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Research Update:

Coty Inc. Downgraded To 'BB' Following Operational Misses; Credit Facilities Ratings Lowered To 'BB+'

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Recovery Analysis

Related Criteria

Ratings List

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Research Update:

Coty Inc. Downgraded To 'BB' Following Operational Misses; Credit Facilities Ratings Lowered To 'BB+'

Overview

- New York-based cosmetics manufacture Coty Inc.'s operating performance fell short of our performance expectations in fiscal 2017 and adjusted leverage is in the mid-5.0x area.
- We believe the company will continue to face headwinds from the mass channel at a time when it is repositioning the acquired P&G beauty assets. We have revised downward our forecast for sales and profits and believe its adjusted leverage will remain elevated for at least the next year.
- We are lowering our corporate credit rating to 'BB' from 'BB+' and the ratings on the secured bank debt to 'BB+' from 'BBB-'. The recovery rating remains a '2'.
- The stable outlook reflects our expectation that management will stabilize and grow the P&G beauty business as it has put in place initiatives to revitalize the brands. In addition, we expect the company to realize greater efficiencies and achieve cost reductions in its fiscal 2018. Our forecast incorporates weakness in the first half of its fiscal 2018 and that Coty's pro forma adjusted leverage will decline to low 5.0x by year-end fiscal 2018 and progress toward 4.0x thereafter.

Rating Action

On Aug. 31, 2017, S&P Global Ratings lowered its corporate credit rating on Coty Inc. to 'BB' from 'BB+'. The outlook is stable.

At the same time, we lowered the ratings on the company's senior secured credit facilities to 'BB+' from 'BBB-'. The recovery ratings remains unchanged at a '2', reflecting our expectation for substantial (70%-90%; rounded estimate 70%) recovery for lenders in case of a payment default.

Rationale

The downgrade reflects our expectation that it will take longer for Coty to reposition the P&G beauty assets it acquired in October 2016 and that adjusted leverage will remain elevated because of a combination of weakness in the mass channel and Coty's need to revitalize its brands, especially the ones that compete in the mass channel.

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Coty's operating performance was weak in the fourth quarter of fiscal 2017, causing pro form adjusted leverage to increase from the low-4.0x area to more than 5.0x. Coty's consumer beauty segment's organic sales dropped 10% in the fourth quarter of its fiscal 2017 (ended June 30) because of a combination of promotional activity, loss of shelf space, and a decline in the beauty category in the mass channel. Rimmel and Sally Hansen were the biggest drag because of reduced shelf space. In addition, the segment was weakened due to unfavorable mix shift because of its Hypermarcas acquisition. Its other segments showed some improvement in the quarter on a sequential basis but also faced headwinds. Its luxury business' organic sales declined 6% for the year primarily because of reduced distribution to mass channel and negative price and mix, and its professional beauty business' organic sales fell 12% for the year because the sales of its new OPI gel products did not offset the decline in its lacquer products. The segment was also hampered by unfavorable regional, channel, and promotional mix.

We estimate pro forma adjusted leverage was 5.5x in fiscal 2017 compared to our expectation for adjusted leverage in the low 4.0x area. Our prior estimate had a lower pension adjustment and did not incorporate our adjustment for the company's redeemable noncontrolling interests of $551 million. These two items contributed a half a turn of leverage. The redeemable noncontrolling interests consist of a 33% interest in a consolidated subsidiary in the United Arab Emirates and a 40% interest in the consolidated subsidiaries related to the Younique acquisition. Since the noncontrolling interest are outside of the company's control, we have added it to our debt adjustments. We forecast that the company should be able to expand margins above 18% in fiscal 2018 from an estimated pro forma 16.4% as it should benefit from initiatives already in place to reposition its brands, the divestment of noncore underperforming brands, greater efficiencies from the former P&G beauty assets, and cost reduction. Adjusted leverage should decline to roughly 5.0x by year-end fiscal 2018 if the company achieves our base-case forecast. Excluding the redeemable noncontrolling interest, our adjusted leverage estimate is 4.8x for year-end fiscal 2018.

Coty's margins are well below those of its peers. We estimate its pro forma EBITDA margin was just under 17% in fiscal 2017, which is well below the 22% and 23% margins that L'Oreal and Estee Lauder respectively maintain but above Revlon's pro forma 13.2% depressed margins. We do not expect Coty's EBITDA margin to exceed 20% until fiscal-year 2019 given its need to reposition the P&G brands; previously we estimated the company would expand it's EBITDA margin to that level by its fiscal year-end 2018.

