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ISSUER IN-DEPTH
28 October 2021

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RATINGS

**Coty Inc.**

| | |
|---|---|
| Domicile | United States |
| Long Term Rating | B2 |
| Type | LT Corporate Family Ratings |
| Outlook | Stable |

KEY METRICS:

**Coty Inc.**

| | 6/30/2019 | 6/30/2020 | 6/30/2021 |
|---|---|---|---|
| Debt/ EBITDA | 7.4x | 21.9x | 7.1x |
| EBITA margin | 8.4% | -3.4% | 10.0% |
| RCF/Net Debt | 6.6% | -2.9% | 8.8% |

*Source: Moody's Financial Metrics*

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# Coty Inc

## Rebounding beauty demand will help provide earnings face-lift, further debt reduction

» **Adding fragrance to earnings as self-care returns**. Growing demand for beauty products, especially luxury lines, will provide an important boost for Coty Inc. (B2 stable), which is in the throes of a four-year turnaround through 2025. New management has been spearheading relaunches and line extensions into luxury and mass beauty and is tapping into a period of resurgent demand, with estimates calling for the global luxury beauty market to hit $173.6 billion by 2025 from $139.8 billion in 2019.

» **Luxury revival is central to earnings growth**. Coty's biggest opportunity to improve earnings and long-term growth is growing the luxury business, which used to contribute about 40% to revenue and has increased to about 60%. Coty's consumer beauty business, at 40% of sales, has struggled over the past few years – especially during the height of the pandemic in 2020, when significant numbers of people stayed at home. The focus on its luxury beauty business languished as Coty focused on building the mass beauty business with a number of largely unsuccessful, expensive acquisitions.

» **Increased focus on new products, travel.** The beauty revival is giving fresh life to some of Coty's biggest brands such as Burberry perfumes and Lancaster skin care. Coty is also rolling out new fragrances and color cosmetics, a critical part of its offering and existing brands such as CoverGirl have been gaining market share as the company focuses more on Gen Z consumers. Travel retail will also play a key role in growth, with an emphasis on China, which is one of the fastest-growing international markets for luxury cosmetics.

» **Product launches will support earnings, free cash flow growth**. High sales from new product introductions within the luxury portfolio and deeper penetration in luxury skin care will support Coty's earnings growth. Solid earnings will drive good annual free cash flow of $350-$400 million (after $50 million of cash preferred dividends and $200 million of capex), compared to $119 million in the June 2021 fiscal year - factors that supported the recent CFR upgrade to B2. Free cash flow in fiscal 2022 will include a significant $325 million estimated working capital improvement, driven by reduced inventory.

» **Stronger liquidity will be key for supporting turnaround runway**. Coty should continue to have capital market access, allowing the company to further push out debt maturities by repaying debt and refinancing. This will improve liquidity and provide the company with its much-needed runway to execute its turnaround strategy through 2025. The company's below 5.0x publicly stated leverage target is positive even though we believe that the company's focus on de-leveraging is partially motivated by a desire to restore the common stock dividend, which would weaken free cash flow.

## Adding fragrance to earnings as self-care returns

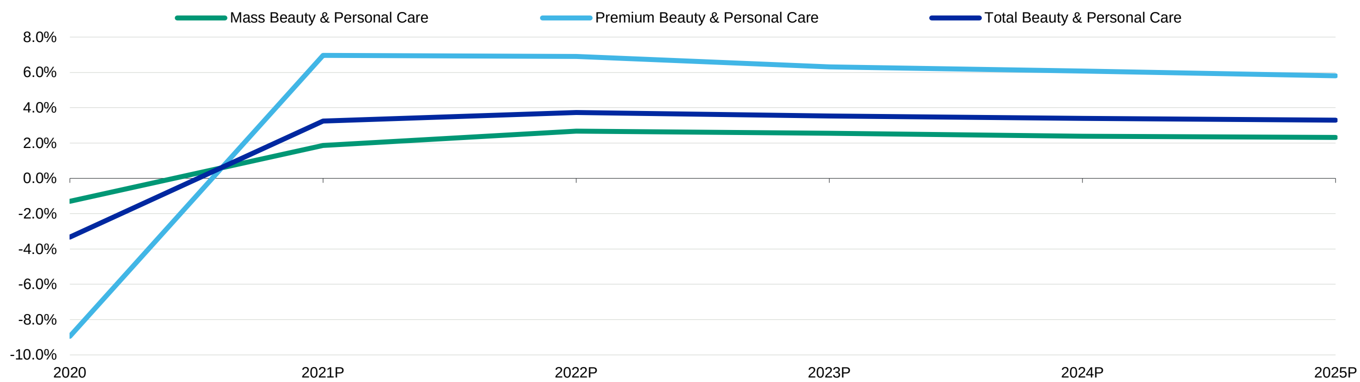
The global beauty market is staggering back to life just as Coty – battered by a litany of troubled acquisitions, strategic misfires and heavy leverage – is reaching an inflection point as it looks to secure long-term growth momentum. As vaccinations gain greater traction in the US and consumers start returning to offices and traveling again, demand for beauty will continue to strengthen as consumers reinstate their everyday beauty rituals and act on strong pent up demand to travel.

