Research Update:

Coty Inc. Upgraded To 'B' On Improved Operating Performance And Debt Reduction; Outlook Stable

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Rating Action Overview

- Coty Inc. continues to execute on its strategic plans resulting in credit metric improvements, which we forecast will result in S&P Global Ratings-adjusted-leverage improving to the mid-5x area in fiscal 2022, below our previous mid-6x upgrade trigger, while also generating free operating cash flow (FOCF) of about $500 million in fiscal 2022.
- The company recently announced that financial sponsor KKR has completed the sale of its entire remaining stake in Coty and utilized a portion of the proceeds from the redemption in exchange for Coty's sale of an additional 4.7% stake in Wella AG while converting the remainder of preferred shares into common equity.
- In addition, we expect the company to make voluntary debt repayments over the next few quarters from proposed transactions, thereby supporting further deleveraging.
- We raised our issuer credit rating to 'B' from 'B-'. Concurrent with this upgrade, we raised the issue-level rating on the company's senior secured debt to 'B+' from 'B' and the issue-level rating on its senior unsecured debt to 'B' from 'B-'. The recovery rating on the senior secured debt and the senior unsecured debt are '2' and '3', respectively.
- The stable outlook reflects our expectation that the company will continue growing sales in the low-to-mid-teens percentage range and earnings by more than 10% while sustaining leverage below 6x, utilizing cash proceeds from proposed future transactions for debt reduction in fiscal 2022.

Rating Action Rationale

The upgrade reflects improved credit metrics from debt reduction following capital structure changes and our expectation for higher EBITDA due to strong revenue growth and as the company reduces its restructuring spend. Coty's prestige segment had substantial growth during the past few quarters, especially the most recent quarter ended Sept. 30, 2021. Total revenues grew 35% in the segment, driven by strong performance across fragrances and cosmetics helped by successful product launches across key brands and the relaunch of the Kylie

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brand. For the 12 months ended Sept. 30, 2021, leverage improved to 7.2x on a pro forma basis from 11x for the prior quarter, fiscal year ended June 30, 2021. The sequential profitability improvement largely reflected favorable product and channel mix, higher pricing, a recovery in travel retail, better demand planning leading to lower excess and obsolete inventory and benefits from cost-savings initiatives that we expect to continue until fiscal 2023. The company continued to lower its cost base realizing incremental savings of about $60 million in the first quarter of fiscal 2022. Coty has significantly reduced its stock-keeping units (SKU) count and packaging formats, streamlined its brand portfolio, closed manufacturing facilities, reduced headcount, and repurposed its marketing investments over the recent quarters. The company also incurred significantly lower one-time restructuring costs associated with its all-in-to-win transformation plan.

Additionally, further deleveraging resulted from capital structure changes. The company entered into an agreement to sell an additional 4.7% of its stake in Wella AG (bringing its ownership stake down to 25.9%) to KKR in exchange for redemption of about 56% of KKR's remaining convertible shares and accrued dividends. KKR has also announced the sale of its remaining 2.4% ownership stake in Coty by converting its preferred shares into common equity, thereby exiting its ownership of Coty. We expect future annual dividend payouts to preferred equity holders to decrease by about $25 million to about $13 million as a result of these transactions. In addition, these transactions reduce our measure of consolidated leverage by about 0.5x, given our treatment of the company's preferred equity as a debt-like obligation.

The company's recent strategic and operational initiatives should support sustained above pre-pandemic profitability over the medium term. Coty generated EBITDA margins of 20.8% in the first quarter of fiscal 2022, which compares with 9.3% and 13.4% for the same period in 2021 and 2020, respectively. The company successfully navigated through inflation and supply chain headwinds that have plagued the industry. The vast majority of the company's freight is under contract and is not dependent on spot-based pricing. The company had secured these contracts in advance which shielded it from a significant amount of freight headwinds. In addition, a significant portion of the company's inventory is manufactured locally within its various global markets, thereby simplifying transportation and alleviating potential pressures from logistics constraints. We expect inflationary pressures and supply-chain bottlenecks to partially offset profitability gains through the remainder of the year as the company's cost savings taper off. In addition, Coty announced it would continue to increase its marketing spend and reinvest proceeds from efficiency gains into its key strategic initiatives. However, we expect cost base optimization and other initiatives to sustain a 50-basis-point (bp) improvement in EBITDA margins relative to fiscal 2019 over the medium term.

