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COTY - Q1 2016 Coty Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 05, 2015 / 2:00PM GMT



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PRESENTATION

Operator

Good morning, ladies and gentlemen, my name is Diane and I will be your conference operator today. At this time I would like to welcome everyone to Coty's first-quarter FY16 conference call.

(Operator Instructions)

As a reminder this conference call is being recorded today, Thursday, November 5. Thank you. I will now turn the conference 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 our 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 nonrecurring and other charges. You can find the bridge from GAAP to non-GAAP results in the reconciliation tables in the earnings release. I will now turn the call over to Bart.



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

Thank you, Kevin. This morning we will provide you with a brief update on the planned merger with the P&G Specialty Beauty Business, our recent corporate developments, and Q1 results. Then Patrice and I will be pleased to take your questions.

In July 2015, we announced the intended merger of Coty with the P&G Specialty Beauty Business to create a strong global leader and challenger in the beauty industry. Since that time, much has happened. Over the last few months the financing structure for this transaction has been put in place.

Extensive discussions with the 12 licensors have taken place. And to date, I can confirm that 10 out of the 12 licenses will transfer to Coty upon regulatory approval and completion of the transaction.

This has allowed us to make good progress on the regulatory clearance process with authorities. We have also announced a new organizational structure for the merged entity.

That structure will be all about servicing consumers, which we believe will strengthen the growth trajectory of the merged entity over time. The Coty business will be organized around three divisions consisting of the Coty Luxury Division, the Coty Consumer Beauty Division, and the Coty Professional Beauty Division.

We will also form a new department focused on accelerating growth by improving capabilities in areas such as innovation, traditional digital communication, as well as sales execution and e-commerce. As a precursor to the formation of this department, we recently acquired Beamly, a cutting edge digital marketing firm.

This week we announced the acquisition of the beauty and personal care business of Hypermarches. This acquisition will help increase Coty's exposure to higher growth in emerging markets and provide a strong platform to absorb both the current Coty business as well as the future P&G Specialty Beauty Business in Brazil.

Finally we have just announced a new Coty executive team effective subject to the closing of our merger with the P&G Specialty Beauty Business. It is a team of highly experienced and proven executives.

We believe the new consumer-centric and category focused organizational structure and our strong brand portfolio together with the new team will position Coty well to realize its ambition of becoming a true leader and challenger in the beauty industry and drive profitable growth and shareholder value over time. Touching briefly on Q1; results were mixed.

The operating profit and margin continues to show very strong progress, with EPS growth substantially higher clearly helped by a one-off tax benefit. This confirms that our global efficiency programs continue to generate the benefits we have been targeting.

On the other hand, revenue growth was not where we would like to be. While color cosmetics growth continued to be very strong due to Sally Hansen and Rimmel, and skin and body care trends are improving, fragrance growth is lacking.

Fragrance revenues continued to suffer from a very large number of unsustainable historical launches not being compensated by current brand building efforts and launches. We will be working hard to clean up past portfolio practices while strengthening our innovation pipeline and improving our capabilities in the areas of innovation and sales and marketing execution. I will now hand over the call to Patrice.

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

Thank you, Bart. And good morning, everyone. Total Q1 net revenues declined 2% like-for-like for the quarter.

The adjusted gross margin increased 70 basis points to 60.3%, reflecting our continuous effort in driving supply chain efficiencies. We keep on building a better business with adjusted operating income growing 4% with a much more substantial 12% increase at constant currency.

The adjusted operating margin grew 150 basis points with improvement in each of the segments, including an increase of 110 basis points in fragrances, 280 basis points in color cosmetics, and 120 basis points in skin and body care. During the quarter, [ethics] negatively impacted revenues and operating income by roughly 800 basis points.

Our programs to build a better business have changed the mix of profits by geography, reducing the natural foreign exchange hedge in the quarter compared to prior periods. We expect this [ethics] impact to continue into Q2 and then moderate in the second half of the year.

