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COTY - Q4 2015 Coty Inc Earnings Call

EVENT DATE/TIME: AUGUST 13, 2015 / 1:30PM GMT

CORPORATE PARTICIPANTS

Kevin Monaco *Coty Inc. - SVP, Treasurer & IR*

Bart Becht *Coty Inc. - Chairman & Interim CEO*

Patrice de Talhouet *Coty Inc. - EVP & CFO*

CONFERENCE CALL PARTICIPANTS

Bill Schmitz *Deutsche Bank - Analyst*

Olivia Tong *BofA Merrill Lynch - Analyst*

Chris Ferrara *Wells Fargo Securities, LLC - Analyst*

Steph Wissink *Piper Jaffray - Analyst*

Mark Astrachan *Stifel Nicolaus - Analyst*

Javier Escalante *Consumer Edge Research - Analyst*

PRESENTATION

Operator

Good morning, ladies and gentlemen. My name is Danielle and I will be your conference operator today. At this time, I would like to welcome everyone to Coty's FY15 fourth-quarter and full-year results conference call.

(Operator Instructions)

As a reminder, this conference call is being recorded today, Thursday, August 13. I would now like to turn the call over to Kevin Monaco, Coty's Senior Vice President, Treasurer and Investor Relations. Mr. Monaco, please go ahead.

Kevin Monaco - *Coty Inc. - SVP, Treasurer & IR*

Good morning and thank you for joining us. On today's call are Bart Becht, Chairman and Interim CEO, and Patrice de Talhouet, Executive Vice President and Chief Financial Officer.

Before we begin, I would like to remind you that many of our comments may contain forward-looking statements. Please refer to our press release and reports filed with the SEC, where you will find factors that could cause actual results to differ materially from these forward-looking statements.

All discussions of net revenues are on a like-for-like basis. In addition, except where noted, the discussion of our financial results and our expectations do not reflect certain non-recurring and other charges. You can find the bridge from reported to adjusted results in the reconciliation table in the earnings release. I'll now turn the call over to Bart.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Thank you, Kevin, and welcome, everybody, to Coty's fourth-quarter and full-year conference call. This morning, we will take you through a summary of today's announcement, and then Patrice and I will be pleased to take your questions.

2015 was a good year and Q4 results were equally encouraging. On a full-year basis, our strategy of investing in and fueling growth of our brands, while at the same time driving strong profit growth behind efficiency programs, is translating into tangible results, as power brands' net revenues grew low-single digits like-for-like, adjusted operating profits grew mid-single digits, and adjusted diluted EPS grew well into the double digits.

We still have work to do in returning Coty to top-line growth, but the strong progress and increased savings targets for our Global Efficiency Program, which Patrice will detail in a minute, should give us the flexibility to invest additional capital in our business and very gradually reignite growth. Growth in our power brands during the year was driven by Marc Jacobs and Chloe in Fragrances, Sally Hansen and Rimmel and Color Cosmetics, and philosophy in skin and body care, offset by lesser performances on the remaining power brands.

To add a bit of insight around the brands contributing to our growth and some of our growth initiatives going forward, I would like to highlight that Sally Hansen's Miracle Gel line continues to be an outstanding success, boosting Sally Hansen's market share of the combined US and European nail markets by approximately 8 percentage points, to 27% last quarter. We intend to build on this momentum with the launch of Miracle Gel 2.0, with a top coat that doubles the volume of the manicure and extend the Miracle Gel color selection by an additional 20 shades.

Other notable new innovations in early FY16 include Marc Jacob's Decadence, Calvin Klein's Eternity Now, Rimmel's Match Perfection foundation, and the launch of the first Miu Miu fragrance by the end of Q1, FY16. As we continue to invest behind our power brands in FY16, we are targeting a very gradual improvement in the total Coty like-for-like net revenues, coupled with continued good growth momentum on the bottom line.

