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Research Update:

Coty Inc. Issuer Credit Rating Lowered To 'B-' From 'B' On High Leverage, Outlook Stable; Debt Ratings Lowered

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Rating Action Overview

- Coty continues to shuffle senior management, while operations have not stabilized and at a time when it is incurring severe headwinds from the fallout of COVID-19.
- Coty's leverage should decline in fiscal 2021 because of store openings, its e-commerce efforts, cost reductions, and applying proceeds from its pending sale of 60% of Wella to debt reduction; however, we expect leverage will remain high through fiscal 2022 because of its high fixed-cost base and need to reposition its consumer beauty business.
- We are lowering our issuer credit rating to 'B-' from 'B' on Coty Inc. and removing all ratings from CreditWatch, where we had placed them with negative implications on March 24, 2020. The outlook is stable.
- Concurrently, we are lowering our rating on the company's senior secured debt to 'B' from 'B+'. The recovery rating remains '2', indicating our expectation of substantial (70%-90%; rounded estimate: 70%) recovery in the event of a payment default. Subsidiary Coty B.V. is a co-borrower under the revolving credit facility. In our rating analysis, we view Coty Inc. and its operating subsidiaries as a group. We are also lowering the rating on the company's senior unsecured debt to 'B-' from 'B'. The recovery rating remains '4', indicating our expectation for average (30%-50%; rounded estimate: 30%) recovery in the event of a payment default.
- The stable outlook reflects Coty's fortified liquidity position after raising $1 billion from the issuance of convertible preferred equity to KKR. Coty has indicated that it will have $1.8 billion to $2.0 billion of available liquidity by the end of July (after it receives proceeds from the $250 million tranche of convertible preferred equity). We believe this will enable it to withstand significant industry headwind and fund cash outflows because of depressed profits over the next 12 months caused by the COVID-19 pandemic. In addition, we expect free cash flow will turn positive in fiscal 2021 under our base case forecast.

Rating Action Rationale

The downgrade reflects our expectation Coty's leverage will remain high, despite the application of $2.1 billion of divestiture proceeds to repay debt, given the severe profit deterioration in its recently completed fiscal 2020. In addition, S&P Global Ratings now expects that overall demand for cosmetics and fragrances will be weak for the next few quarters given S&P Global's economic forecast for global GDP to contract 3.8% in 2020, which is worse than the 2.4% contraction it previously expected. We also believe there is risk to our base case forecast given Coty's large restructuring programs, history of poor operating execution, and high senior management turnover.

The constant senior management changes are a risk. The appointment of Sue Y. Nabi as CEO, effective Sept. 1, 2020, marks its third CEO this year and the sixth since the company acquired the P&G beauty assets in 2015. Although Peter Harf, current CEO since June 1, 2020, will be elevated to the role of Executive Chairman, Sue Nabi could change the company's strategy in terms of restructuring the company. Peter Harf announced the implementation of a new restructuring program on June 1, 2020. The company is still in the process of completing Pierre Laubies', then CEO, "Rediscover Growth" and "Regain Operational Leadership" programs announced in July 2019 which focus on improving the consistency of top-line growth. The current "All-In-To-Win" program broadens the revenue and savings targets of the July 2019 restructuring programs with particular focus on reducing fixed costs.

Coty's business was also significantly affected by store closures related to COVID-19. We forecast Coty's sales declined about 20%, EBITDA dropped more than 45%, and discretionary cash flow was negative $630 million in fiscal 2020 (ended June 30, 2020). Store re-openings in U.S. and Europe, its key markets, as well as its cost restructuring program, should help drive some improvement in its operating performance in fiscal 2021. Nevertheless, Coty had a significant debt burden before COVID-19 because of its poorly executed merger with P&G beauty assets and structural headwinds in the mass beauty channel. We expect its consumer beauty and luxury businesses' EBITDA to remain below the fiscal 2019 levels in fiscal 2021 despite stores re-opening. We believe store foot traffic will be weak given consumers' need to social distance because of COVID-19, a higher number of consumers working at home compared with 2019, high unemployment, and weak consumer discretionary spending.

Coty's credit metrics should remain weak through fiscal 2022. We forecast leverage will be close to 13x in fiscal 2020 (including the preferred equity as debt and EBITDA from Wella since the transaction has not closed). We modestly revised our forecast for fiscals 2021 and 2022 given S&P Global's economist's expectation for slower economic recovery. Pro forma for the Wella transaction, we expect leverage to decline to 7.5x in fiscal 2021 (6.5x excluding the preferred) and to 6.5x in fiscal 2022 (5.8x excluding the preferred).

Notwithstanding the struggles with its consumer beauty segment, Coty's luxury business, which was 55% of its pro forma net revenue, should remain healthy. Its luxury business has historically generated organic sales at a mid- to high-single-digit rate and has had good operating performance. The company holds the No. 1 position in the global fragrance market. Although we expect fiscal 2021's organic sales growth rate to be below its historical growth rate, we expect it to return to historical levels once retailers sell-through existing inventory, consumers return to more typical shopping behavior, and the global economy returns to growth.

Outlook

The stable outlook reflects Coty's fortified liquidity position after raising $1 billion from the issuance of convertible preferred equity to KKR Rainbow Aggregator L.P. (KKR). Coty has indicated that it has $1.8 billion to $2.0 billion of available liquidity by the end of July. We believe this will enable it to withstand significant industry headwind and fund cash outflows because of depressed profits over the next 12 months caused by the COVID-19 pandemic. In addition, we expect free cash flow will turn positive in fiscal 2021 under our base case forecast.