Supported by a one-time tax benefit of \$113 million and our profit growth, our Q1 adjusted diluted EPS increased to \$0.59 from \$0.28 in the prior year. Turning now to the balance sheet and cash flow, we had another very strong quarter.

We generated \$116.7 million in operating cash flow and \$74 million in free cash flow, up to over \$100 million versus the prior year, driven primarily by an improvement in the earnings profile and working capital. Supported by this very strong cash flow, our \$700 million share buyback program is progressing as planned, with over 60% of the program completed throughout November 4.

We also increased our annual dividend by 25% this year from \$0.20 to \$0.25 per share. This dividend increase and ongoing share repurchase program demonstrate our confidence in Coty's ability to generate substantial cash flow as well as our commitment to return cash to our shareholders.

We recently closed on a \$4.5 billion credit facility to refinance existing Coty debt with new borrowings subject to longer maturities, which was a great success and well oversubscribed. I would like to add that despite volatile financial markets, we increased the size of the Coty financings by \$500 million reflecting strong market demand.

In addition, certain lenders have committed to loan up to \$4.5 billion to an affiliate of P&G, which is expected to become available to Coty in connection with the exciting merger with the P&G Specialty Beauty Business. Finally, I wanted to share some additional details on our announced acquisition of Hypermecas beauty and personal care business.

This acquisition offers several excellent benefits for Coty. First, it encompasses a portfolio of leading beauty brands in Brazil which include leading retail positions in skin care, nail polish, men's care, and men's hair color.

Second, this acquisition brings a state-of-the-art manufacturing plant and a distribution center. Third, it offers critical go-to-market capabilities including a sales and merchandising force of approximately 630 people.

And finally, while we will not disclose the full financials for the business, I would like to point out that it is highly profitable with operating margin above current Coty levels. Thank you. We will now open the call for questions.

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

And our first question comes from Bill Schmitz. Your line is open.



Bill Schmitz - Deutsche Bank - Analyst

Can we just like drill down a little bit on the Hypermecas deal? I know you don't want to give us the exact numbers.

But it seems like about \$50 million of EBITDA, so it's I think \$20 million -- I'm sorry, 20 times EBITDA is the rough map on the deal. I just want to know if that is directionally right.

And are you buying it for the manufacturing and distribution center, or are you buying it because you think there's still a lot of legs left in the brand? Also, maybe how you think about the Brazilian beauty market, and are we at the bottom and do you think it's going to accelerate from here? Then I have a follow up if I can.

Bart Becht - Coty Inc - Chairman & Interim CEO

Yes. First clearly Brazil, even in today's environment, is a faster growing market than the markets that we are in in North America and in Western Europe still in most of the categories in which Hypermecas operates. This business also has shown basically good share progression over the last years.

Clearly its brands are also well positioned in the market because they don't tend to set in the premium and the super-premium end of the market, and therefore certainly in the current environment can be more successful as a result of that. So we believe that this business has continued growth potential, and it's certainly ahead of where Coty is today, as you can imagine.

So I would say that is point 1. Point 2, this is a very profitable business. It's a business which has higher profitability than Coty has today.

In terms of its capabilities, it provides us with a strengthening of our capabilities really in two areas. First, it has a state-of-the-art supply chain, both from a manufacturing and a distribution and warehousing point of view, which you know is one of the key things that we are lacking on both the Coty and the P&G side.

And so this will be a very welcome platform for us from a supply point of view. From a go-to-market point of view, it is a very strong organization on the ground, well supported by a proven management team considering the market share results. And so also this clearly will help us when we integrate the three businesses between P&G, Hypermecas, and Coty is to have a very, very strong team and go-to-market organization going forward.

Bill Schmitz - Deutsche Bank - Analyst

Okay, great. And then can we just talk about the fragrance category, like what you think the big challenges are? How the holiday season is progressing?

How far along are we on the inventory clean up of some of the tail inventory? And then broadly speaking the health of the Calvin Klein brand? Because I feel sometimes that you do more than your fair share of work trying to build the equity there, but if the brand owner is going to continue to divert it in and over-distribute it, it's almost like you are running against hurricane-force winds because the brand equity keeps getting diluted.