Coty has recently launched a number of new products including Gucci Flora Gorgeous Gardenia and Burberry Hero fragrances, Rimmel's Wonder'Extension mascara, and first-to-mass Kind & Free range of clean, vegan, and cruelty-free cosmetics products and Max Factor's Facefinity foundation. It also completed a relaunch of Kylie cosmetics and is successfully executing Lancaster's repositioning in the skincare segment. We expect these efforts will continue to improve the company's positioning in the respective segments while elevating its portfolio, resulting in market share growth amid the increasingly competitive beauty industry. We expect this to also benefit operating leverage as volumes increase, further accelerating EBITDA growth in fiscal 2022, resulting in adjusted EBITDA margin expansion to 16%-17% from 14% in fiscal 2021.

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We expect Coty's management to continue prioritizing debt reduction with all excess cash proceeds being applied toward debt repayment, thus reducing and sustaining leverage below 6x. We believe Coty will use cash proceeds from its Brazilian IPO and additional sales of its stake in Wella toward debt repayment, which we estimate will exceed $500 million in fiscal 2022. The company is also undertaking several real estate divestitures in the second quarter of fiscal 2022 which are expected to yield about $150 million of cash proceeds that we expect the company will use for debt reduction. The reduction in consolidated debt levels, combined with strong EBITDA growth, should result in leverage declining to the mid-5x area, compared to our previous forecast of 6.2x. We expect Coty to remain committed to a disciplined approach toward asset sales and debt reduction and continue to look for opportunities for potential asset dispositions to further streamline its portfolio. The company reiterated its target to reduce leverage towards 5x by the end of 2021 and 4x (based on management's calculations) by the end of 2022. Moreover, we expect voluntary debt repayments to help improve the cushion under the company's net leverage covenant over the next few quarters to around 15% from 11%at the end of the first quarter of fiscal 2022.

The revolver maturity extension addresses the company's refinancing risk. Coty has secured commitments to extend its revolver maturity to April 2025 and reduce its revolver capacity to $2 billion from previous $2.75 billion. We recognize the extension largely addresses the refinancing risk associated with its upcoming debt maturities. The company has $111.1 million of euro term loan A facility maturing in April 2023 that we expect to be repaid by the end of 2021. Its largest upcoming maturity is the 4% $638 million euro notes in April 2023 that we assume will be redeemed with an equal new issuance. The company has about $377 million cash on the balance sheet that we believe includes some cushion due to the uncertain macro environment and persistent supply chain disruptions. Given the increase in its EBITDA margins due to its improved product mix and cost optimization initiatives as well as our expectation of cash inflows through better working capital management, we expect Coty to generate free cash flow of $450 million to $500 million in fiscal 2022 and fiscal 2023.

Outlook

The stable outlook reflects our expectation that the company will continue growing sales in the low-to-mid-teens percentage range and earnings by more than 10% while sustaining leverage below 6x, utilizing cash proceeds from proposed future transactions for debt reduction in fiscal 2022.

Upside scenario

We could raise our rating on Coty if we believed the company would sustain leverage below 5x along with:

- Achieving sustained organic growth and establishing a successful record of retaining its market shares and sustaining its improved cost structure;
- Continuing to execute its strategy of utilizing all excess cash proceeds, including from future asset sales and the Brazilian IPO for debt reduction; and
- Demonstrating conservative financial policies by not making large, debt-financed dividends or acquisitions.

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Downside scenario

- We could lower our ratings on Coty if we expect adjusted leverage to remain above 7x, which could occur due to:
- A revision to the company's asset sale and Brazilian IPO plans that leads to lower than currently forecasted debt reduction;
- A resurgence of COVID-19 variants causes increased mask wearing or reimposition of restrictions on consumer mobility leading to demand for the company's products remaining weak, resulting in material organic revenue declines; or
- An operational misstep, a worsening macro environment, heightened competition, higher inflation or additional restructuring charges stall sales and profit recovery prospects.

Company Description

Coty Inc., together with its subsidiaries, develops, manufactures, markets, and distributes fragrances, cosmetics, skin care and body care products worldwide. JAB Holding Company is Coty's largest shareholder, with a 61 percent ownership in the company as of Sept. 30, 2021.

