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Coty, Inc. (COTY)

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MANAGEMENT DISCUSSION SECTION

Dara W. Mohsenian
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All right. Well, good morning everyone. I'm Dara Mohsenian, Morgan Stanley's household products, beverage, and food analyst. And I'd like to welcome Pierre-André Terisse, Coty's Chief Financial Officer here today. It's certainly been a transformational period for Coty. They've come out recently with a new strategic plan under a new management team as well as announced a significant strategic partnership with Kylie and a divestiture. So it's a great time to have them here and we really appreciate you coming. Thanks for coming, and I'll turn it over to you for an overview in the beginning and then we'll get into Q&A. Thanks.

Pierre-André Terisse
Chief Financial Officer & Executive Committee Member, Coty, Inc.

Thank you. Good morning everyone and thank you for joining for today's presentation. So my name is Pierre-André Terisse. I've been the CFO of Coty for a little less than a year now so it's pretty recent. And I must say, it's been quite a journey in that time but I'm even more excited for what lies ahead for Coty and their incredible portfolio of iconic brands.

So Coty is a company with a very strong asset base with iconic brands across key categories and channels and [ph] core (00:01:30) position in key beauty markets [indiscernible] (00:01:35) over time with some legacy brands, Lancaster for instance, some licensees afterwards with Calvin Klein, some acquired brands like Rimmel 20 years ago, and Covergirl more recently. And today, as we have done in the past, Coty is a company which is transforming itself and trying to adapt in a very fast changing environment.

For this we – for the past one year we have built a roadmap in three different stages to transform the company. We spent initially many months, from January to basically July, June or July 2019 in a detailed review of the business, trying to understand the way we could improve the performance first and foremost, and that's what we have called the turnaround plan which we have shared with the investment community in July with a detailed four-year roadmap to return Coty to revenue growth and maybe more importantly to improve and step up the level of execution, step up the profitability and the margins to 14% to 16% and start deleveraging the business.

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And so that was step one, the turnaround which we thought was obviously very, very important and very key but not sufficient. We have therefore designed a second phase which aimed at both refocusing the group and recovering financial flexibility, and that's the opening of a strategic review on product portfolio which is the Professional Beauty division, the hair brands which exist as well on the consumer side, and the Brazil business. And again, the intention with this strategic review is to refocus the group and the efforts of the group, both financial and human, on things on which we think we can make a difference and recover financial flexibility.

The phase three of the roadmap is to accelerate. So with phase one, we fixed the fundamentals and the profitability of our portfolio. With phase two, we give ourselves the ability to grow faster and to be more focused and to have more flexibility. And with phase three, we're trying to accelerate. It's been obviously about a recent announcement which is a partnership with Kylie Jenner which is going to be one element helping us to step-change the growth profile of Coty, allowing us to expand our presence in both premium cosmetic and skincare which are two categories where we are currently under-indexed and where we are focused on growing.

So maybe I can go into each of the elements of the change and transformation program a bit in more detail. I'll start with phase one, the turnaround, and maybe with the two elements of the portfolio which are going to remain post the strategic review. Starting with Luxury, our Luxury division, we are the global leader in fragrances with iconic brands like Hugo Boss, Calvin Klein, Gucci, Chloé, Marc Jacobs. We have three out of the top 10 global fragrance brands. We are, and I think that's very important to have that in mind, we are a best-in-class operator in this category. There are not so many. We are one of the few covering I think a global and worldwide coverage, and that makes us, that makes Coty a licensee of first choice. And while our fragrance portfolio is primarily licensed, the long-term nature of these licenses assures a steady and predictable revenue stream with the average remaining life for our entire portfolio being roughly eight years, all the big licenses being in excess of 10 years and most of them being renewed before the expiry among the reasons because, again, we are an operator of – which is best-in-class.

Our strong capabilities in fragrance have allowed us to deliver strong results. So first of all, to grow in line or ahead of the underlying luxury fragrance market for the last two years, and we estimate that the growth of this category is about 3%. And in connection with that, we've been steadily improving our operating margins, reaching 15.5% in fiscal 2019. We believe, by the way, that there is room for further margin expansion growth and margin expansion in the business even if we don't expect it's going to be as strong and steep as it has been for the past three years. So that's a big part of our business, the Luxury division.

The second one I want to comment on is the Consumer Beauty division with an overall measured mass beauty market which has been declining 1% to 2% in the last three years, a moderate decline which is in large part due to the growing penetration of indie brands which are sold predominantly in channels which are not measured and therefore not part of this measured universe. But even in the measured market where we play, the performance is not uniform. As you can see on the chart, in the US mass cosmetic market which is only part of the world market which has been declining low to mid-single-digit, there is a clear trend of premiumization with the higher-priced tier growing nicely and much less so as you go deeper into mass. And the roadmap towards stabilizing our market share for the division rests on better execution on the one hand which is the most important element but it includes as well gradual premiumization as well as an increased support for our brands, and we have started increasing the support behind our brands that [indiscernible] (00:08:06) helped in the first quarter of this year.