So it's almost like a fool's errand because it's hard to control your destiny when the brand is diluted in other channels. I would love to hear your thoughts there and again, the difference between sellout versus shipments relative to the inventory destocking you referenced.

Bart Becht - Coty Inc - Chairman & Interim CEO

Yes. There clearly -- there have been a number of unsustainable efforts from a sales point of view, and there have also been a number of unsustainable lines of business which were launched over the last couple of years which are coming back to haunt us today and are not being offset -- or more than offset by our current brand building efforts and launches.



So I think you have already alluded to what the issue there is. So I don't need to elaborate on that. All I can say is that there are -- before everybody is seriously depressed about this business, there are some very nice successes also.

We do have a Marc Jacobs Decadence, which is off to a very, very strong start. We have Miu Miu, which is off to a very strong start, but it is more than offset by a number of past launches and practices which quite frankly we're going to have to go through and clean up.

As a result of that from a growth point of view, for the full year I'm not looking for a material improvement against the Q1 trend as we have it today. Because we will need to continue to have a number of cleanup efforts over the balance of the year potentially going into next year, and they will impact in particular the fragrance category.

Operator

And our next question comes from John Faucher from JPMorgan. Your line is open.

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

Hello?

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

Hello, John.

John Faucher - *JPMorgan - Analyst*

Yes. You can't hear me?

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

Yes. Now we can.

John Faucher - *JPMorgan - Analyst*

Sorry about that. So as we look at the trend from the Procter businesses, obviously the trends have continued to be tough. How should we think about how you view those businesses and the performance before you get a hold of them?

Because we get a lot of questions in terms of the trends and everything, and I guess what kind of shape are you expecting those businesses to be in when they get transferred? And then secondly, I just wanted follow up on -- if we could get some thoughts in terms of the power brands and how you feel about the shift in spending that you've had on those.

Do you feel like you're beginning to see the underlying equities improve on the power brands given your new strategy? Thanks.

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

So on the P&G trend clearly we cannot comment on that. What I can tell you from the e-market performance, which is publicly available, is that this business is performing at a better level than where Coty is performing.



So are all the trends positive? No. There are certain brands where there clearly are challenges.

And you can look at the US market data, I'm sure which you have access to, and clearly identify that. On a global basis, there are also pockets where they're doing very well. And I think that is probably all I can say about the P&G trend for the time being.

So I do anticipate that this business will come to us in a shape and a form which is very much when we did the transaction. I don't think there will be a substantial change from what we anticipated.

On the power brands, improving brand equity is one of the key things that we have and are starting to work on. If you ask me -- as you know, brand equity doesn't change overnight. It doesn't even change in 12 months no matter what you do.

So this will take some time, but this is going to be a key focus. We need to move Coty much more from a let's call it sell-in type mentality to a sellout type of mentality, and that clearly means that we need to do much more work in terms of building the brands from the ground up through brand equity programs like communication programs and innovation programs.

John Faucher - JPMorgan - Analyst

Got it. Thank you.

Operator

And our next question comes from Dara Mohsenian. Your line is open. From Morgan Stanley.

Dara Mohsenian - Morgan Stanley - Analyst

Good morning.

Bart Becht - Coty Inc - Chairman & Interim CEO

Hello, Dara.

Dara Mohsenian - Morgan Stanley - Analyst

So first just a couple of clarity questions. The two licensees under the P&G portfolio that you have not reached an agreement on, are those still up in the air, or are you not expecting them to transfer?

And how big are they? And then second, are you expecting like-for-like revenue growth here for the full year, or is that no longer a realistic goal with the fragrance trends? I'm assuming it's not, but just wanted clarity there.

Bart Becht - Coty Inc - Chairman & Interim CEO

Yet. So 10 out of the 12 are confirmed to transfer. So that pretty much means they are signed off -- fully signed off.

The remaining two, one is just in progress and one basically is decline. But the one which has declined is very, very small.