On the M&A side, the Bourjois integration is proceeding as planned, and we remain excited about the strategic and financial opportunities for this brand. We remain equally excited about the merger agreement with P&G's fragrances, color cosmetics and hair color businesses, and the potential of this transaction for Coty. We believe we will not just create a pure-play global leader and challenger in the beauty industry, with approximately $10 billion in revenues, but it will also offer material cost and cash savings, as well as longer term enhanced growth opportunities.

We will also continue our share repurchase program, with $700 million authorized by the Board. I will now hand over the call to Patrice, who will provide a few comments on the financials and our updated targets for the Global Efficiency Program.

Patrice de Talhouet - *Coty Inc. - EVP & CFO*

Thank you, Bart, and good morning, everyone. Total net revenues were flat like-for-like in the fourth quarter and full year. For the fourth quarter, the adjusted gross margin increased 160 basis points, to 59.9%. During the year, our adjusted gross margin increased 50 basis points, to 60.1%. The solid improvement in gross margin reflected our continuous effort in driving supply chain efficiencies, despite an ongoing increased level of discount and allowances.

We have made significant progress in reducing our cost structure and identifying additional savings opportunities. Given our execution success thus far, we are raising the savings target for our Global Efficiency Program by 35%, to $270 million. As you will recall, our original $200 million target by FY17 included $20 million from the China business reorganization, $60 million from the productivity program, and $120 million from the One Coty reorganization.

With over a year of progress on these programs, we now see the channel reorganization yielding $45 million in savings, the productivity program offering $65 million of savings, and One Coty generating $160 million. We are now approximately halfway towards this new saving target, as we saw $105 million in savings in FY15, following the $25 million savings we generated in FY14.

This incremental $70 million of savings stems from our existing efforts to drive efficiencies, including in-dollar procurement and more streamlined operation in China. As a result, we do not expected to incur additional costs associated with this savings beyond the $250 million to $300 million we had previously outlined.

In the fourth quarter, our adjusted operating margin grew 120 basis points, supported by the efficiency realized from our savings program. Our FY15 adjusted operating income grew 6%, with margin expansion of 100 basis points, to 12% from 11% in the prior year. During the year, we continued to execute on our strategy on investing behind our power brands, while maintaining discipline in our overall spending and reducing [non-strange expend].

Total ANCP at constant currency was in line with prior year, while the NCP for our power brands increased by mid-single digits. As Bart mentioned, power brands net revenue grew low-single digits during the year, an indication that our investment strategy is beginning to bear fruit.

By segment, our FY15 Fragrance adjusted operating margin improved 150 basis points, reaching a new high of 16.2%. The Skin and Body Care adjusted operating margin expanded 170 basis points, to 2%, while the Color Cosmetics margin declined modestly by 40 basis points, to 11.1%, reflective of the acquisition of the Bourjois business. We continue to expect FY16 to be a transition year for Bourjois, as we integrate and optimize the operating model, with Bourjois becoming accretive to our Color Cosmetic earnings profile in FY17.

Moving down the P&L, our adjusted effective tax rate for the year was 15%, compared to 18.9% in the prior year. At this time, we expect our long-term adjusted effective tax rate to be approximately 25%, with potential for viability depending on the mix of profit by region. Altogether, our FY15 adjusted diluted EPS of $0.99 was slightly above the upper end of our guidance range and reflected very strong 22% growth.

2015 was also another strong year of cash generation, as operating cash flow totaled $526 million and free cash flow totaled $325 million, up from $305 million in the prior year. This was our six consecutive year of generating more than $300 million in free cash flow. Our cash conversion ratio, adjusted for cash restructuring costs, exceeded 100%, demonstrating our strong ability to convert solid profit growth into even stronger cash generation. We ended the year with $2.3 billion in net debt.