Our Base-Case Scenario

- S&P Global Ratings economists expect U.S. GDP will expand 5.7% in 2021 and 4.1% in 2022, Europe GDP will increase 5.0% in 2021 and 4.1% in 2022, and Asia-Pacific GDP will expand 6.3% in 2021 and 5.0% in 2022.
- Revenue increases about 16% in fiscal 2022 to $5.4 billion, backed by a rebound in overall regional sales because of an improving economy and successful product launches. For fiscal 2023, we expect sales to increase by a mid-single-digit percentage amid a more normalized consumer environment.
- We expect EBITDA margin to improve to 16.8% in fiscal 2022 from 14.1% in 2021 on higher volumes, favorable mix, realization of benefits from the company's transformation plan, and lower restructuring charges. This is somewhat offset by reinstatement of employee bonuses and reinvestment into the company's operational priorities. We expect EBITDA margin to remain stable at similar levels as we believe company will reinvest its increased profitability on enhanced marketing spend.
- Capital expenditures (capex) of about $200 million annually over the next two years are mainly driven by maintenance capital spending requirements to support the higher sales volumes.
- Mandatory debt amortization of $23 million per year.
- Discretionary cash flow of about $500 million in fiscal 2022 and fiscal 2023, meaningfully above $89 million in fiscal 2021.
- No share repurchases or acquisitions over the next 12 months.

Based on these assumptions, we project following metrics:

- Debt to EBITDA in the mid-5x area in fiscal 2022, improving to 5x in fiscal 2023 (excluding preferred stock:

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- 5.4x and 4.7x respectively); and
- EBITDA interest coverage of about 3.2x in fiscal 2022, improving to the high-3x area in fiscal 2023.

Liquidity

We continue to assess Coty's liquidity as adequate despite our view that its sources will likely be at least 2x its uses over the next 12 months and remain positive even if EBITDA declines by 30%. We believe Coty has well-established and solid relationships with its banks--demonstrated by its ability to secure large, committed credit facilities--and satisfactory standing in credit markets. However, we continue to believe the company will need to refinance if it experiences a high-impact, low-probability event (such as severe market turbulence, sovereign risk, or the activation of material-adverse-change clauses).

Principal liquidity sources

- About $377 million cash as of Sept. 30, 2021;
- Availability of $1.4 billion under the revolving credit facility due 2025; and
- Annual cash FFO of about $550 million over the next 12 months.

Principal liquidity uses

- Debt repayment of more than $500 million in fiscal 2022 from the proceeds of Brazil IPO, return on the Wella investment and proceeds from real estate divestitures;
- Mandatory scheduled debt amortization of approximately $23 million per year;
- Capital spending of about $200 million over the next 12 months;
- Working capital (including seasonal peak) requirements of about $500 million; and
- No dividends paid to common equity shareholders or share repurchases over the next 12 months.

Covenants

Compliance expectations

We expect Coty to remain in compliance with all applicable covenants under the ABL revolving credit agreement and term loan agreement for the respective periods over the next 12 months. The company had 11% headroom under its total net leverage ratio covenant as of September 30, 2021. We expect the company to have sufficient headroom of about 15% over the next 12 months under our base-case forecast.

Requirements

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Coty's credit agreements contain a maximum 5.25x total net leverage ratio maintenance financial covenant requirement through Dec. 31, 2021, that steps down to 5.00x on March 31, 2022, 4.75x on June 30, 2022, 4.50x on Sept. 30, 2022, 4.25x on Dec. 31, 2022, and to 4.00x March 31, through June 30, 2023. The company's 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.

Issue Ratings - Recovery Analysis

Key analytical factors

- The company's debt structure is composed of:
- --A $2 billion revolving credit facility (with $590 million outstanding as of September 30, 2021) maturing in April 2025;
- --Term A facility with $111 million outstanding as of Sept. 30, 2021, maturing in April 2023;
- --Term B facility with $1.5 billion outstanding as of Sept. 30, 2021, maturing in April 2025;
- --2026 senior secured dollar notes with $900 million outstanding as of Sept. 30, 2021, maturing in April 2026;
- --2026 senior secured euro notes with $812 million outstanding as of Sept. 30, 2021, maturing in April 2026;
- --2023 senior unsecured euro notes with $638 million outstanding as of Sept. 30, 2021, maturing in April 2023;
- --2026 senior unsecured dollar notes with $550 million outstanding as of Sept. 30, 2021 maturing in April 2026; and
- --2026 senior unsecured euro notes with $290 million outstanding Sept. 30, 2021, maturing in April 2026.