A key part in improving our performance in Consumer Beauty is prioritizing the brands and markets we want to focus and meaningfully increasing our investment behind that to allow us to advertise them at scale and sufficiency. And as we shared before, we will triple the percentage of priority brand/country combination supporting a scale to 60% by fiscal 2023. Another level is restoring our competitive pricing architecture for our

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brands. In the last few years our price position has eroded as a result of over-promoting and being timid to take price where warranted. We were absolutely looking for top line for the sake of top line. Today we are looking for profitable top line and we are being much more selective, and therefore we are changing this now. And over the course of fiscal 2020 and beyond we will gradually restore or increase our pricing architecture in all of our key markets.

Specifically around this pricing architecture, in the last month we had implemented list price increase in a key European country for Max Factor and Rimmel SKUs. And based on the initial sell-out data coming in, it's encouraging to see on the top left of the screen that the double-digit list price increase on these SKUs and on the right as well has resulted in only a moderate deterioration in unit volumes. So in other words, the elasticity is the one we expected. It's favorable and that confirms our data analysis coming in that beauty is a relatively price-inelastic category giving us room to drive sales and gross margin expansion through a disciplined and pragmatic approach to pricing and promotion and a very careful execution obviously because you need to do it well.

As we shared in our recent earning calls, we have seen other green shoots in our sell-out performance. As you can see on the slide, the combination of increased media support, strong performance of innovation, and better in-store execution has driven significantly improved trends for Rimmel in the UK and Sally Hansen in the US, and we aim to replicate the improvement across all of our core Consumer Beauty brands over time.

So that's for the turnaround and Consumer Beauty. Let me now shift to phase two of our roadmap which is the refocusing of our portfolio. As I was telling in the introduction, we have decided to engage a strategic review of the Professional Beauty business associated hair brands, Wella and Clairol, as well as the Brazilian operations. And you can see on the slide some of the iconic brands included in this group, they include Wella, they include Clairol as I said, they include ghd, OPI globally but also extremely strong brands locally in Brazil being Monange, Risque, Paixão as well which is not on the chart and that's clearly as I said very attractive brands and a very attractive portfolio.

The objective of the review, very simple. It's unlocking shareholder value, of course. It's sharpening our focus on our fragrance, color cosmetic, and skincare core businesses, and by doing so reducing the complexity and increasing our level of impact with potential proceeds to deleverage Coty with a target pro forma leverage at 3 times.

About the business which is under review, a few elements. So the scope covers $2.7 billion of annual revenue. This includes $1.8 billion for Professional Beauty which is a market or a division that has continued to see steady growth and where there is an incredible amount of customer loyalty and repeat purchase so, yeah, a very steady performer of the group. It also includes $900 million of revenue across the retail hair brands and our Brazil operation. The operating margin profile of the business under review is similar to that of Professional Beauty which reported fully allocated operating margin of roughly 12% last year. However, in a scenario of a divestiture the margin is likely to be higher as not all of the allocated overhead cost will transfer with the business. We already received strong interest from both strategic and financial buyers and we're advancing with the review process which we anticipate to complete by next summer.

So that's phase two which is obviously a very important one of the transformation. And phase three now is accelerate, and I'll start with the recently announced strategic partnership with Kylie Jenner which is one component, not the only one, but one component of accelerating our growth and which sets the foundation for a global beauty business. The compelling part of the partnership is that we are each, Kylie and us, bringing complementary assets and capabilities which will allow this business to grow and strengthen in the coming years. On the one side, Kylie brings her incredibly strong brand equity as both a person and a brand with unparalleled

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social media reach amongst Generation Z consumer. This exposure to much younger consumers is something currently lacking in our portfolio as all you know, in the portfolio of our leading beauty brands. On the other side, we as Coty bring our extensive R&D, manufacturing, distribution, and selling capabilities as well as our expertise in core beauty categories across cosmetic, skincare but also fragrances. And together, therefore, we expect that we are going to create a lot of value and that the transaction is going to be accretive to our top line growth meaningfully by more than 1 point and that our – the returns are going to exceed our cost of capital by year three and may be earlier than that.