We also announced this morning that we are continuing our share repurchase program, with the Board authorizing $700 million, which includes any remaining amounts under the prior authorization. This authorization further supports our commitment to return cash to shareholders and is consistent with our repurchase of over $900 million in Coty stock over the last 18 months, including the repurchase of Class B Shares from Berkshire Partners and Roan Capital. Our results illustrate that we are building a better business and are well on our way to become a strong leader in the global beauty industry.

Let me now spend a minute on the announced merger with the P&G beauty business. As we communicated to you last month, the P&G business had FY14 revenues of $5.9 billion of [carve all] EBITDA of approximately $1.15 billion, which excludes $400 million of non-transferred costs. We expect to realize $550 million in total cost savings, including the $400 million in non-transferred costs, which would be an immediate benefit at close, and an [in credit] to the $150 million in net synergies to be recognized by the end of the third year after close.

We expect to realize these net synergies from areas like procurement, manufacturing, logistics and SG&A, net of the investment we plan to make in order to run businesses in which we are not currently present, such as hair color, and to support a business which feels double the size of Coty standalone. Beyond these synergy expectations, we intend to leverage best practice from each of the businesses and to improve the underlying performance of the combined company.

Efforts to prepare for the closing of the transaction and ensure a smooth integration and transition are well underway. Each organization has appointed transition teams, and Coty has also appointed a post-merger integration team. This team meets on a weekly basis with the transition teams to coordinate activities and then provides visibility on the overall progress to the executive leadership. We have met with the different parts of the P&G organization, with each meeting reinforcing our excitement about the combination of these two strong businesses.

Thank you. We will now open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

[Isabel Schmidt], Deutsche Bank.

Bill Schmitz - *Deutsche Bank - Analyst*

It is actually Bill Schmitz. (Laughter) I don't know where Isabel came from. Good morning, guys. One housekeeping question and then just a question on the acquisition. Can you tell us what the savings are to date from the program?

Patrice de Talhouet - *Coty Inc. - EVP & CFO*

Sorry. Can you say that again?

Bill Schmitz - *Deutsche Bank - Analyst*

The savings to date for the restructuring program.

Patrice de Talhouet - *Coty Inc. - EVP & CFO*

The Global Efficiency Program is $105 million, and we have achieved $25 million last year. So that would be $130 million year-to-date, which is roughly halfway on the overall savings target of $[270[million.

Bill Schmitz - *Deutsche Bank - Analyst*

Okay. Great. Can we just have an update on the acquisition, how the fragrance license discussions are progressing, any further color, any potential divestitures? And then as you look at the channel inventory, the quality and quantity of what's in the channel right now, especially at some of the wholesalers and diverters?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

I can give you an update on that. We have visited all but one of the licensors. I would say the initial discussions are very positive, but it is still very early days. We need to have further discussions; and ultimately, clearly, we need to have pieces of paper signed for the transfer of all the licenses. So it's early days, but so far, I would say the discussions are very encouraging.

In terms of the quality of the businesses, there is nothing really to discuss for the time being. And also, we're not at liberty to discuss anything, because clearly P&G is a public company and this is part of their business until the deal is closed. So I can't really comment on that. But I would say overall, as Patrice already has outlined, there are teams basically on both sides. They're working very cooperatively together, in terms of getting the deal closed and getting the business integrated. It's very early days, but the project has been kicked off on the right footing.

Bill Schmitz - *Deutsche Bank - Analyst*

Okay. Great. I appreciate the commentary. Thanks.

Operator

Olivia Tong, Bank of America.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Great. Thank you. First, with Procter, what are you guys discussing during meetings and who was involved on both sides?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

So there is a very large group of people involved on both sides. Right now, we are literally having hundreds of people basically involved in both concluding the transaction and integrating the business. So there are transition teams on both sides, and the transition teams are very much focused on closing the transaction. So that's everything from transfer of licenses and to trust filings, to financing, legal, and tax issues.