Our ratings also reflect Coty's good cash flow generation capabilities and that it will repay a modest amount of debt annually. We forecast adjusted leverage will decline to the low-4.0x area in fiscal 2019 due to a combination of debt reduction and EBITDA growth. In our view, the company will moderate its financial policy such that it will not make additional large acquisitions until it fully integrates the P&G beauty assets. We expect Coty to generate operating cash flow of $1.1 billion in fiscal 2018 assuming neutral working capital and excluding restructuring and it will increase further as it

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achieves synergies from its acquisitions and benefits from its cost reduction programs.

The assumptions in our base-case scenario for the newly combined company in fiscal years 2018 and 2019 include:

- Global GDP growth 3.1% in 2017 and 3.6% in 2018 and 2019.
- Revenues decline at a low-single-digit rate in fiscal 2018, below the industry rate and global GDP growth, as we believe it will continue to face headwinds in the mass channel and management has stated that it plans to divest underperforming noncore brands equaling 6%-8% of sales. In fiscal 2019, we forecast sales will be roughly in line with economicgrowth as we believe the company will be successful at gaining shelf space in mass and that consumers will respond well to its new products introductions.
- Pro forma EBITDA margin expands above 18% in fiscal 2018 from an estimated pro forma about 17% and exceeds 20% in fiscal 2019 as it benefits from exiting some underperforming noncore brands, scale, greater efficiencies in the former P&G brands, and a focus on cost reductions.
- Dividends of about $415 million.
- No material acquisitions and no share repurchases over the next two years.

Though we expect Coty to continue to face headwinds in the first half of its fiscal 2018 as it integrates its transformational acquisition of the P&G beauty assets, with $9 billion in annual sales, it has the potential to be a formidable player in the cosmetics industry. The company holds the No. 1 position in the global fragrance market with almost twice the market share of its next largest competitor, L'Oreal. In the color cosmetics market, the company holds the No. 3 positon, though we expect Coty will gain additional market share from its competitors, such as Avon, Shiseido, and Revlon. However, it will be hard for Coty to gain market share from L'Oreal and Estee Lauder, which have solid positions in most of their categories, a history of strong brand management, and a greater level of financial resources to invest in their businesses. Coty holds the No. 2 position in the professional hair salon category. Its market share is about half that of L'Oreal's but twice the size of Henkel's. We believe it could be difficult for Coty to take market share away from L'Oreal and Henkel given their financial and marketing strength; however, Coty's salon business is significantly larger than Kao's, Estee Lauder's, Shiseido's, and Revlon's, and we believe it has the potential to gain share from these players. Due to the increasing diversity of the beauty products industry, Coty faces competition from both cosmetic bellwethers and smaller niche players with unique product propositions (i.e., fast-fashion approach, local players that use indigenous ingredients, or an experiential approach). These small niche players have been increasingly taking market share away from the well established companies whose products have high brand equity.

In our view, Coty not only needs to focus on rebuilding the P&G beauty assets but will also need to maintain a high level of innovation and packaging

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uniqueness while accelerating the sale of its products through e-commerce channels to at least maintain its market share. Moreover, in order to remain competitive and accelerate its top-line growth, we believe Coty will need to acquire companies in the emerging markets and niche cosmetic companies that are uniquely positioned.

Coty should benefit from the favorable trends in its industry. The beauty sector is one of the most attractive industries in consumer products, valued at approximately $300 billion according to Euromonitor, and it has grown at a compound annual growth rate (CAGR) of 3.8% over the last five years. Furthermore, we expect the industry will grow at a higher than 3.0% CAGR over the next five years. We forecast Coty will be able to stabilize and strengthen its operating performance because of its diverse portfolio of brands and products at a wide range of price points. Its luxury and professional segments have already demonstrated improvement. However, we expect it to grow its sales at a slower pace than its key peers and the rest of the industry because of its exposure to the mass channel and the fact that it still predominantly competes in developed markets, where growth is slower than in the emerging markets, and that it is under-indexed compared with its key peers in the skin care category.

If Coty is successful at repositioning the P&G's beauty assets it should be able to slowly close the gap between its growth rate and the growth rate of the overall industry as the P&G's beauty assets provide Coty with additional expansion opportunities in faster-growing markets such as Brazil and Japan. Its acquisition of the Hypermarcas Brands should also help it accelerate growth in Brazil. Moreover, Coty now has representation in all channels.

Liquidity

We believe the company has adequate liquidity. We expect the company's liquidity sources to be at least 2x its uses over the next two years and anticipate its sources will cover its uses even if its forecasted EBITDA declines by 50%. Our view of the company's liquidity also incorporates our belief that the new company has sound relationships with its banks.

Based on our quantitative analysis, Coty qualifies for a stronger liquidity assessment; however, it does not meet our qualitative requirements. Coty does not have any public bonds or other data to assess its standing in the credit markets. Moreover, 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, it is too soon to assess whether the company is committed to maintaining its current high level of liquidity.