Downside scenario

We could lower the rating if we believed Coty's capital structure would become unsustainable or it would face a liquidity crisis. This could occur if Coty did not effectively execute its restructuring programs. They are broad, and there is risk that there will be missteps that could keep credit metrics at elevated levels because of further market share losses and additional restructuring charges. Its progress toward stabilizing the business could also be affected by a prolonged global recession and consumers dramatically reducing spending because of high unemployment. We could lower the rating if leverage remained above 10x or if the company continued to burn cash and its liquidity position became constrained such that it fell below $1 billion.

Upside scenario

We could raise the ratings if Coty demonstrated traction lowering its cost structure, stabilized sales, and expanded its EBITDA margin close to 15% and if we believed leverage would be sustained below 7x. In addition, it would need to have at least 15% cushion under the covenants in its credit facility that go into effect in its fiscal fourth quarter of 2021.

Company Description

Coty, together with its subsidiaries, manufactures, markets, distributes, and sells beauty products including fragrances, color cosmetics, hair care products, and skin and body related worldwide. It operates in three segments: Americas; Europe, Middle East, and Africa; and Asia Pacific. On June 1, 2020, Coty announced it had signed a definitive agreement with KKR to enter into a strategic transaction for Coty's Professional and Retail Hair business, including the Wella, Clairol, OPI, and ghd brands (together, "Wella"), valuing 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 receive $2.5 billion of net proceeds when the transaction closes in six to nine months.

Our Base-Case Scenario

S&P Global Ratings acknowledges a high degree of uncertainty about the evolution of the coronavirus pandemic. The consensus among health experts is that the pandemic may now be at, or near, its peak in some regions but will remain a threat until a vaccine or effective treatment is widely available, which may not occur until the second half of 2021. We are using 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 3.6 in 2021. U.S. GDP falls 5.0% in 2020 and grows 5.2% in 2021. Eurozone GDP falls 7.8% in 2020 and grows 5.5% in 2021. U.K. GDP falls 8.1% in 2020 and grows 6.5% in 2021
- Sales decline almost 20% in fiscal 2020 because of the fallout from COVID-19 and to a lesser extent its stock-keeping units rationalization. Pro forma for the Wella divestiture, organic sales increase 5.5% in fiscal 2021 because of stores reopening as government stay-at-home mandates ease.
- Adjusted EBITDA margin drops to 11% in fiscal 2020 (including Wella) from 16.5% in fiscal 2019 because of the severe drop off of sales in the second half of its fiscal year caused by COVID-19. The pro forma fiscal 2021 adjusted EBIDA margin expands to 15.9% because of operating leverage from better sales trends and lower fixed costs.
- Discretionary cash flow negative $630 million in fiscal 2020 and positive $580 million in fiscal 2021.
- No shareholder distributions or material acquisitions over the next two years.

Liquidity

We believe Coty has adequate liquidity. We expect sources to exceed uses by more than 2.3x during the next 12 months and that sources will cover uses even if forecast EBITDA declines 15%.

Based on our quantitative analysis, Coty qualifies for a stronger liquidity assessment; however, it does not meet our qualitative requirements. 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 market turbulence, sovereign risk, or the activation of material-adverse-change clauses) without refinancing. In addition, improvement in consumer store traffic remains uncertain due to the COVID-19 pandemic and could result in an prolonged cash burn.

Principal liquidity sources:

- Cash balances of approximately $1278.5 million as of March 31, 2019;
- Revolver availability of about $11 million revolving credit agreement due 2023;
- Funds from operations of about $450 million over the next 12 months; and
- Cash proceeds from convertible preferred shares offering of $1 billion.

Principal liquidity uses:

- Capital spending of about $225 million over the next 12 months,
- Peak seasonal working capital requirements of $500 million per year,
- Mandatory debt amortization of approximately $200 million per year,
- 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) though its fiscal fourth quarter fiscal 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 maintenance financial 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 might need to again amend the credit facility if it cannot add back costs related to COVID-19 or if there is a widespread spike in COVID-19 cases that results in its business again being materially disrupted from governments' re-instating mandates that close non-essential retail stores.

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 6.5x multiple of our projected emergence EBITDA value. We lowered the multiple to 6.5x from 7.0x because of its operating missteps. Our recovery analysis takes into account the company's current capital structure. We will factor in its divesture of 60% of the Wella business and debt repayment after the close of the transaction.

Simulated default assumptions

Our simulated default scenario contemplates a default in 2022, primarily due to missteps with its "All-In-To-Win" turnaround plan.

- Year of default: 2022
- Emergence EBITDA: $979 billion
- Implied enterprise value multiple: 6.5x

Simplified waterfall

- Net recovery value (after 5% administrative costs): $6.043 billion
- Valuation split (obligor/nonobligors): 30%/70%
- Collateral for secured creditors: $4.592 billion
- First-lien claims: $7.714 billion
- --Recovery expectation: 70%-90% (rounded estimate: 70%)
- Collateral for unsecured creditors: $1.480 billion
- Unsecured claims: $4.649 billion

- --Recovery expectation: 30%-50% (rounded estimate: 30%)

Note: All debt amounts at default include six months accrued prepetition interest.

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	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
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, 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; CreditWatch/Outlook Action

	To	From
Coty Inc.		
Issuer Credit Rating	B-/Stable/--	B/Watch Neg/--
Issue-Level Ratings Lowered; Off CreditWatch; Recovery Expectations Revised		
Coty Inc.		
Senior Unsecured	B-	B/Watch Neg
Recovery Rating	4(30%)	4(35%)
Coty Inc.		
Coty B.V.		
Senior Secured	B	B+/Watch Neg
Recovery Rating	2(70%)	2(75%)

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.