So let me provide a quick overview of the Kylie beauty business as I have done for the business under review, for the strategic review. Kylie beauty generated approximately $177 million of revenue over the last 12 months. That would represent over 40, 4-0, percent growth related to calendar 2018 so that's clearly a brand, and I don't need to mention that, which has a strong momentum. The elements underpinning their performance are the DTC website, the direct-to-consumer website where quarterly sales has remained steady year-to-date; the strong performance of the Kylie brand at Ulta which has allowed new and existing Kylie Cosmetics consumers to try their products; and last, the launch of the Kylie skincare line in May 2019, so very, very recently which results to a great start. And importantly, this brand has been very profitable with a level of EBITDA margin which exceed 25%.

So that's the first element of the acceleration. But in addition to this new partnership, we see significant opportunity to improve our growth profile by expanding our existing brands in existing and new categories. While we are number one in a $36 billion luxury fragrance market, our license agreements with the fashion houses allow us to expand the brand into cosmetic and skincare, and that's actually most of the time what they would like us to do. It's a great untapped opportunity given these two markets, skincare and color cosmetic luxury, together represent $60 billion and are growing high single-digit. So we have already begun this expansion with a relaunch of Gucci makeups several months ago and that has been performing very well.

In skincare, we do already have a small but strong base that we believe we can build on provided we focus on it, and that's also the reason why we want to be focusing on part of the portfolio. On top of Kylie which as I said is in skincare, Lancaster which you see on the left started off as a premium European skincare brand before moving to sun care today and it has gained strong momentum in China as a skincare brand, ranked as the number six brand in China Sephora which is [indiscernible] (00:17:35) the only channel where it operates. But we believe the legacy of the brand, we believe its position in this particular channel in China, the quality of the recipe, the quality of the research makes it something which we can expand and expand faster. philosophy which remains a predominantly US brand is the number six skincare brand in the US, and here again we think we can leverage it. So together, the traction achieved by these brands clearly exemplifies our R&D capabilities in skincare which presents another incredible opportunities for us going forward, and again we are going to increase our focus on those.

In prestige cosmetic, the Gucci lipstick launch has done incredibly well and we aim to continue the momentum by expanding the line into additional doors as well as adding new cosmetic categories; for the moment we only have lipstick. Our Burberry makeup line which is currently primarily in Asia and [indiscernible] (00:18:33) retail is also performing quite well, and that's the basis for further growth.

So that's, in three steps, the roadmap of transformation we have built in less than a year at Coty to transform the company. The turnaround of the existing brands in particular in Consumer Beauty, the step up in the profitability with the streamlining of all costs, the reshaping of the portfolio to increase our focus and regain financial flexibility, and the redeployment to accelerate our growth profile through newly – through new partnerships like Kylie but also through going to new categories with existing brands. So that's a very clear agenda. It's not only the agenda for tomorrow; it's an agenda for today.

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The change of performance starts now and we expect fiscal 2020 to already show progresses versus last year with the following guidance which we have set in July and which we have recently confirmed. Like-for-like net revenues stable to slightly down year-on-year versus minus 3.5% last year and adjusted OI which is going to be like-for-like up by 5% to 10% with a strong A&CP reinvestment; and adjusted EPS which we expect to be mid-single digits, growing mid-single digits year-on-year; and a free cash flow which we expect to continue improving.

That's really what I wanted to tell you about the transformation of Coty and I think we have a little bit of time for questions now. Thank you.

QUESTION AND ANSWER SECTION

Dara W. Mohsenian
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Great. Thank you very much. So maybe we'll start around the Kylie partnership. You quantified that you expect returns to exceed your WACC by year three. By my math, that sort of gets you to high single-digit revenue growth on that business to low double-digit revenue growth depending on your assumptions for investment, etcetera. Does that sound reasonable in terms of a growth profile for that business looking out over the next few years or what's implied in that ROIC count? And then secondly, what are the key growth drivers as you look at that business? Obviously it's had a very strong growth profile on its own the last few years. As you look out over the next few years, what are the key growth drivers keeping in mind its historical growth plus the advantages that Coty can bring to the Kylie business?

Pierre-André Terisse
Chief Financial Officer & Executive Committee Member, Coty, Inc.

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Yeah. So, I mean, the great thing about this deal is that, I mean, obviously it's combining strength and therefore there is a strong rationale to create value together. But it's also that it really lies on three different levels. One of them is of course top line, and we believe the combination of the power of our brand and the ability to expand into adjacent categories with the combination of our distribution ability, manufacturing ability, everything we can bring to it, to the partnership, the knowledge of the skincare category, the knowledge of the cosmetic category but also the knowledge of the fragrance category, the nail category can allow the brand to expand category-wise, channel-wise but also geography-wise, so we believe the scope of expansion is very high.

