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Coty Inc.

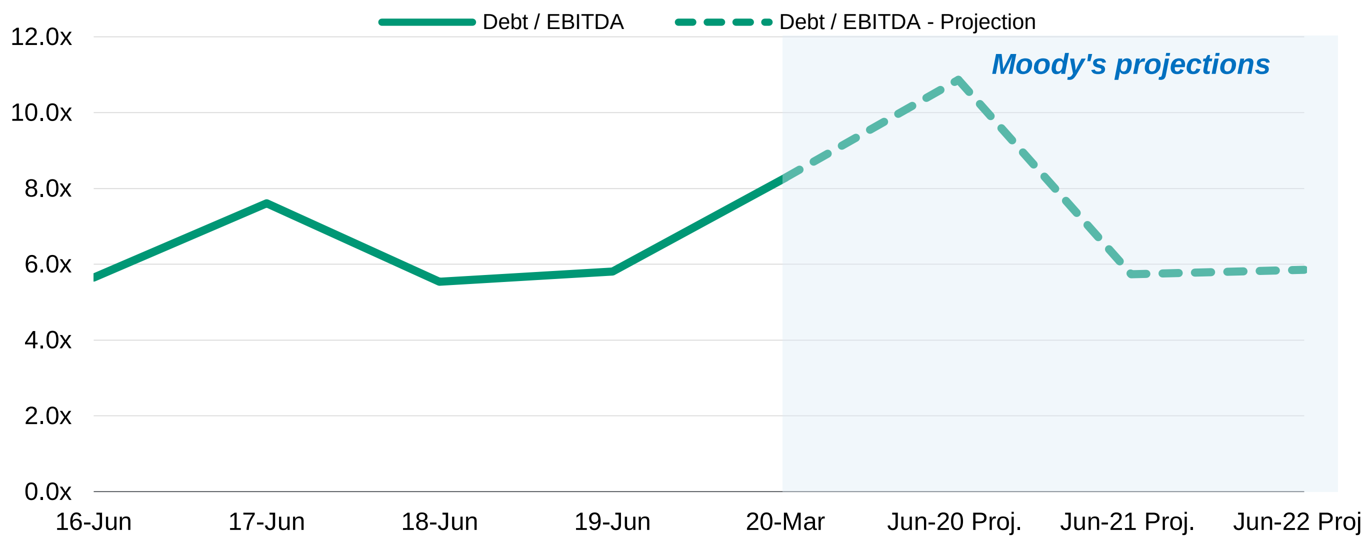
Coty's operating risks and leverage remain high despite benefits of professional business sale and KKR investment

Coty recently announced the divestiture of 60% its professional beauty and hair care businesses for $2.6 billion to Kohlberg Kravis Roberts & Co. (“KKR”), as well as KKR's $1.0 billion investment in Coty preferred shares. The company also suspended its $380 million dividend until April 1, 2021 or until it reaches a leverage ratio of 4.0x (as per the company's definition). These actions are credit positive because they generate proceeds and free up cash to repay debt and improve financial leverage, and help the company fund operational turnaround initiatives including high cash restructuring costs. But debt repayment without a significant improvement to the company's operating earnings will not be enough to meaningfully improve the company's high financial leverage that we estimate will reach a high of nearly 11.0x debt-to-EBITDA in fiscal 2020 ended June 30th. Our estimate follows debt repayment from the sale of preferred stock to KKR from Coty. We expect financial leverage to improve thereafter largely due to the company's asset sales and a reopening of important retail distribution points, although we estimate that debt to EBITDA will hover near 6.0x by the end of fiscal 2021. Absent the divestiture and the KKR investment we estimate that debt to EBITDA would have been roughly a turn higher at 11.7x in fiscal 2020 and 7.2x in fiscal 2021. The company expects the divestitures to close by the end of calendar 2020.

