MOODY'S INVESTORS SERVICE

ISSUER IN-DEPTH
6 November 2019

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RATINGS

Coty Inc.

Corporate family rating	B2
Outlook	Stable

KEY METRICS:

Coty Inc.

	6/30/17	6/30/18	6/30/19
Debt/ EBITDA	7.60x	5.54x	5.81x
EBIT/ Interest	1.56x	1.93x	1.70x
RCF/Net Debt	(4.87%)	4.30%	6.45%

Source: Moody's Financial Metrics

Contacts

Chedly Louis +1.212.553.4410
VP-Sr Credit Officer
chedly.louis@moodys.com

Peter H. Abdill, CFA +1.212.553.4024
MD-Corporate Finance
peter.abdill@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
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Coty Inc.

Ambitious turnaround plan poses significant execution challenges

» **Restructuring program remains fraught with risk.** The restructuring plan that Coty Inc. (B2 stable) announced in July carries high execution risks given the company's historical challenges with change management. The latest restructuring follows unsuccessful attempts by the company to improve the operating performance of its consumer beauty segment following its acquisition of The Procter & Gamble Company's (P&G, Aa3 stable) beauty assets in October 2016. In addition, Coty's senior management team, its fourth in five years, lacks experience in the beauty space.

» **Possible divestitures would increase Coty's concentration in highly cyclical businesses.** On 21 October, Coty said that it is considering a possible sale of its professional beauty division and Hypermarcas Brazilian operations as part of its restructuring plan. But selling these operations will increase the company's concentration in highly cyclical businesses, such as skin care, fragrance and color cosmetics.

» **Impact of asset sales on financial leverage remains unclear.** Coty says it will use proceeds from asset sales to repay debt and return cash to shareholders, but we are uncertain if proceeds from asset sales will meaningfully improve Coty's financial leverage. Also unclear is what, if any, portion of the proceeds would flow to majority owner JAB Holding Company S.a.r.l. (Baa1 negative). Before the impact of a possible divestiture, we estimate that modest EBITDA growth and some debt repayment will reduce Coty's enterprise adjusted debt/EBITDA, including its JAB term loan, to around 6.4X by the end of 2020 and 6.2X by the end of 2021 from 7.0X in 2019.

» **Consumer beauty business still struggling.** Without a significant turnaround, Coty's consumer beauty segment will continue to pressure profits and impede the company's ability to improve financial leverage. Coty's numerous restructuring initiatives largely reflect declining sales in the consumer beauty division. This division will represent about 44% of sales if the company succeeds in selling the professional beauty and Hypermarcas businesses, up from about 41% in 2019.

Restructuring program remains fraught with risk

The ambitious restructuring plan that Coty announced in July carries significant execution risks given the company's historical change management challenges. The latest restructuring follows unsuccessful attempts by the company to improve the operating performance of its consumer beauty segment since the completion of the P&G beauty acquisition in October 2016. In addition, Coty's senior management team, its fourth in five years, lacks experience in the beauty space.

The four-year turnaround program, which Coty announced in July, is focused on simplifying the company's product portfolio by investing more in its successful key brands, while divesting nonperforming assets. Roughly 25% of the company's brands generate about 60% of its revenue. Some of the company's key brands include Rimmel, Burberry, Hugo Boss, Max Factor, Covergirl and Gucci.

The restructuring will also be expensive. Coty expects to spend $600 million through 2023, on top of the $160 million in ongoing restructuring costs. Excluding the divestiture, Coty expects the restructuring program to generate about $200 million in annual cost savings, a significant improvement in operating margins to about 14%-to-16% (compared to about 11% today, excluding Moody's adjustments) and free cash flow of about $1 billion by 2023. In the fiscal year ended 30 June, Coty generated about $213 million in free cash flow (excluding Moody's adjustments). Given the number of changes that Coty is simultaneously undertaking, management does not expect meaningful improvements to its credit profile before 2023, although the company's credit profile will improve a little every year.

Coty's senior management team moved to Amsterdam from London to be closer to the company's main market, which will help speed up decision making. Europe is the company's largest market and represents 44% of sales. The company will create regional commercial teams in the Americas, Asia Pacific and Europe, Middle East and Africa (EMEA) with marketing units for luxury and consumer beauty. Coty will also increase the number of countries it focuses on for growth to the US, UK, Germany, Russia, Brazil and China.

The company will emphasize innovation by increasing its R&D spending to 2.3% of sales from 1.9% today (i.e from about $164 million to $200 million). This level of spending compares favorably to that of The Estee Lauder Companies Inc. (A2 stable) at 1.3% and Unilever PLC (A1 stable) at 1.8%, but is less than the 3.4% of sales spent by L'Oreal S.A. (P-1 stable) (3.4%), the largest beauty company in the world.