And then there is a post merger integration team, which works, clearly, with people from both sides in terms of actually integrating the business, which is everything from organizational structure, staffing, culture for the new company, ways of working, as well as IS and supply integrations, so all of the physical aspects of the deal. But like I said, this whole process is just being kicked off, so it's still very early days. But all I can say is that it's been a very constructive process from both sides.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Thanks. Have you guys identified the key members of management on the Procter side yet who will be coming over with the deal?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

From an organizational structure and staffing point of view, that's just being kicked off. And the executive team should be selected in the next couple of months. And that goes beyond just the executive committee, including basically people which are reporting below that.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. Thanks. Just on sales, you guys talked a lot last quarter about starting to build the reinvestment into your power brands, now that you've realized a lot of those significant cost savings. But you also mentioned that it would take time, and you reiterated that again today. So relative to your own expectations, was flat organic sales for this quarter in line with your expectations? And can you give a little bit more parameters around quote-unquote taking time? Because I'm just curious also how much you've starting to already push the incremental spend and how that's going to build and what ultimately you think you can grow at long term.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

I think it will be a very gradual process, in terms of building top line growth momentum. I don't think it will be a rapid acceleration from where we are today, for a variety of reasons. It takes a long time in the beauty industry to build momentum, in general, because it requires, basically, an extensive pipeline of the right innovations and initiatives that go into the market; and at the same time, as you well know, we still have a drag, basically, from a legacy celebrity fragrance business which is a drag basically on the growth of the total company. So I do think it will take time.

The market growth the company is exposed to is somewhere around 2%, since we're mostly in established markets business, in terms of segments and countries we're exposed to, market growth rate is slightly ahead of 2%. And clearly, we need to be, at some point in time, to grow at least in line with the market. But it will take time. So I would say that's the ultimate target of where we want to be, is to be at least in line with the market, if not ahead of that. But it will take time to get there.

I would say, on the other side, from a profit point of view, so from a top line point of view, I think it is going to take longer than I originally anticipated. From a bottom line point of view, we are well ahead of where I thought we would be originally. And I can see continued very strong momentum from a bottom line point of view going forward.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. And just lastly, on the launches, you mentioned Miu Miu at the end of Q1, but could you give us a little bit more detail on some of the other big launches? Because I'm looking at the Q1 comp, and that's particularly tough this year. So it sounds like, while you expect modest growth for the year, perhaps you're not necessarily expecting quote-unquote modest growth every quarter of this year. Thank you.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

That's correct. Q1 will be one of the tougher comparisons, because we had a big Calvin Klein launch last year, which clearly meant we had substantial pipeline fill last year in the first quarter which we'll be indexing against. Miu Miu will be a good launch, in my mind, but it is not all hitting in the first quarter. It's hitting as the quarter evolves. And the other big launch which will be there, which is Decadence, is really happening at the very end of the first quarter.

So you're absolutely correct. We're looking for very modest growth for the full year, but Q1 will be a bit more of a challenge.

Operator

Chris Ferrara, Wells Fargo.

Chris Ferrara - *Wells Fargo Securities, LLC - Analyst*

Thanks, guys. Obviously, very good gross margin expansion this quarter. I was wondering if you could talk a little bit about how discounted allowances played in. Obviously, you guys have talked about that as an initiative, the ability to roll that back and not lose volume growth, particularly in Fragrance. So if you could talk a little bit about that, that would be great.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

So we had positive price mix impact in the fourth quarter, which clearly indicates that we are gradually starting to improve in this area. Having said that, we need to see both good volume momentum and good price mix momentum. And so far, we're not really been able to combine the two in every single quarter. And we need to be able to do that consistently. So we are making some progress on the discounts and allowances front. We need to make progress in both volume and discounted allowances front going forward. So there's still work to be done in this area.

Chris Ferrara - *Wells Fargo Securities, LLC - Analyst*

I guess following up, are there specific places, specific brands, specific businesses, where you have been able to combine both where you weren't before, not ones where you've been able to do it for a while, because it's a particularly strong place in your business, but areas where you have shown progress, would be great.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Where we have very good results is in the Color area, where for the full year last year, we had both basically good volume momentum and very good price mix momentum. So there, we clearly have been able to achieve it. So I would say that's the highlight. In terms of the Fragrance area, it's still an area where we need to improve, from a discount and allowances point of view, as well as on the Body Care. Skin Care is not really an issue either. So the challenge for us really is in Fragrance and is in Body Care.