Principal liquidity sources:

- Ongoing cash balances of more than $500 million and $2.2 billion of availability under its revolving credit facilities that total $3.0 billion; and
- Funds from operations of more than $250 million in fiscal 2018 and more

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than $900 million in fiscal 2019.

Principal liquidity uses:
- Capital spending of roughly $400 million in fiscal 2018 and 2019;
- Dividends of about $415 million per year; and
- Mandatory debt amortization of roughly $215 million per year.

Outlook

The stable outlook on Coty reflects our expectation that management will stabilize and grow the acquired P&G beauty assets as it has put in place initiatives to better merchandise the brands and management has a history of developing new products and successfully market them. In addition, we expect the company to realize greater efficiencies from the former P&G brands, and achieve cost reductions in its fiscal 2018. Our forecast incorporates weakness in the first half of fiscal 2018 and that pro forma adjusted leverage will decline to roughly 5.0x by year-end fiscal 2018 from the mid-5.0x area at year-end fiscal 2017.

Downside scenario

We could lower our rating on Coty if it continues to encounter difficulty in repositioning P&G's beauty business, resulting in the company not being able to expand its EBITDA margin and reduce leverage. If this were to occur, we could reconsider the business risk. We could also lower the rating if the company's financial policy becomes more aggressive such that it makes additional debt-financed acquisitions and sustains adjusted leverage above 5.0x.

Upside scenario

We could raise our rating on Coty if it gains traction in rebuilding the P&G brands, stemming its decline in market share, demonstrating that it can maintain its strong market position in the beauty category, and improve its profitability such that its EBITDA margin expands to 20% or above resulting in it being able to sustain adjusted leverage below 4.0x. We believe this is unlikely over the next year given its recent weak operating performance.

Ratings Score Snapshot

Corporate Credit Rating: BB/Stable/--
Business risk: Satisfactory
- Country risk: Low
- Industry risk: Low
- Competitive position: Satisfactory

Financial risk: Aggressive
- Cash flow/Leverage: Aggressive

Anchor: bb
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: Neutral (no impact)

Recovery Analysis

Key analytical factors

- Our simulated default scenario contemplates a default in 2022, primarily due to its inability to integrate P&G's beauty business.
- We believe that if the company were to default, a viable business model would continue to exist given Coty's portfolio of well-recognized brand names and its geographic diversity.
- We continue to value the company on a going-concern basis using a 7.0x multiple of our projected emergence EBITDA.
- We estimate that for Coty to default, its EBITDA would need to decline significantly from recent levels.
- Jurisdiction insolvency regimes: The company has operations globally, with approximately 30% of its EBITDA generated in the U.S. and 70% overseas. The company's debt is incurred primarily in the U.S., and each of the facilities is 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 and will not involve 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.

Capital Structure consists of senior secured:

- Coty $1.5 billion revolver credit facility due 2020
- Coty $1.75 billion term A bank due 2020
- Coty $600 million term B bank due 2022
- Coty euro 665 million term B bank 2022
- Coty $975 million incremental term A due 2021
- Coty B.V. euro 325 million incremental term B due 2022
- Coty B.V. euro 140 million incremental term A due 2020
- Galleria $1.5 billion revolver credit facility due 2021
- Galleria $944 million term A bank due 2021
- Galleria Co. $1 billion term B bank due 2023

Simulated default assumptions

- Year of default: 2022
- EBITDA at emergence: $986 million
- Implied EV multiple:7.0x

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Simplified waterfall

- Net recovery value (after 5% admin. costs): $6,560 mil.
- Valuation split in % (Obligor/non-obligors): 30%/70%
- Collateral for secured creditors: $3,294 mil.
- First-lien claims: $5,619 mil.
- Recovery expectation: 70-90% (rounded estimate 70%)

Note: All debt amounts at default include six months accrued prepetition interest. Collateral value equals asset pledge from obligors less priority claims plus equity pledge from nonobligors after nonobligor debt.

Related Criteria

- 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 - Industrials: Key Credit Factors For The Branded Nondurables Industry, May 7, 2015
- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Downgraded/Outlook Action

	To	From
Coty Inc.		
Corporate Credit Rating	BB/Stable/--	BB+/Stable/--

Ratings Downgraded/Recovery Rating Unchanged

	To	From
Coty Inc.		
Galleria Co.		
Coty B.V.		
Senior Secured	BB+	BBB-
Recovery Rating	2(70%)	2(70%)

Rating Downgraded/Recovery Rating

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	To	From
Coty Inc.		
Senior Secured	BB+	BBB-
Recovery Rating	2(70%)	2(75%)

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