Possible divestitures would increase Coty's concentration in highly cyclical businesses

On 21 October, Coty said that it is considering the possible sale of its professional beauty division and Hypermarcas Brazilian operations. That announcement is in line with Coty's previously announced restructuring plan, which was its third such plan since the company's acquisition of P&G's beauty assets in 2016.

But the divestiture will increase Coty's exposure to highly cyclical markets because its remaining business will be more heavily concentrated in skin care, fragrance and color cosmetics. Fragrance and color cosmetics tend to be volatile and vulnerable to fashion risk. We expect more volatility in these categories than in other consumer packaged goods sectors. To generate growth, Coty will have to continually reinvest and launch successful new products. Succeeding in an industry with high fashion risk requires continuous investment in product development and brand support to sustain market share.

The divestiture of the professional beauty and Hypermarcas businesses will help Coty make progress in its goal of simplifying its product portfolio, while also reducing the complexity of its global distribution platform. Professional beauty is largely sold at salons, while products from the company's consumer beauty and luxury divisions are sold at department stores, specialty retail and independent retailers. Potential synergies are limited given that there is little overlap in the distribution channel. The company says it expects to complete any such sales by the summer of 2020.

Impact of asset sales on financial leverage is unclear

Coty says it will use divestiture proceeds to repay debt and return cash to shareholders, but we are uncertain if these moves will be sufficient to meaningfully improve Coty's financial leverage. We are also are uncertain about how much the sale of these businesses will generate. Although the professional beauty division has historically been a stabilizing force in the company's business, the division's revenue fell 5.4% in the fiscal year ended 30 June. This reflected problems in consolidating one of the company's distribution centers in the US related to the P&G integration, coupled with trade inventory reductions at certain key customers. In addition, the difficult political climate in Brazil will likely hurt sale proceeds for a divestiture of the Hypermarcas operations. Political uncertainty in Brazil, Latin America's largest economy, has led to high unemployment, which will negatively impact demand for consumer beauty products. Moody's Macro Economic Board sees limited upside potential for Brazil's economy given weak domestic demand.

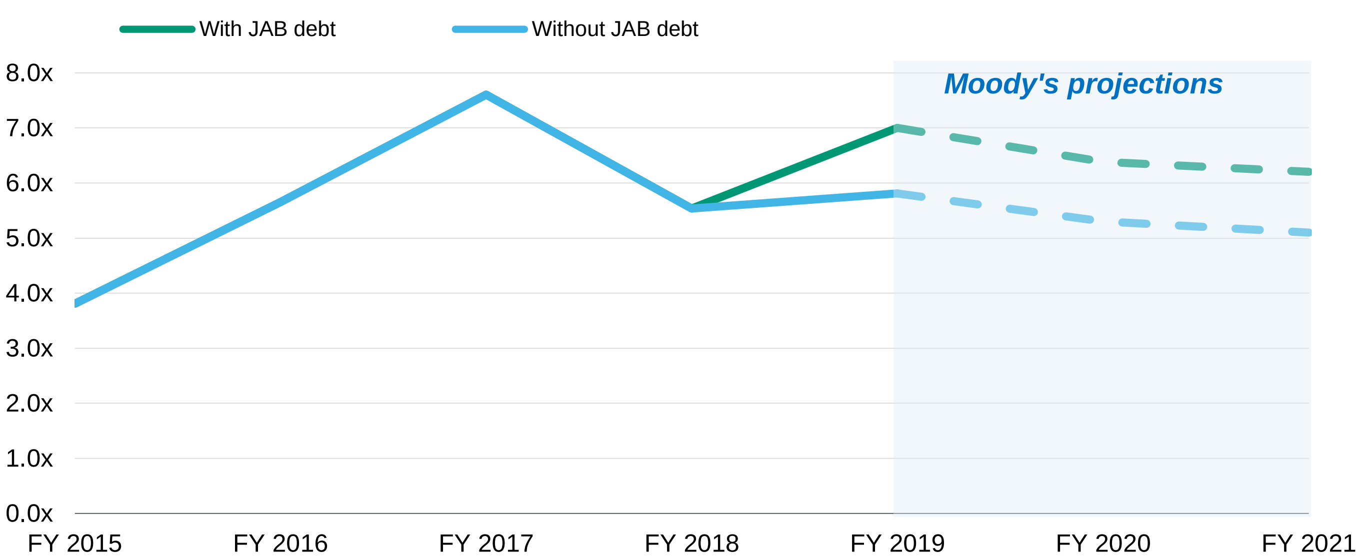
The company's Moody's-adjusted enterprise debt/EBITDA will be high at 7.0x in 2019, including the $1.77 billion JAB term loan and 5.8x excluding the term loan. JAB incurred the term loan in 2019 in order to increase its ownership in Coty from 40% to 60%. While the term loan is not a direct obligation of Coty, we include it in total enterprise debt to reflect that the ultimate source of repayment are cash flows generated by Coty. The JAB debt can also be repaid through the subsequent sale of Coty's shares, and stock price appreciation of those shares will in part reflect Coty's operating performance.