Chris Ferrara - *Wells Fargo Securities, LLC - Analyst*

Along the lines of your expectation for a little bit, for building cadence of growth, do you guys think that Fragrance will grow on a like-for-like basis for the year in 2016?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

I'm not going to make any commitments on that, at this stage of the game. We have some clear plans in place. Like I said, we're looking for a very gradual shift, from a top line point of view, for the total company, largely driven by power brands. But beyond that, I'm not making any comments.

Operator

Steph Wissink, Piper Jaffray.

Steph Wissink - *Piper Jaffray - Analyst*

Thank you. Good morning, everyone. We have two questions. The first, with respect to the legacy celebrity fragrances business that you referenced earlier, can you talk a little bit about that contract cycle? Is there any opportunity in the next few years to either retire or exit some of those legacy fragrances that are no longer relevant to the portfolio?

And then separately, with respect to the Color Cosmetics business, if you'd be willing just to give us any more detail behind the makeup versus the nail care side, just looking at those two sub categories, can you talk a little bit about the performance there? Thank you.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

In terms of celebrity fragrances, this was a segment within the category which was very popular a number of years ago and which has kind of seen its heyday and now is not very much in vogue, either with the consumer or with the trade. And as a result, we are seeing a gradual erosion of this business. It's a highly profitable business, because the investments are not always huge in this area. So it would be very difficult to divest it and to make sense out of it for shareholders. So it is better to keep it than to divest it.

Your second point, in terms of the Color Cosmetics category, that category is doing very, very well, both on the nail, as well as on the general color cosmetics side. Clearly, the big brands in this area are Sally Hansen, OPI and Rimmel. We've seen OPI basically doing very well, despite the fact that we've taken out some wholesale business. Sally Hansen, clearly, is on fire, as I already alluded to, and Rimmel is also gaining share across the globe. So I would say this business overall is doing very, very well.

Operator

(Operator Instructions)

Mark Astrachan, Stifel.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Thank you. Good morning, everyone. Bart, I had a couple of pointed questions, so apologies as to how it will come out. But you've lost a number of key executives in recent months, four fairly substantial executives, by my count. I guess I'm curious why it is, timing wise, ahead of what seems like a fairly exciting time in the history of the Company. So what are your plans for moving forward with increasing the bench strength? And related to that, has the combining of the prestige and mass businesses impacted the ability to attract or retain talent? How do you think about all of that? I realize there's a lot of moving parts there.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

I would say we are in a process of transforming the business. And that includes basically transforming the capabilities of the company. And that, at times, might involve changing the management team. So I would really look in this regard more towards what will happen going forward with the merger with Procter. We are looking very much forward to combining the business, the Coty business, with the Procter business and to strengthen the overall capabilities in the management team of the combined entity. And I think there is a wealth of talent on both sides which should allow us to do that. I think basically going forward, you should expect to see a very strong management team on the combined entities. That's certainly my target.

Mark Astrachan - *Stifel Nicolaus - Analyst*

So as you think about it going forward, it sounds then like it's more promote from within, including folks coming over from the Procter side, as opposed to potentially looking externally?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

No, I will never have 100% internal movement. We will also attract some talent from outside still. So as you think about the combined entity, yes, the ball clearly will come from the Procter and the Coty side. But we might complement it with a number of candidates from outside. As I'm interim CEO -- and at some point in time, I will basically move back into my Chairman position -- I want to make sure that this business is in tiptop shape. And my first priority, therefore, is to make sure that I have a very strong management team in place that can manage the combined entity. And as you can imagine, that's my number one priority over the next couple of months is to make sure we get there.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Great. Okay. Thank you.

