Research Update:

Coty Inc. Rating Lowered To 'B+'; Debt Ratings Lowered; Outlook Stable

July 11, 2019

Rating Action Overview

- New York-based cosmetics manufacturer Coty Inc. continues to have difficulty reviving its consumer beauty business, and announced a turnaround plan to improve sales and operating efficiency.
- The company will incur $600 million cash charges to implement its "Rediscover Growth" plan, which will weigh on EBITDA through fiscal 2023.
- We believe leverage will remain high at over 5x until fiscal 2022.
- We lowered our issuer credit rating on Coty and issue-level rating on its unsecured debt to 'B+' from 'BB-'. At the same time, we lowered our rating on the company's senior secured debt to 'BB-' from 'BB'. The recovery rating remains '2', indicating our expectation of substantial recovery (70%-90%; rounded estimate: 75%) in the event of a payment default. Subsidiary Coty B.V. is a co-borrower under the revolver. In our rating analysis, we view Coty Inc. and its operating subsidiaries as a group.
- We also lowered the rating on the senior unsecured debt to 'B+' from 'BB-'. The recovery rating remains '4', indicating our expectation for average recovery (30%-50%; rounded estimate: 35%) in the event of a payment default.
- The stable outlook reflects our belief that Coty's turnaround strategy will stabilize its consumer beauty business and that it will expand its luxury and professional beauty businesses. This confluence should enable the company to deleverage below 5.5x in fiscal 2021 and increase free cash flow to $725 million.

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Rating Action Rationale

The downgrade reflects Coty's significant debt burden, difficulty turning around its consumer beauty segment, and our belief that leverage will remain above 5x until fiscal 2022.

Coty's new management team recently announced a turnaround plan that will result in $600 million cash charges. Over the next four years, the company plans to reduce SKUs, improve the profitability of currently low-margin but strategic SKUs, shift consumer beauty's product mix to higher-margin premium products, increase research and development spending, improve the productivity of its supply chain, and be more targeted with its brand support. Coty is also flattening its organizational structure.

We believe Coty's progress in increasing its operating efficiency will be slow and uneven given its struggles integrating the beauty assets it acquired in October 2016 from Procter & Gamble and that the $600 million restructuring charge will weigh on EBITDA through fiscal 2023. In our view, it underestimated the complexity of the acquired business, was distracted by additional acquisitions, and poorly executed the consolidation of its supply chain. Its consumer beauty segment underperformed the most and lost significant market share

Therefore, we lowered our sales and EBITDA forecast, and now expect sales to decline 2.5% in fiscal 2020. Previously, we forecast sales would increase roughly 3% in fiscal 2020. We believe Coty's EBITDA margin will decline to 17.8% in fiscal 2020 from an estimated 18.4% in fiscal 2019 because of the restructuring charge. Previously, we forecast EBITDA margin would be almost 20% in fiscal 2020. Our financial leverage forecast for fiscal 2020 is now 6x, from below 5x.

Coty continues to have difficulty reviving its consumer beauty business and has significantly underperformed the market.

In fiscal 2019, the company's business was hindered by its poorly executed consolidation of its supply chain. This resulted in market share losses and the need to increase brand support to move products and maintain shelf space. Organic sales fell 10.4% in the first nine months of fiscal 2019, compared with 0.5% growth in the global mass beauty market. We believe it will be difficult to regain all of its share loss given intense competition from key competitor L'Oréal and from consumer-savvy independent brands.

Notwithstanding the struggles with its consumer beauty segment, Coty's luxury and professional beauty segments, which compose 60% of sales, remain healthy.

Its luxury business increased organic sales 4.4% in the first nine months of fiscal 2019, compared with 4.1% market growth for global luxury fragrances. Its professional beauty business was also affected by the disruption from its supply chain consolidation, but without the steep declines of the consumer beauty business. In its fiscal third quarter, organic sales declined 0.6% compared to a 2.6% decline in the first quarter. Generally the business generates 1%-2% organic sales growth.

The company holds the No. 1 position in the global fragrance market, with almost twice the market share of No. 2 L'Oreal. Coty is No. 2 in the professional hair salon category, in which its market share is about half that of L'Oreal but twice that of Henkel. We believe it could be difficult to take market share from L'Oreal and Henkel given their financial and marketing strength. However, Coty's salon business is significantly larger than Kao's, Estee Lauder's, Shiseido's, and Revlon's, and we believe it has the potential to gain share from these players.

Outlook

The stable outlook reflects our belief that Coty's turnaround strategy will stabilize its consumer beauty business primarily through favorable product mix over the next few years. In addition, we believe that it can expand its luxury and professional beauty businesses. That confluence should enable the company to deleverage below 5.5x in fiscal 2021 and increase free cash flow to $725 million.

Downside scenario

We could lower the rating if Coty does not effectively execute its "Rediscover Growth" turnaround strategy. It is broad, and there is risk that there will be missteps that could deteriorate credit metrics because of further market share losses, margin erosion, and additional restructuring charges. We could lower the rating if leverage exceeds 6.5x or if its covenant cushion falls below 10%.