- Coty Inc. is the borrower/issuer of all the debt. Coty BV is a co-borrower under the revolver. We continue to value the company on a going-concern basis. The bank loans are guaranteed by the borrower and its direct and indirect wholly owned domestic subsidiaries and secured by perfected first-priority security interest in substantially all assets of the borrower and each subsidiary guarantor, subject to certain exceptions, whether owned on the closing date or thereafter acquired. (All facilities are cross-guaranteed.) The unsecured notes are guaranteed direct and indirect wholly owned domestic subsidiaries (U.S. and euro notes cross-guaranteed).
- The company has operations globally, with approximately 35% of its EBITDA generated in the U.S. and 65% overseas. The company's debt is incurred in the U.S. (with the exception of Coty BV being a co-borrower on the revolving credit facility), and each of the secured facilities are cross-guaranteed and cross-collateralized. In the event of an insolvency proceeding, the company would most likely file for bankruptcy protection under the auspices of the U.S. federal bankruptcy court system even though it has significant foreign operations, we do not assume any filings in foreign jurisdictions. The company could file for bankruptcy protection in foreign jurisdictions as well but in such a case, it would add complexity to the administration of the bankruptcy case and would incur additional bankruptcy-related costs, resulting in lower recovery prospects.
- We believe the company would be reorganized rather than liquidated under a default scenario,

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given Coty's portfolio of well-recognized brand names with strong market shares and its geographic diversity.

- We estimate $5.4 billion in gross recovery value at the time of default under our projected scenario. We base this on assumptions of the realization rates for Coty's ownership stakes in Wella and King Kylie as well as an assumption of an EBITDA multiple applied against the company's distressed emergence EBITDA under our hypothetical default scenario. Our analysis considers a 60% realization rate on the company's investments in Wella and King Kylie, resulting in a $1 billion combined DAV at default. We have valued the company's base business based on an enterprise value to gauge recovery and apply a 6.5x multiple on an assumed distressed emergence EBITDA of $681 million that results in an estimate gross recovery value of $4.4 billion. To determine net recovery value available for distribution to creditors, we reduced our estimate of total gross recovery value of $5.4 billion by 5% to account for estimated bankruptcy administrative expenses. This results in a total net recovery value of about $5.2 billion.

Simulated default assumptions

Our simulated default scenario contemplates a default in 2024, primarily due to missteps in executing its restructuring plan or due to a steep decline in demand for the company's products. We believe that in a distressed situation, funds from the company's operations would not be adequate to support the interest burden and cash needs for its operations.

Calculation of EBITDA at emergence

- Debt service: $407.8 million (default year interest plus amortization)
- Maintenance capex: $136.8 million
- Default EBITDA proxy: $544.6 million
- Operational adjustment: $136.2 million (25% of preliminary emergence EBITDA)

Simplified waterfall

- Emergence EBITDA: $680.8 million
- Multiple: 6.5x
- Gross recovery value: $4.4 billion
- Gross asset value: $1.0 billion
- Realization rate: 60%
- DAV: $1.0 billion
- Total gross recovery value: $5.4 billion
- Net recovery value for waterfall after administrative expenses (5%): $5.2 billion
- Valuation split (obligor/nonobligors): 21%/55%/18%/6%
- Collateral for secured creditors: $3.3 billion
- First-lien claims: $5.0 billion

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- —Recovery expectation: 70%-90%; rounded estimate: 85%
- Collateral for unsecured creditors: $1.9 billion
- Unsecured claims: $3.2 billion
- —Recovery expectation: 50%-70%; rounded estimate: 55%

All debt amounts include six months of prepetition interest.

Ratings Score Snapshot

Issuer Credit Rating: B/Stable/--

Business risk: Fair

- Industry risk: Low
- Country 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 impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- General Criteria: Hybrid Capital: Methodology And Assumptions, 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 | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013

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- 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: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Upgraded; Outlook Action

	To	From
Coty Inc.		
Issuer Credit Rating	B/Stable/--	B-/Positive/--
Issue-Level Ratings Raised; Recovery Expectations Revised		
	To	**From**
Coty Inc.		
Coty B.V.		
Senior Secured	B+	B
Recovery Rating	2(85%)	2(75%)
Issue-Level Ratings Raised; Recovery Ratings Revised		
Coty Inc.		
Senior Unsecured	B	B-
Recovery Rating	3(55%)	4(45%)

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