Operator

Javier Escalante, Consumer Edge Research.

Javier Escalante - *Consumer Edge Research - Analyst*

Good morning, everyone. My question has to do with the cadence of savings versus investments. I understand that the reinvestment top line growth is going to be slower. But you've got to prepare for a merger that is going to double the size of the company in a year. So when the investment for the staffing and the capabilities that you need to build is going to happen so that the Company is ready to accommodate the Procter business within a year? Is that investment coming out of FY16 numbers? How are you going to basically work that out? Thank you.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Patrice.

Patrice de Talhouet - *Coty Inc. - EVP & CFO*

Yes, Bart. Javier, thanks for the question. The way that we think about that, as I said already in the July call, when we announced the P&G merger, is really the first year is going to be an investment year. So when you think about it, FY17, provided that we close in FY16, FY17 is going to be a year of investments. So this is where we're going to start to build the capabilities. We need to make a couple of upfront investments in many different areas. IT is one of them. Capabilities is another one. I've quoted a couple of examples, like the hair care business. We need to step up on that one. In terms of North America, we're getting a mass business without the demand capabilities to be able to support it, because these are the corporate sales force from P&G that are coming with the transaction.

So we need to build this capability. So I think the way you should look at it is that as far as the Global Efficiency Plan, we are planning to reinvest gradually in order to start regain momentum on the top line. As far as the pro forma at Coty is concerned and the integration of the P&G business is concerned, the way you should look at it is that FY17 will be a year of investments, and then FY18 and FY19 will be years where you will see all the savings coming through.

And it's worth noting that the $400 million -- out of the $550 million, the first $400 million are going to materialize immediately at closing, because these are costs that are not transfers. So when I speak about the investment, I am more referring to the $150 million of net savings, which is composed of two legs. First, the investment in year one, second, year two and year three, some savings, and the net of these two are $150 million.

Javier Escalante - *Consumer Edge Research - Analyst*

But as a follow-up, if I'm understanding this correctly, basically during FY16, you are not going to be making accommodations in terms of preparing the IT capability and the staffing to get ready for the merger. So actually, Coty will be running as is through FY16, and FY17 is when all the investment and recruitment that essentially represents $400 million in cost for Procter is going to take place. And if you can help us understand what is, in your view, if Procter is spend $400 million to run this business, what is the amount that you can think you can run it with, $100 million, $50 million? What is that investment? If you can quantify that investment for us, that would be very helpful.

Patrice de Talhouet - *Coty Inc. - EVP & CFO*

Great question. So in terms of when we spoke about the one-time cost, which is $900 million, to be able to step up the organization, there is $400 million of CapEx. Some of this CapEx -- and there is more to come, because we need -- we are in the process of meeting with the transition team, formalizing everything -- but some of this CapEx will happen in FY16. Because if you think about it, just from an IT standpoint, we need to start to prepare ourselves to be able to support a $10 billion business. So we are not going to start this in FY17.

And so the way you should think about that is that we are going to close in the middle of the calendar year FY16, plus or minus one quarter, depending on the regulatory issues, and we have some limited duration for the GSA. So we have to make sure that we are ready to operate as soon as closing. So I think from a CapEx standpoint, we are going to incur some of the costs in FY16. It's the same for the one-time cost of the other $500 million, in terms of preparing the organization, and especially if you think about the North American organization, the mass business coming from Procter. We will need to give the capabilities beforehand.

So now, in terms of the latter part of the question, I think it's a little bit too early to be able to answer that. I think more to come. In the coming earnings, we will be able to give you a little bit more color and precision and garner IT on the phasing of the savings.

Operator

(Operator Instructions)

Sir, I'm not showing any questions at this time. That will conclude today's question-and-answer session.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Okay. Thank you all for attending the call, and hope to basically talk to you in about three months time. Thank you. Good-bye.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude today's program. You may all disconnect. Everyone have a great day.