So we're talking a couple of percentage points of the total P&G revenue and therefore is not really a concern. And the last one is still being discussed. So there is no news on that.

We do not disclose basically what the sizes are of the ones which are being discussed. All I can tell you is that the one which is being discussed is not immaterial. It is a material one, and that's it.

In terms of like-for-like growth, just to be crystal clear, I do not anticipate that what we have seen in Q1 will materially change for the full year 2016. I think the fragrance trends might improve from where we are today. Having said that, on the color cosmetics side as you all know we will be lapsing a major launch which is the Miracle Gel.

And so I would expect that we'd continue to see good momentum on color, but probably not to the same extent as what we have seen so far. So I think you will see offsetting trends with an overall situation where at this point in time I do not anticipate a material improvement versus Q1.

Dara Mohsenian - *Morgan Stanley - Analyst*

Okay, that is helpful. And then can you just talk a little bit about the balance between top line growth and margins obviously strong, profit performance here in Q1, revenues didn't come through to the extent you expected.

So does that mean more investment going forward? Any tweaks in the way you view that, or is it more you look to innovation in other areas to drive growth going forward?

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

Yes. We continue to anticipate that we will have a good improvement on operating margin also for the full year. Not to the same extent that we had in Q1, but we will have operating margin improvement for the full year both in constant and actual rates.

The efficiency programs will come through. We are not worried about that. We are tracking those very closely and so we weight the bottom line.

Some of that will be reinvested back in the business. But we are still building a better business from a margin point of view for the full year.

Clearly on EPS, EPS will be good because we have a huge one-off tax benefit. So that's not really up for discussion. But margin-wise we will continue to make progress.

Clearly, as we've discussed it before, we are working harder and harder in terms of improving this business structurally. And that means moving this from a sell-in to a sellout organization and that will take some time.

Dara Mohsenian - *Morgan Stanley - Analyst*

Thanks. That is helpful.

Operator

And our next question comes from Chris Ferrara from Wells Fargo. Your line is open.



Chris Ferrara - Wells Fargo Securities, LLC - Analyst

Thanks. Can you guys talk maybe a little bit more specifically about I guess maybe what the cleanup means in fragrance just for the overall size of the business? I'm trying to dimensionalize it.

Is 5% of the fragrance business perhaps unsustainable, or is it 10% or 20%? How big a deal is this for you guys?

Bart Becht - Coty Inc - Chairman & Interim CEO

Yes. I'm not going to answer that A, because it is a work in progress. I would say this is premature to have this discussion.

It is very clear that we have a number of lines of business where -- which are not sustainable which we have to tackle. And we will tackle those over time. We will not be able to tackle all of those in one go.

So -- and at the same time we need to push much harder in terms of structurally building our brands from a brand equity point of view and an innovation point of view. So I'm not going to give you any clarity on this point.

Chris Ferrara - Wells Fargo Securities, LLC - Analyst

Okay. I guess two quick follow ups. One, how big an element of the Hypermecas deal also is tax savings or duty avoidance in manufacturing locally for the whole business?

And then, the motivation behind moving to London, I get proximity to Europe for a lot of the executives, but is there a tax element to that to? If you could flesh that out a little bit would be great. Thanks.

Patrice de Talhouet - Coty Inc - EVP & CFO

Yes, so Chris, on the first part of the question clearly the Hypermecas deal is primary a business reason. We wanted, as Bart said, we wanted to have a platform in Brazil with state-of-the-art go-to-market capabilities and manufacturing ability.

So that's the main reason why we are acquiring this business. There are some tax benefits that Hypermecas is enjoying that will go with the transaction. So that's for sure, but that is not the primary reason.

On the second question which is executive committee in London, actually the underlying reason why we are doing that is first that we want the headquarter not to be in the same location as one of the headquarter of the division. We just don't want the ex-comm to overlook systematically the divisions.

The divisions are fully empowered to drive the business, fully focused and dedicated management team. So that is really important.