Growing demand for beauty products — especially luxury lines – will provide an important top-line boost for Coty, which is in the throes of a four-year turnaround through 2025. Coty's new management team, led by Sue Nabi, has been spearheading relaunches and line extensions into luxury and mass beauty. The global luxury premium beauty market will reach $173.6 billion by 2025 from $139.8 billion in 2019, according to Euromonitor, growing at a CAGR of 3% over the next six years. This compares to a CAGR of 1.5% for mass beauty and 2% of the entire beauty market.

Exhibit 1

**Growth in total beauty market size set to outpace mass beauty but lag premium beauty**

**World Market Size year-over-year growth**



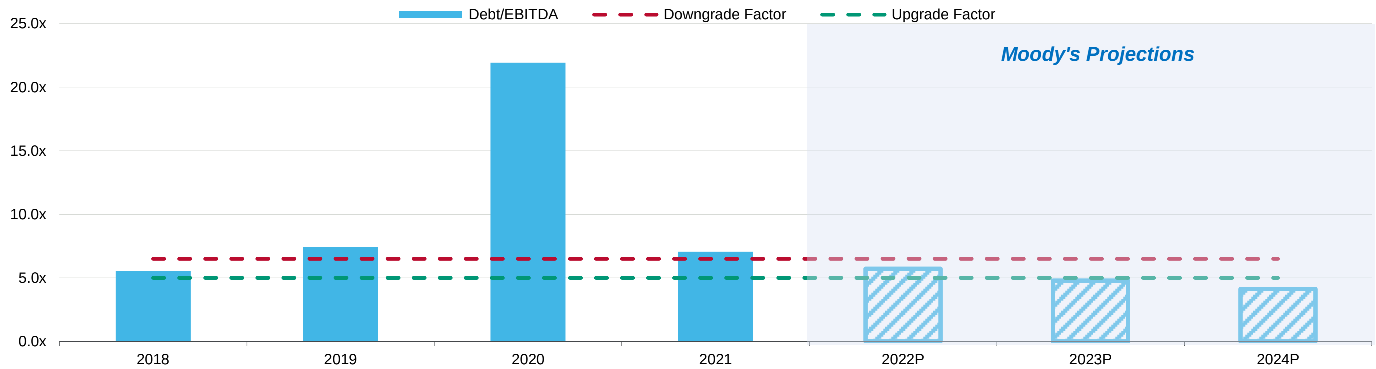

*Source: Euromonitor*

The company's restructuring plans include turning around its Consumer Beauty business (40% of sales), which has struggled over the last few years. This segment took a hit as consumers started staying home as the pandemic took hold in early 2020. We expect Coty to focus more on reasserting the importance of luxury beauty – especially skin care, where it plans to double prestige skin care sales to 10%. Recent luxury skin care relaunches have included premium brand Lancaster and entry skin care brand, Kylie. The company relaunched Gucci Beauty color cosmetics in April 2021 and plans to launch Kim Kardashian's SKKN, a premium skin care line, sometime in the future. Coty is also relaunching CoverGirl and Rimmel and introducing new products from Max Factor, which all occurred earlier this year to some success.

While many of these initiatives are still fairly recent, the company is clearly on a recovery roll – having sliced its debt/EBITDA from a stratospheric 21.9x to 7.1x in the past year (Exhibit 2). We believe Coty is well positioned to build longer-term earnings momentum and continue reducing leverage under CEO Sue Y. Nabi, a seasoned veteran of L'Oreal who has been steering the company's six-step turnaround plan. Over the next 12 to 18 months, we expect leverage to improve by about 1.5x to about 5.5x debt-to-EBITDA through debt repayment and earnings growth. Debt repayment will reflect good free cash flow, potential asset sales and some 1 billion reais ($190 million) in proceeds from the August 2021 IPO filing of its Brazilian Unit. Overall, we expect the company to repay between $500 million and $700 million of debt over the next 12-18 months.