Coty's ratings including the Caa1 CFR and negative outlook are not affected because we believe that Coty faces high execution risk to improve operating performance and sustainably reduce financial leverage. We also recognize the challenges that Coty will face executing an operational turnaround given social distancing will keep department stores and specialty retail closed or operating at reduced volume for an unknown period, and amid higher unemployment.

The professional business will be held in a 60/40 joint venture (“JV”) with Coty. Upon close of the transaction, the JV plans to raise $1.0 billion of debt and use the proceeds to fund a dividend to its owners, with Coty receiving $400 million based on its 40% ownership stake that it plans to use to repay debt. Including the proposed dividend and net of transaction fees and taxes, Coty's estimates $2.5 billion of net proceeds that would be used to repay debt. EBITDA for the professional business was roughly $350 million in fiscal year June 2019 net of $160 million of stranded costs that Coty will retain.

Exhibit 1
We expect financial leverage to increase in 2020 given operational weakness, then decline given proceeds from asset sales



Source: Moody's Financial Metrics and Moody's Estimates

Coty has considerable operating risks and we believe the recent appointment of co-founder Peter Harf as CEO effective in June demonstrate the significant strategic challenges facing the company. There has been meaningful turnover at the chief executive level and Mr. Harf, who is a managing partner of JAB Holding Company S.a.r.l., represents the company's fourth planned CEO since 2016. Mr. Harf follows Pierre Laubies, who was CEO from November 2018 to May 2020. However, the move is a departure from Coty's February 2020 announcement that Pierre Denis (CEO of Jimmy Choo) was to be Coty's CEO following the divestiture of the professional and hair care businesses. Pierre Laubies took over for Camillo Pane in November 2018, who took the helm in October 2016.

Operating challenges include a consumer business that has been hurt by market share losses to smaller nimbler independent brands, and high concentration in categories that require continuous product and brand investment to minimize revenue volatility, such as fragrance and color cosmetics (about 96% of pro-forma sales). These categories tend to be more fashion driven than other beauty products, such as skin care (about 4%). Operating challenges also include ongoing revenue declines from its beauty products over the next few quarters reflecting efforts to contain the coronavirus, as a large percentage of the company's distribution channels, including department stores and specialty retail are closed. While a number of these retail channels are starting to reopen, and are offering curb side pick up, these actions reduce the physical opportunities for impulse purchasing achieved when consumers browse the store. Following its announced divestitures Coty will remain more concentrated than its primary competitors in mature developed markets given that roughly 87% of pro-forma revenues will be generated from the Americas and EMEA. We recognize that revenues generated from the Americas and EMEA include emerging markets (Brazil, Latin America, and the Middle East), which together account for greater than 10% of sales.

Coty has high execution risks in terms of its ongoing turnaround strategy, given its weak free cash flow, despite the suspension of its \$380 million dividend. We estimate that the company will generate about \$(700) million of negative free cash flow in fiscal 2020 ending June 30th largely reflecting the drop in earnings, dividends prior to the suspension, and ongoing cash restructuring costs. We estimate that the company will generate about \$21 million fiscal 2021. Coty also completed the debt financed acquisition of its 51% share of Kylie Jenner Cosmetics in January 2020 for \$600 million also contributed to a higher debt load. The company's ongoing turnaround efforts have be fraught with difficulty and were stalled by the arrival of the coronavirus. Coty recently announced its plans to cut \$600 million of its operating costs over the next 3 years through 2023. Some of the company's restructuring plans include work force reductions, lease termination expenses and supply chain consolidation. The company expects the restructuring program to costs about $500 million in one-time costs over the next 3 years. Coty expects revenue growth to come from additional investments in Kylie Jenner Cosmetics. The company is also targeting additional investments in skin-care products, which are more profitable than color cosmetics, and in core mass-beauty brands, such as CoverGirl, Max Factor and Rimmel to boost sales. But given the highly competitive nature of mass beauty we remain uncertain regarding the success of these investments.

Moody's related publications

Update following CFR Downgrade to Caa1; outlook negative

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