Before the impact of possible divestitures, we estimate that modest EBITDA growth and some debt repayment will reduce Coty's enterprise adjusted total debt/EBITDA, including the JAB term loan, to around 6.4x by the end of 2020 and 6.2x by the end of 2021. The professional beauty unit, which is comprised of hair and nail care products for salon professionals and includes such brands as OPI, ghd, Clairol and Wella, generates about $1.8 billion in revenue per annum. The Hypermarcas personal care and beauty business, which Coty acquired in 2015 for $1 billion, generates about $900 million in annual revenue. Assuming a 15% EBITDA margin and an 8.0x -12.0x multiple on $2.7 billion of sales (combined revenue from Professional Beauty and Hypermarcus), we estimate proceeds from divestitures of about $3.2 - $4.9 billion. It is unclear what, if any, portion of these proceeds will flow to majority owner JAB. If 100% of our estimated proceeds go to repay debt, then debt to EBITDA will improve to 6.1x - 4.8x in 2020 from 7.0x today. However, if we assume that 50% of asset sale proceeds go to repay debt, then we estimate debt to EBITDA at 7.4x - 6.8x in 2020.

Exhibit 1

Leverage to decline slowly excluding the impact of a possible divestiture

Coty's total debt/EBITDA with and without the $1.77 billion JAB term loan



Note: All figures incorporate Moody's standard analytic adjustments
Sources: Moody's Financial Metrics and Moody's estimates

Consumer beauty business still struggling

Without a significant turnaround, Coty's consumer beauty segment will continue to pressure profits and impede the company's ability to improve financial leverage. Coty's numerous restructuring initiatives largely reflect declining sales in the consumer beauty division, which will represent about 50% of sales if the company succeeds in selling the professional beauty and Hypermarcas businesses, up from about 41% in the fiscal year ended 30 June.

Coty's consumer beauty business has been hurt by market share losses to smaller, nimbler independent brands. The mass beauty market is intensely competitive, with existing brands and a large number of new brands all vying for customers. While some of Coty's mass beauty products are sold at specialty retail, such as Ulta, a large percentage of its mass beauty products are sold at grocery/drug stores, which have been reporting declining foot traffic in their beauty aisles. Selling at specialty retail allows products to be more attractively displayed and enables consumers to sample products, an option not available at drug or grocery stores.

The color cosmetics and skin care market will remain crowded with a number of new brands entering the market at record levels. New brands are largely targeted at the prestige (luxury high price points) and so-called "masstige" segments (good quality products at attractive price points) of the market.

In addition, heightened interest from private-equity investors and strategic buyers will provide some new entrants with significant resources to expand their distribution into new domestic and international markets. In July, Colgate-Palmolive Company (Aa3 stable) agreed to acquire skin care company Laboratoires Filorga after acquiring PCA Skin and Elta MD last year. In October Shiseido Company Limited's (A2 stable) announced the acquisition of Drunk Elephant. Other transactions in 2018 included TPG Capital's acquisition of minority stakes in beauty company Anastasia Parent LLC (dba Anastasia Beverly Hills, B3 stable) and Rodan & Fields LLC (B2 stable), a maker of skin care products, P&G's purchase of First Aid Beauty, Snowberry and Native, and Edgewell Personal Care Co. (B1 stable) purchase of men's skin care company Jack Black.

Exhibit 2
New celebrity brand entrants in 2019

Name	Launch Date
Kylie Jenner/Kylie Skin	May-19
Lady Gaga/Haus Laboratories	July-19
Suzanne Somers/Suzanne Organics	August-19
Victoria Beckham	September-19

Source: Moody's Investors Service

Moody's related publications

Credit Opinion

» Coty Inc.: Update following CFR downgrade to B2; outlook stable, July 2019

Industry Outlook

» Consumer packaged goods - Global: Outlook remains stable on moderating commodity costs, growth in prestige beauty, November 2019

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