Coty's operational turnaround thus far and progress at chipping away at its upcoming debt maturities were key drivers in upgrading its Corporate Family Rating to B2 in September, and we believe that the company's business profile could support a higher rating. Coty's ratings could be further upgraded if the company successfully refinances its remaining debt due 2023 in a timely manner, and improves liquidity overall. Coty would also need to reduce financial leverage such that debt to EBITDA approaches 5.0x. We estimate that the company could be positioned for further upgrade in about 12-18 months if the company maintains good execution and if leverage and free cash flow improve.

Exhibit 2
**Debt/EBITDA will improve with earnings growth and debt repayment**




Note: All figures and ratios are calculated using Moody's estimates and standard adjustments. Moody's Forecasts (f) or Projections (proj.) are Moody's opinion and do not represent the views of the issuer. Periods are Financial Year-End unless indicated. Last 12 months = Last Twelve Months; Fiscal year ends in June
*Source: Moody's Financial Metrics™; Moody's estimates*

## Luxury revival is central to future growth plans

But getting there will not be easy. Coty is looking to stabilize its mass beauty business – a critical part of its turnaround plan – and to revive its traditionally more lucrative luxury beauty business in a crowded field of successful competitors such as LVMH's Fenty Beauty, L'Oreal's Lancome and Estee Lauder. Many of these luxury brands are also feeling pain from competition arising from lower-priced premium indie brands that may offer comparable quality products without the high price tag. That means many consumers with the budget to afford higher priced brands continue to trade down to brands, such as Unilever's Paula's Choice, Drmtlgy, Estee Lauder's DECIEM brands or the Sephora brand, which all cost less.

In addition, a high percentage of Coty's brands are licensed, and we generally view the licensing model to be weaker than one where companies actually own the brand. This reflects the possibility for diverging views developing between the licensee and licensor, the need to renew licenses at economic commercial terms, and strategic uncertainty regarding investment returns if licenses do not have long terms. High license concentration also renders the company more susceptible to shifts in strategies or reputation of the brands, related to actions of either the brand's owner or other licensees. On the other hand, a well-executed brand licensing program can take the brand into new categories where it has no expertise, open new distribution channels that would otherwise not be available to it and reach new customers. Coty has an extensive portfolio of licenses in popular high-end fragrances, skincare and makeup.

We believe Coty's biggest opportunity to improve its earnings and long-term growth recovery is dependent on how well it continues to grow its luxury business, which used to contribute about 40% to revenue and has increased to about 60%. This is in part because of the sale of a 60% stake in its Wella business in 2020 and the relaunch of new brands. Coty produces some of the world's most popular luxury fragrances, skin care products and color cosmetics on behalf of other well-known brands, such as Tiffany, Burberry and Gucci. Coty is particularly well placed to further strengthen its luxury fragrance portfolio.

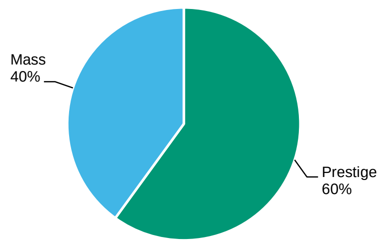
How quickly Coty will continue to stabilize its consumer beauty business is also key to the turnaround strategy. Coty's consumer beauty business, at 40% of sales, has struggled over the past few years – especially during the height of the pandemic in 2020, when significant numbers of people stayed at home. Prior to the pandemic, Coty failed to differentiate its brands in the crowded aisles of the mass channels where its products are sold, which negatively impacted demand, operating earnings and cash flow. Nonetheless, Coty is making progress is relaunching and repositioning a number of its mass brands. For instance, Coty recently relaunched its CoverGirl brand with some initial success. Coty secured 90s supermodel Niki Taylor to return as the face of CoverGirl, after more than 20 years. This updated strategy supports the new "skinification" trend in color cosmetics, which reflects skin care powered makeup. Coty has plans to elevate its "skin care powered makeup" franchise going forward.

The focus on its luxury beauty business – which accounts for 60% of sales and meaningfully higher profit margins than other parts of its business – languished as Coty focused on building the mass beauty business with a number of largely unsuccessful, expensive acquisitions (eg. P&G Beauty and Younique).