Upside scenario

Although unlikely over the next year, we could raise the ratings if Coty stabilizes sales, expands its EBITDA margin close to 20%, and if we believe leverage will be sustained below 5x.

Company Description

Coty, together with its subsidiaries, manufactures, markets, distributes, and sells beauty products worldwide. It operates in three segments: luxury, consumer beauty, and professional beauty.

Our Base-Case Scenario

- Global GDP growth of 3.3% in 2019 and 3.6 in 2020.
- Organic sales growth declines an excess of 8% in fiscal 2019, well below GDP growth, because it cannot recapture all of the lost sales from the supply disruptions and needs to reposition its consumer beauty segment. In fiscal 2020, we forecast organic sales will decline 2.5% because of its plans to rationalize SKUs in the consumer beauty business.
- Adjusted EBITDA margin expands to approximately 18% in fiscal 2019 from 16.3% in fiscal 2018 because of synergies and cost-saving initiatives. It contracts to 17.8% in fiscal 2020 because of the restructuring costs.
- Free operating cash flow of approximately $425 million in fiscal 2019 and almost $525 million in fiscal 2020 after capital expenditures of roughly $400 million in fiscal 2019 and $320 million in fiscal 2020.
- Dividends of about approximately $350 million in fiscal 2019 and $245 million in fiscal 2020.
- No material acquisitions or share repurchases over the next two years.

Liquidity

We believe Coty has adequate liquidity. We expect sources to exceed uses by more than 2x during the next 12 months, and that sources will cover uses even if forecast EBITDA declines 15%. Coty recently amended its credit facility to better align with its strategic plans and the size of the business. The amendment loosened covenants, extended restructuring add-backs, and reduced the facility by $500 million to $2.75 billion.

We believe Coty has well-established and solid banking relationships and satisfactory standing in credit markets. It would need to refinance if a low-probability, high-impact event (such as market turbulence, sovereign risk, or the activation of material-adverse-change clauses) occurs.

Principal liquidity sources:

- Cash balances of approximately $384.1 million as of March 31, 2019;
- Revolver availability of $1.5 billion, taking into account its covenants, under its $2.75 billion revolving credit agreement due in 2023; and
- Funds from operations of about $800 million over the next 12 months and about $1 billion in the subsequent 12 months.

Principal liquidity uses:

- Mandatory debt amortization of approximately $190 million per year;
- Capital spending of about $300 million-$350 million over the next 12-24 months;
- Peak seasonal working capital requirements of $500 million per year;
- Dividends of about $260 million-$290 million; and
- No share repurchases for the next two years.

Covenants

The credit agreement contains a maximum 5.25x total net leverage ratio maintenance financial covenant through fiscal 2021 that steps down to 4.75x in fiscal 2022 and 4x in fiscal 2023. We expect Coty will maintain over 20% covenant cushion in the next two years.

Issue Ratings - Recovery Analysis

Key analytical factors

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. Therefore, in evaluating recovery prospects for debtholders, we value the company on a going-concern basis using a 7x multiple of our projected emergence EBITDA value.

Simulated default assumptions

Our simulated default scenario contemplates a default in 2023, primarily due to missteps with its

"Rediscover Growth" turnaround plan. We believe that if Coty were to default, a viable business model would remain given its portfolio of well-recognized brand names and geographic diversity.

- Year of default: 2023
- Emergence EBITDA: $915 billion
- Implied enterprise value multiple: 7x

Simplified waterfall

- Net recovery value (after 5% administrative costs): $6.082 billion
- Valuation split (obligor/nonobligors): 30%/70%
- Collateral for secured creditors: $4.592 billion
- First-lien claims: $7.301 billion
- --Recovery expectation: 70%-90% (rounded estimate: 75%)
- Collateral for unsecured creditors: $1.49 billion
- Unsecured claims: $4.195 billion
- --Recovery expectation: 30%-50% (rounded estimate: 35%)

Ratings Score Snapshot

Issuer Credit Rating	B+/Stable/--
Business risk	Fair
Country risk	Low
Industry 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 additional impact)
Management and governance	Fair (no impact)
Comparable rating analysis	Positive (+1 notch)

Related Criteria

- Guidance | General Criteria: Group Rating Methodology, July 1, 2019
- Guidance | 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 | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | Industrials: Key Credit Factors For The Branded Nondurables Industry, May 7, 2015
- 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: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded; Outlook Action

	To	From
Coty Inc.		
Issuer Credit Rating	B+/Stable/--	BB-/Negative/--
Issue-Level Ratings Lowered; Recovery Ratings Unchanged		
Coty Inc.		
Coty B.V.		
Senior Secured	BB-	BB
Recovery Rating	2(75%)	2(75%)
Coty Inc.		
Senior Secured	BB-	BB
Recovery Rating	2(75%)	2(75%)
Senior Unsecured	B+	BB-
Recovery Rating	4(35%)	4(35%)

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.