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Research Update:

Coty Inc. Outlook Revised To Negative On Continued Pandemic-Related Headwinds; Ratings Affirmed

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Rating Action Overview

- Coty's operating performance and cash burn in its first quarter of fiscal 2021 (ended Sept. 30, 2020) were substantially better than its very weak fiscal fourth quarter (ended June 30, 2020).
- Coty announced that it expects to close the sale of 60% of Wella to KKR by the end of November for $2.5 billion net cash proceeds.
- The company's adjusted leverage in fiscal 2020 (including Wella's EBITDA) was well into the double digits because of a significant drop in demand from the pandemic and its high cost structure. While we expect Coty's adjusted leverage to decline to about 10x (8.5x excluding preferred stock) in fiscal 2021 and improve further in fiscal 2022, there are still risks to our forecast. Many countries in Europe and states in the U.S. are reinstating stay-at-home orders amid a resurgence in coronavirus cases. These actions could cause Coty's progress to be slow and uneven, and could pressure our view of the company's liquidity if it is not able to refinance its 2023 debt maturities in the next 18 months. Moreover, the company has consistently underperformed our expectations over the past five years.
- We are affirming our 'B-' issuer credit rating on Coty, given its adequate liquidity position and our forecast that its operating performance and credit measures should improve.
- We are revising our outlook to negative from stable, since there is little room in the rating for Coty to miss our base case forecast. We could lower the rating if economic disruptions from the second wave of the coronavirus pandemic appear to be longer lasting and more severe than our base case forecast indicates, and its leverage remains elevated and free cash flow is negative. This could make it more difficult to refinance its more than $2 billion of debt maturing in April of 2023.

Rating Action Rationale

The rating affirmation reflects our assessment of Coty's liquidity as adequate, and our forecast for improving credit measures and positive free cash flow due to better sales trends, cost reductions, and debt repayment. We are affirming the rating on Coty because we expect credit

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measures to improve significantly in fiscal 2021 (ending June 30, 2021). The company plans to repay debt with the $2.5 billion of proceeds from its pending sale of Wella AG to KKR & Co Inc. In addition, sales trends are beginning to improve and the company is beginning to realize the benefits of its cost-reduction initiatives. The company's sales showed sequential improvement in all regions and across both its prestige and mass businesses in the first quarter of fiscal 2021 (ended Sept. 30, 2020). Its organic sales declined 19% in the quarter, which was much better than the 60% drop that occurred in its fiscal fourth quarter (ended June 30, 2020).

In addition, the company has made significant changes to its cost structure by focusing on its marketing investments and executing its fixed-cost reduction strategy. Coty took out approximately $80 million of fixed costs in the quarter, which was a 17% decline year over year. This enabled it to generate a gross margin of 58.6% and an S&P Global Ratings' adjusted EBITDA margin of 9.3%, compared with 60.2% and 13.3%, respectively, in the prior year quarter despite significantly lower sales. The company is in the midst of a three-year cost-restructuring program that should result in total cost savings of $600 million annually by fiscal 2023 and is on target to reduce costs by $200 million this fiscal year. Partially offsetting these cost savings are the costs to execute the program, about $500 million spread over the next three years.

Coty fortified its liquidity position earlier this calendar year by raising $1.0 billion from the issuance of convertible preferred equity to KKR. It had about $1.7 billion of liquidity as of Sept. 30, 2020, consisting of $536 million of cash and about $1.2 billion of revolver availability. We believe this will enable it to withstand significant near-term industry headwinds. The company has a minimum liquidity covenant of $350 million through March 31, 2021. Based on its current liquidity position and our expectation it will generate positive free cash flow in fiscal 2021, we expect it to meet this requirement.

Despite the expected improvement, credit measures should remain weak as the company continues its restructuring and faces ongoing headwinds caused by the pandemic. Though we expect credit measures to improve in fiscal 2021, we still expect them to be weak. We forecast leverage at about 10x in 2021 (about 8.5x excluding preferred stock) and EBITDA interest coverage at about 2x. Though we expect free cash flow will turn positive, our forecast for about $100 million of discretionary cash flow in fiscal 2021 is modest relative to the company's adjusted debt load, which includes more than $5.5 billion of pro forma reported debt and $1 billion of preferred stock. We forecast discretionary cash flow to improve to above $400 million in 2022, but leverage will likely still be high at around 7.5x (low-6x excluding preferred). Coty's credit metrics will likely remain weak through fiscal 2022 because its portfolio is heavily skewed to fragrances and color cosmetics. Demand for these categories is highly correlated to social activity and is affected by in-school participation and people going into their offices to work. We forecast Coty's organic sales will decline in the fiscal second quarter but will show sequential improvement, and its sales could be flat for the full fiscal year. Still, it is vulnerable to demand changes because of the pandemic. Currently it only generates about 13% of sales through the fast-growing e-commerce channel and it has little presence in the skincare category, which is currently the best performing category in the beauty market. It is heavily dependent on developed markets, and has a modest presence in China, which is one of the fastest growing markets. This could make it difficult for the company to offset declines in its core markets if the current spike in COVID-19 cases persists for a prolonged period or gets worse.