Exhibit 3

**Revenue Breakdown by Channel**

**For the fiscal year ended June 30, 2021**




Note: Excludes corporate

*Source: Company filings*

By fiscal 2025, Coty says its skincare business will make up more than 10% of revenue, up from about 6% now while prestige cosmetics will increase to a high-single digit percent of revenue from about 3%, and China's contribution will make up more than 10%, or triple current levels. Coty's restructuring of its consumer beauty and fragrance businesses will include work force and product offering reductions and efficiency improvements. Coty will spend $400 million through 2023 on its turnaround plan.

The company expanded its Gucci color cosmetics earlier this year and is tapping stronger demand for its fragrance products as consumers focus on self-care. This strategy, combined with a continued focus on costs, will improve Coty's earnings.

**Coty's turnaround plan**

Stabilize consumer beauty brands and mass fragrances

Accelerate luxury fragrances and become a key player in prestige makeup

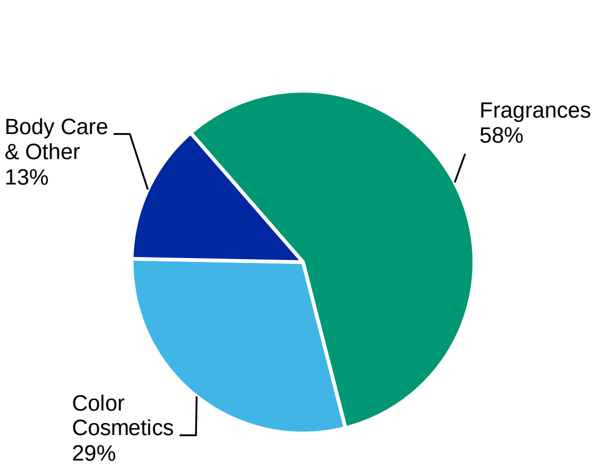
Build skin care portfolio across both divisions

Build e-commerce and direct to consumer expertise and capabilities

Expand in China on luxury and select consumer beauty brands

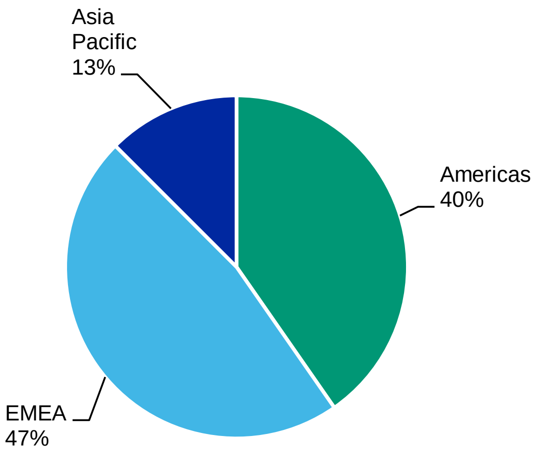
Become a beauty leader in sustainability

Exhibit 4
**Revenue by Segment**
For the fiscal year ended June 30, 2021




*Source: Company filings*

Exhibit 5
**Revenue by Geography**
For the fiscal year ended June 30, 2021




*Source: Company filings*

Exhibit 6
**Coty's Brands and Price Points**


*Source: Company presentation*

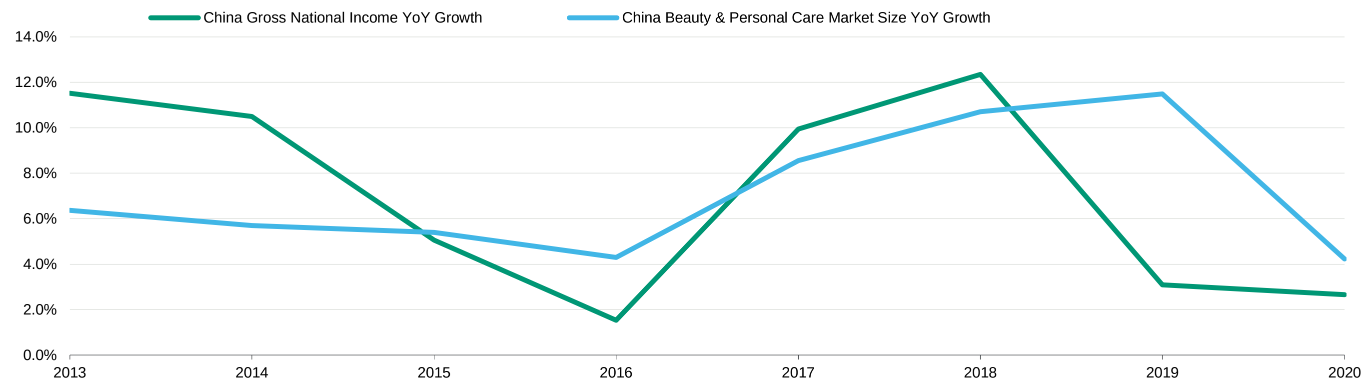
## Increased focus on new products, travel