So there's a lot of upside on the deal. Beyond that, it's important to understand that we also expect to bring efficiency, the efficiency of the network of Coty, the efficiency through our ability to research and manufacture products – I mean how to manufacture, how to distribute, and to sell products. And the structure of the deal is interesting as well because it's a 51/49 JV, so the value creation from these three different levels and therefore it's not a deal which is entirely relying on growth but it's a deal which is balanced.

Dara W. Mohsenian
Analyst, Morgan Stanley & Co. LLC

Q

Okay. And on the geographic aspect, what gives you comfort that this is a business that has significant potential internationally? Obviously it's done very well in the US over time but it's really a US-centric business. So what gives you comfort there's international expansion opportunity for the Kylie business?

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Pierre-André Terisse
Chief Financial Officer & Executive Committee Member, Coty, Inc.

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Well, we have research and we know that some countries are going to be an obvious possibility for development; this is true in Europe in particular and this is true in the UK, this is true in Germany. And there are some countries for which we need a little bit more work to make sure that we can expand, and Asia is obviously one of them. But before Asia, important geographies for Coty we know we can expand and we know because we've researched the brand and its ability to grow.

Pierre-André Terisse
Chief Financial Officer & Executive Committee Member, Coty, Inc.

Q

Okay. And then turning to the base Coty business. You've talked about looking to take more pricing looking out over the next few years and that being a more important piece of the go-forward plans. How important is that to hitting your algorithm that you've outlined in that longer-term outlook? And conceptually it makes a ton of sense, right? You get pricing, you get gross margin expansion, you have room to reinvest behind the business as you've articulated but oftentimes these categories and brands are very competitive. So what gives you the confidence that there is room to take pricing as you look out over the next few years? And maybe also just talk about the process of how you take pricing and how you decide where to take pricing or not?

Pierre-André Terisse
Chief Financial Officer & Executive Committee Member, Coty, Inc.

A

Okay. Well, there's two elements of confidence, maybe three element of confidence and the third – the first is maybe anecdotal but it's important, is that our CEO has experienced many turnarounds and has already gone through that kind of experience many times, and I acknowledge that beauty is a different category, but he has his experience in other categories. The two others which are more important maybe is that it's a balanced plan. So it's not like we say we're going to go with the existing brands, we're going to take pricing, and we'll get more money, and we'll improve the margins, and we reinvest. I mean that will be easy but uncorrect.

The way to do it is not that one. The way to do it is we need to cut costs, we need to revisit the costs both at the COGS level and at the overhead level. We need to make sure that we recover some margins which allow us to invest beyond A&CP. At the same time, we need to have a look at the execution for each of the SKUs. We need to support the right SKUs, we need to be a bit more selective in terms of SKUs, i.e. not cut SKUs for the sake of it but replace the – I mean, strengthen the winning SKUs by giving them more space and giving less space to the one which are bringing primarily complexity. Finding a way to increase velocity so that we can pass pricing because you cannot pass pricing if you don't have a good reason for that.

Renovating the SKUs, innovate. As a process of renovation, innovation which is aiming at pricing which has not been – which is very much the case in the industry overall. I mean, whenever someone is launching a new product usually they want an added value for the consumer, and this added value for the consumer has an effect on the price. And that's something we've not been, for many reasons, we've not been really doing and now we want to do that. So it's really a combination of all that and making sure that it's progressively getting to traction. So it's not going to be one day before, one day after but it's going to be cost saving, supporting the brands, reworking the SKUs and doing that step by step. So that's what gives me confidence. [ph] It's an articulated time. (00:26:39)

The second thing which give me confidence is that it works. Objectively, when we look at what we're doing at the moment in the UK, it works; in Germany it works; it works for Rimmel; it works for the US for Sally Hansen. It doesn't work everywhere; this is true. I mean, when you look at the performance of Covergirl for instance for the past few months in the US, it's been improving a bit but not that much, so we have not found the solution. So we

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have found the solution in some markets, not in all of them. Now what I believe is that it's a matter of consistency and persistency, so we are going to continue trying. There are some markets in which for whatever reason there would be increased competition and it's not going to be immediately working, but we have to be patient and we have to be consistent and it will work the same way it has been working for Sally Hansen, the same way it works for Rimmel, the same way it works for Max Factor in UK.

Dara W. Mohsenian

Analyst, Morgan Stanley & Co. LLC

Okay, great. That's helpful. Well, thank you very much for being here, Pierre-André. I think we're out of time so we'll head to the breakout room.

Pierre-André Terisse

Chief Financial Officer & Executive Committee Member, Coty, Inc.

Thank you.

Dara W. Mohsenian

Analyst, Morgan Stanley & Co. LLC

Thank you so much.

Pierre-André Terisse

Chief Financial Officer & Executive Committee Member, Coty, Inc.

Thanks.

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