Downside risks are present due to renewed stay-at-home orders, and the company has little room for underperformance. There are downside risks to our forecast given many countries in Europe and states in the U.S. are implementing new stay-at-home mandates because of a surge

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in COVID-19 cases. We do not expect these mandates to be as restrictive as those seen in March and April of 2020, so we do not believe the revenue declines will be as severe. Nevertheless, these actions could cause Coty's progress to be slow and uneven, and there is little room in the current rating for Coty to underperform our base case forecast. A significant portion of the company's debt capital structure matures in April 2023, including its $2.75 billion revolver ($1.56 billion outstanding as of Sept. 30, 2020), $3.0 billion term loan A (about $1.9 billion expected to be outstanding after repayment with Wella proceeds), and $645 million euro notes. This means the company must show a significant improvement in operating performance over the next two years in order to successfully refinance on satisfactory terms. Under our base case forecast, we expect the company to improve leverage to the mid-7x area (low-6x excluding preferred stock) and generate more than $400 million of free cash flow. However, if the company does not achieve its expected cost savings, or if demand drops significantly more than we currently expect, this could result in negative free cash flow in 2021, which we believe may jeopardize the company's ability to successfully refinance on satisfactory terms.

Outlook

The negative outlook reflects the risk of a lower rating over the next 12 months if economic disruptions from the second wave of the coronavirus pandemic appear to be longer lasting and more severe than our base case forecast indicates, and the company's leverage remains elevated and free cash flow remains negative.

Downside scenario

We could lower the rating if we believe Coty's capital structure will become unsustainable or it will face a liquidity crisis because it cannot refinance its 2023 debt maturities before becoming current in April 2022. In our view, an unsustainable capital structure would be reflected by leverage sustained above 10x while the company continues to burn cash.

This could occur if:

- The recent surge in COVID-19 cases is not contained and consumer mobility becomes more restricted due to personal choice or government mandates; or
- Coty does not effectively execute its "All-In-To-Win" transformation strategy. The program is broad, and there is risk there will be missteps that could keep credit metrics elevated because of further market share losses and additional restructuring charges.

Upside scenario

We could revise the outlook to stable if Coty improves its operating performance such that we are confident it can successfully refinance its 2023 debt maturities on satisfactory terms before they become current in early 2022.

This would require the company to:

- Continue to demonstrate progress in lowering its cost structure such that EBITDA margin approaches 15%;
- Stabilize sales;

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- Sustain leverage below 10x; and
- Maintain at least 15% cushion under the covenants in its credit facility which go into effect in its fourth fiscal quarter of 2021 (ending June 30, 2021).

Company Description

Coty, together with its subsidiaries, manufactures, markets, distributes, and sells beauty products including fragrances, color cosmetics, hair care products and skin & body related products worldwide. It operates in three segments: Americas, EMEA, and Asia Pacific. On Nov. 12, 2020, Coty announced that it expects to complete the sale of Wella by Nov. 30, 2020. The strategic transaction for Coty's Professional and Retail Hair business, including the Wella, Clairol, OPI and ghd brands (together, Wella), valued the businesses at $4.3 billion on a cash- and debt-free basis. KKR will own 60% of this separately managed entity and Coty will own the remaining 40%. Coty will received $2.5 billion of net proceeds.