Despite the challenges, Coty's turnaround timing couldn't be better. The pandemic is finally easing and pent-up consumers are out again shopping for beauty supplies as they return to offices and resume traveling – giving fresh life to some of Coty's biggest brands such as Burberry perfumes and Lancaster skin care. The company is also rolling out new fragrances, a critical part of Coty's offering, including Burberry Hero and Calvin Klein Defy. The company's cosmetics brand CoverGirl, also gained market share for three consecutive months between April and June for the first time in five years as it has focused more on Gen Z consumers.

Travel retail is one of the company's top six turnaround themes, with an emphasis on China, which is one of the fastest-growing international markets for luxury cosmetics. China has been a key growth market, reflecting the consumers' growing disposable income combined with their love of luxury. The company said this April that by 2025, it will double sales from travel retail from about 7% today and double sales generated from China to 10%.

Exhibit 7

**We expect growth in the Chinese beauty & personal care market to continue to mirror growth in income**




*Source: Euromonitor, World Bank*

## Product launches will be key to earnings, free cash flow growth

Coty's earnings growth will be supported by high sales from new product introductions within the company's luxury portfolio and deeper penetration in luxury skin care. Solid earnings will drive good free cash flow of about $350 million to $400 million per annum after cash preferred dividends of about $50 million. This is an improvement in free cash flow compared to $119 million in fiscal 2021 ending June 30th. Free cash flow in fiscal 2022 will include significant working capital improvement, driven by reduced inventory levels.

Coty will continue to face risks associated with its significant reliance on revenue from the color cosmetics and fragrance categories, which tend to be volatile and vulnerable to fashion risk. We expect more volatility in these beauty categories than in other consumer packaged goods sectors. To generate growth, Coty will have to continually reinvest and launch successful new products given its exposure to fashion-driven fragrance (especially designer brands) and color cosmetic products. Succeeding in an industry with high fashion risk requires continual investment in product development and brand support to sustain market share.

Coty is also pursuing other paths to improve operating cash flow. The focus on de-leveraging is beneficial for credit quality, but we believe that the company is partially motivated by a desire to restore the common stock dividend, which was suspended in May 2020. KKR's recent partial conversion of preferred stock into common stock will reduce a potential future claim on Coty's cash flow. The conversion reduces cash dividend requirements by approximately $30 million annually. However, because the company has not been paying the preferred stock dividends in cash until the fiscal fourth quarter, the boost to free cash flow relative to fiscal year 2021 is negligible. The company's preferred dividends will be further reduced by an additional $26 million following Coty's recently announced exchange with KKR. On October 1, 2021, Coty announced that it would exchange 9% of its 40% stake in Wella to KKR in return for roughly 312 million of KKR's outstanding convertible preferred shares and accrued dividends of about $26 million. However, this deal reduces Coty's stake in Wella to about 30.6% and reduces an asset to repurchase stock that could otherwise be used to repay debt or fund investments in earning assets. Coty is currently restricted from paying common dividends until all accrued dividends of the convertible preferred equity have been declared and paid in cash. The company has accrued unpaid preferred dividends of about $74.1

million. Coty is also restricted from making common dividend payments if net debt to EBITDA is above 4.75x. Although we do not expect Coty's common dividend payment to return to historical levels, reinstatement of the dividend would weaken free cash flow. We believe that Coty will restart the dividend at a lower level and gradually increase the payout if operating performance improves. Included in the company's strategic update is an aggressive global cost reduction plan, which also carries high execution risks. The restructuring itself will be expensive. Coty expects to spend $400 million through 2023.

