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating: BB-/Stable/--

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: Neutral

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

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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
- 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

Upgraded; Outlook Action

	To	From
Coty Inc.		
Issuer Credit Rating	BB-/Stable/--	B+/Positive/--

Issue-Level Ratings Raised; Recovery Expectations Revised		
Coty Inc.		
Coty B.V.		
Senior Secured	**BB**	**BB-**
Recovery Rating	2(85%)	2(80%)
Issue-Level Ratings Affirmed; Recovery Ratings Unchanged		
Coty Inc.		
Senior Unsecured	**BB-**	**B+**
Recovery Rating	3(60%)	3(60%)

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.