Coty Inc. Rating Remains On CreditWatch Negative As Sale Of Professional Beauty Business Progresses

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KEY TAKEAWAYS

- Coty Inc. announced that it has signed a memorandum of understanding (MOU) with KKR Rainbow Aggregator GP LLC, along with KKR Rainbow Aggregator L.P. (KKR), for the sale of a 60% interest in its Professional Beauty business and retail hair brands, including OPI and ghd.
- If the transaction is executed, Coty will receive $3.0 billion of proceeds.
- Coty also announced it will receive $750 million of convertible preferred equity proceeds from KKR immediately and an additional $250 million if KKR signs a definitive agreement with respect to the sale.
- We are keeping the rating on CreditWatch negative, where we placed it on March 24, 2020, to reflect the potential for a lower rating over the next few quarters if Coty's business continues to be hurt by massive retail store closures and the COVID-19 pandemic and it doesn't receive asset sale proceeds by the first half of calendar 2021.

Coty shored-up liquidity by issuing convertible preferred stock, announced an MOU to sell various assets, and received covenant relief; it also plans to reduce fixed costs by an additional $700 million. Coty's operating performance in its fiscal third quarter (ending March 31) was significantly affected by widespread retail store closures and a significant decline in travel as a result of the COVID-19 pandemic. Its sales dropped 23%, EBITDA plunged 93%, and discretionary cash flow was negative $344 million. We expect Coty's sales decline in the fourth quarter to be worse than its third quarter because stores have been shut down for longer and that the decline in EBITDA will also be severe. We forecast discretionary cash will be an outflow of more than $600 million for fiscal 2020. The cash infusion is in the form of $750 million convertible preferred stock and an amended credit agreement, which gives Coty a one-year covenant holiday that will help it weather the crisis.

Coty has completed its strategic review of asset sales and plans to use the majority of the proceeds to repay debt. On Oct. 21, 2019, the company announced plans to divest assets, including its Professional Beauty business and associated hair brands as well as its Brazilian operations. Its strategy was to focus more on its fragrance, cosmetics, and skin care businesses. At that time, we expected that upon completion of the divestitures, leverage would decrease to 3.0x (net debt) on a pro forma basis.

On May 11, 2020, the company announced that it signed an MOU with KKR for the sale of a 60% interest in its Professional Beauty business and retail hair brands, including OPI and ghd, at an enterprise value of $4.3 billion. Under the terms of the MOU, Coty agreed to exclusively negotiate a definitive agreement with respect to the sale of PB assets with KKR. Upon reaching such an agreement, Coty will transfer these assets into a stand-alone company, in which KKR will acquire a 60% stake, with Coty retaining the remaining 40% interest. A definitive agreement is expected to be signed by the end of this month.

Coty expects to use the $3.0 billion in proceeds from the potential transaction during the next year to pay down debt. It can use a maximum of $500.0 million to fund operations. It plans to retain its Brazil mass beauty operations. We forecast that pro forma for the potential transaction and treatment of $1.0 billion of preferred equity as debt, leverage will be about 8x in fiscal 2021, down from our estimate of 12.5x in fiscal 2020. If the company achieves its cost-reduction goals and the retail environment is not still being affected by massive closures, we believe the company can lower leverage to the 6.0x area by fiscal 2022. Excluding the preferred equity, we forecast leverage will be in the high 6.0x area in fiscal 2021 and in the mid-5.0x in fiscal 2022.

S&P Global Ratings acknowledges a high degree of uncertainty about the rate of spread and peak of the coronavirus outbreak. Some government authorities estimate the pandemic will peak about midyear, and we are using this assumption in assessing the economic and credit implications. We believe the measures adopted to contain COVID-19 have pushed the global economy into recession (see our macroeconomic and credit updates here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Coty has high fixed costs and plans to right-size its cost structure by the end of its fiscal 2023. The company announced plans to reduce its fixed cost base by $700 million (25%). This will make it more agile to react to changes in the environment. Combined with its other cost-reduction programs, it plans to decrease fixed costs by $920 million by the end of fiscal 2023. These cost-reduction initiatives include increasing the efficiency of its end-to-end supply chain, reducing procurement costs, and flattening its organizational structure. The cost to achieve these programs is an estimated $500 million, which will be spent over fiscal 2021 and fiscal 2020. The company expects to achieve 30%-40% of the cost reductions in fiscal 2021, 33% in fiscal 2022, and the remainder in 2023. It is too soon to determine if these efforts will be successful. Management turnover has been high, and the company has underperformed since the merger in 2015.

The CreditWatch negative placement reflects further downside risk over the next few quarters if massive retail store closures extend beyond Coty's fiscal fourth quarter (ending June 30) and if the company is unable to execute a definitive agreement to sell the Professional Beauty assets and receive proceeds of $3.0 billion. Use of the proceeds to repay debt as well as signs its business is recovering could result in an affirmation of the rating. In resolving the CreditWatch placement, we will assess the effects of the pandemic and asset sales on the company's credit metrics and liquidity.

RELATED CRITERIA

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This report does not constitute a rating action.