## Stronger liquidity key for supporting turnaround runway

We believe Coty has ready access to the capital markets, as demonstrated by its recent refinancing activities earlier this year. We believe the company will be successful in refinancing its significant 2023 debt maturities in a timely manner. This will allow the company to further push out its debt maturities by paying down debt and refinancing, which will improve liquidity and provide the company with its much-needed three- to four-year runway to turn the company around through 2025. We expect cash flow from operations less capex as a percentage of debt to meaningfully improve to about 10% over the next 12-18 months from roughly 2.5% in fiscal 2021 ending June 30, 2021. (Exhibit 9)

Exhibit 8
**Debt Capitalization**
**As of June 30, 2021**

| Debt Instrument | Amount Outstanding (USD Millions) | % Total |
|---|---|---|
| $2.05bn Revolving Credit Facility due April 2023 | $670 | 12.2% |
| $700mm Revolving Credit Facility due April 2025 | $0 | 0.0% |
| Term Loan A due April 2023 | $114 | 2.1% |
| Term Loan B due April 2025 | $1,462 | 26.7% |
| US Senior Unsecured Notes due April 2026 | $550 | 10.0% |
| Euro Senior Unsecured Notes due April 2023 | $655 | 11.9% |
| Euro Senior Unsecured Notes due April 2026 | $298 | 5.4% |
| US Senior Secured Notes due April 2026 | $900 | 16.4% |
| Euro Senior Secured Notes due April 2026 | $833 | 15.2% |
| **Total Debt** | **$5,481** | **100.0%** |

*Source: Company filings, Moody's Estimates*

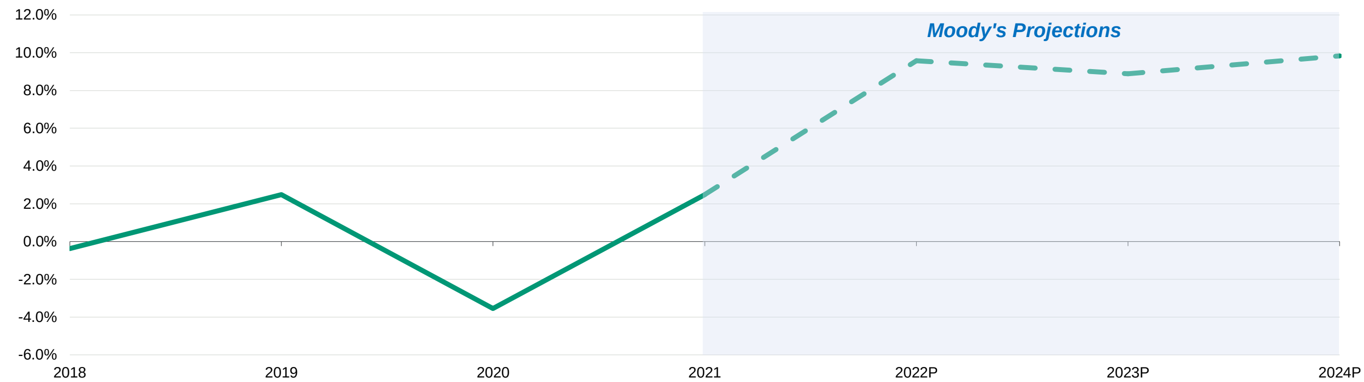
Over the next 12 months, we expect the company to generate free cash flow of about $350 million to $400 million, which is after capital expenditures of about $200 million and cash preferred dividends of about $50 million and includes working capital inflows of approximately $325 million. The company also has annual term loan amortization of about $22.5 million. Working capital inflows largely reflect inventory reductions. The company generally consumes cash from June to September and generates significant cash from October through December related to the heavy holiday sales season. As of June 30, 2021 Coty had $254 million of unrestricted balance sheet cash.

The company's $2.05 billion revolver expiring in 2023, $700 million revolver expiring in 2025 and the term loan A are subject to a maximum 5.25x total net leverage financial covenant with step downs. As of June 30, 2021, the company had about $2.08 billion available under its revolver. We estimate covenant leverage is approximately 5.1x as of June 2021. The covenant steps down to 5.0x in March 2022, 4.75x in June 2022, 4.50x in September 2022, 4.25x in December 2022 and 4.0x in March 2023 and thereafter. We project that the company will have weak headroom under the total net leverage covenant over the next 12 months. Coty will need to reduce leverage to meet the step downs, which creates reliance on a recovering economy, good execution and, potentially, identification of additional cost saving opportunities to avoid a covenant violation.

Exhibit 9

**We expect improved cash flow and reduced debt to improve CFO less CapEx-to-Debt**

**(CFO - CapEx)/Total Debt**

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*Source: Moody's Financial Metrics™; Moody's estimates*

## Moody's related publications

### Credit Opinion

» Coty Inc.: Update following upgrade to B2, 15 October 2021

### Rating Action

» Moody's upgrades Coty's CFR to B2; outlook stable, 21 September 2021

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

REPORT NUMBER 1302452

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