Our Base-Case Scenario

S&P Global Ratings believes there remains a high degree of uncertainty about the evolution of the coronavirus pandemic. Reports that at least one experimental vaccine is highly effective and might gain initial approval by the end of the year are promising, but this is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by the middle of next year. We use this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

- Global GDP falls 3.8% in 2020 and grows 5.2% in 2021. U.S. GDP falls 4.0% in 2020 and grows 3.9% in 2021. Eurozone GDP falls 7.4% in 2020 and grows 6.1% in 2021. U.K. GDP falls 9.7% in 2020 and grows 7.9% in 2021.
- Sales are flat to down modestly in fiscal 2021 as government restrictions ease compared to February through April of 2020, and Coty focuses marketing efforts on its strongest products, new launches, and increasing online penetration. Sales increase in the mid-single-digit percentage area in fiscal 2022 primarily because consumers become more socially active. Coty's repositioning of its portfolio and investments in e-commerce will also contribute to sales growth.
- S&P Global Ratings' adjusted EBITDA margin increases to the 15% area in fiscal 2021 compared with 4.1% (including Wella) in fiscal 2020. EBITDA margin expands to the high-teens percentage area in 2022 because of its cost-reduction program and operating leverage from higher sales.
- Discretionary cash flow of about $100 million in fiscal 2021 and more than $400 million in fiscal 2022, significantly above the $515 million outflow that occurred in fiscal 2020.
- No shareholder distributions or material acquisitions over the next two years.

Based on these assumptions, we arrive at the following credit measures:

- Preferred stock adjusted debt to EBITDA at about 10x in fiscal 2021, improving to the mid-7x area in 2022 (excluding preferred stock: 8.5x and low-6x area, respectively).

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- EBITDA interest coverage at about 2x in 2021, improving to the high-2x area in 2022.
- EBITDA cash interest coverage in the high-2x area in 2021, potentially improving to about 4x in 2022.

Liquidity

We believe Coty has adequate liquidity. We expect sources to exceed uses by more than 1.2x during the next 12 months, and that sources will cover uses even if forecast EBITDA declines more than 15%.

We believe Coty has well-established and solid banking relationships and satisfactory standing in credit markets. However, we do not believe the company has the ability to absorb high-impact, low-probability events (such as severe market turbulence, sovereign risk, or the activation of material-adverse-change clauses) without refinancing. In addition, improvement in consumer store traffic due to the COVID-19 pandemic remains uncertain, and could result in a prolonged cash burn.

Principal liquidity sources:

- Cash balances of approximately $536 million on Sept. 30, 2020;
- Revolver availability of about $1.19 billion under the revolving credit facility due 2023;
- Funds from operations of about $400 million over the next 12 months; and
- Cash proceeds of about $2.5 billion from the sale of Wella.

Principal liquidity uses:

- Capital spending of about $170 million over the next 12 months;
- Peak seasonal working capital requirements of $500 million per year;
- Mandatory scheduled debt amortization of approximately $200 million per year;
- Pro rata pay down of the term A and B facilities required with $2 billion of the proceeds from the Wella sale;
- Acquisition of 20% ownership interest in Kim Kardashian West beauty business for $200 million; and
- No dividends or share repurchases for the next two years.

Covenants

Coty amended its credit agreement in March 2020, including obtaining a waiver on its leverage covenants for its fiscal third quarter 2020 (ended March 31, 2020) through its fiscal third quarter 2021. Thereafter, the company will need to comply with the covenants contained in its credit agreement, including: A maximum 5.25x total net leverage ratio financial maintenance covenant through fiscal 2021 that steps down to 4.75x in fiscal 2022 and 4x in fiscal 2023. The credit agreement does not include the preferred equity as debt and allows it to add back 36 months of forward cost savings and excludes some restructuring costs. The company may need to again amend the credit facility if it cannot add back costs related to COVID-19 or if there is a widespread

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spike in COVID-19 cases, which results in its business again being materially disrupted from governments reinstating mandates which close nonessential retail stores.

Debt Maturities

April, 2023:

- Revolving credit facility: $2.75 billion ($1.56 billion outstanding as of Sept. 30, 2020);
- Term A facility: $3.006 billion outstanding as of Sept. 30, 3030 (about $1.9 billion expected pro forma for repayment with Wella proceeds);
- 2023 senior unsecured euro notes: $645 million outstanding as of Sept. 30, 2020;

April 2025:

- Term B facility: $2.343 billion outstanding as of Sept. 30, 2020 (About $1.5 billion expected pro forma for repayment with Wella proceeds);

April 2026:

- 2026 dollar notes: $550 million outstanding as of Sept. 30, 2020; and
- 2026 euro notes: $293 million outstanding as of Sept. 30, 2020.

Ratings Score Snapshot

Issuer Credit Rating: B-/Negative/--

Business risk: Fair

- Country risk: Low
- Industry risk: Low
- Competitive position: Fair

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: b

Modifiers

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- 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 Negative (-1 notch)

Related Criteria

- 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 | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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

Ratings Affirmed; Outlook Action

	To	From
Coty Inc.		
Issuer Credit Rating	B-/Negative/--	B-/Stable/--

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.

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