The second point is that we wanted to be in an area where we can attract talent for the headquarters. And that is in it from an infrastructure standpoint.

And so clearly London was an ideal location if you exclude Paris and Geneva where we have already a headquarter of a division. So not really tax driven.

Bart Becht - Coty Inc - Chairman & Interim CEO

No.

Operator

And our next question comes from Olivia Tong from Bank of America. Your line is open.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Great. Thanks. First on fragrance, how do you assess whether it is really the focus on cleaning up the portfolio versus just underlying challenges in that category that you've been facing for some time? And then on the Hypermarcas deal, is there sufficient capacity already existing at their facility so that you can self manufacture should you want to on some of your own brands?

And on the tech structure, is that going to -- are the benefits that they get going to pass along to you? Do you have sign off on that?

And then just lastly on the trends there, it looks like the sales trends have been relatively solid, but their margin trends have been less. So I know the absolute margin is better than yours, but the trajectory hasn't been great.

So how do you think about plans to manage that business versus what prior management has done? Thanks so much.

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

Right. That was a bunch of questions. So let me make sure -- so I think the first one was on fragrance. Can you repeat that one more time? Because I lost track of your questions.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Sorry I should have probably asked it in parts. On fragrance, how do you know that it's really what is driving that decline is the things that you're doing versus just underlying challenges in the category that you've been facing for some time?

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

Yes. I would say, as you know, the fragrance category overall is not a high-growth basically category. So clearly that doesn't help us.

Having said that, within the category there certain brands -- from a portfolio point of view, yes you are right. That we have a drag on the tail -- from the tail in particular where these celebrity fragrances clearly in terms of in-market performance.

But we also have launched historically on a number of key brands, new lines which clearly were not sustainable and never basically had a chance of being sustainable for any medium or long term. And so that cleanup, that decay rate that you have on those lines and the cleanup associated with that, is going to depress the net revenues going forward before we can put things in place, or as we're putting things in place to really fundamentally drive the business from an equity and innovation point of view.

On Hypermarcas I'm going to hand over to Patrice on the tax. But before we get there on the infrastructure, since I have been there, this is truly a state-of-the-art manufacturing facility which can produce anything from nail care to skin care products to deodorants and many other personal care items.

It has a state-of-the-art warehousing facility site as well. So it is something -- it also produces hair colorants which will be clearly helpful as we absorb the P&G business.



So it is really something which we can build on, which if we would have done this without it in our wildest dreams we wouldn't have gotten there until years from now. So from an infrastructure point of view, it is a true help. It's the same on the go-to-market site because it has a very large sales force which clearly will be very helpful when we absorb the other two businesses into it.

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

And so to complement Bart's answer on Hypermarches, so first on the tax line; clearly we anticipate most of the tax benefits to transfer. And we will be working very closely with Hypermarches toward this objective.

But more broader, in terms of capacity; so clearly there are some capacity that will be able to welcome our products. And if you think about the synergies and the accretion of the deal, I will not be very specific.

But what I can tell you is that we do expect this acquisition to provide some benefits on both the synergy side and the one-time CapEx side, which we had focused for the merger with the P&G Specialty Beauty Business. However it's clearly premature to examine precise amounts.

And excluding any synergy with the anticipated merger with the P&G Specialty Beauty Business, we would expect these deals to be marginally EPS accretive in year two. So I think this acquisition is spot on our strategy, is facilitating the merger of P&G, and is creating a great platform in Brazil, as Bart said, and we are very excited and happy about it.

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

So just to answer your last question in terms of margin trend, the margin trend is not deteriorating on this business. As you know, this is a business which is to have two fundamental businesses; one is their consumer business and the other is their healthcare or pharmacy/OTC business.

Within the consumer business you have two businesses; you have a paper business, or a diaper business, and you have the business that we are buying. The margin trends on the business that we are buying has not deteriorated over the last years.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. Thank you so much.

Operator

And our next question comes from Wendy Nicholson from Citi. Your line is open.

Wendy Nicholson - *Citi Investment Research - Analyst*

Good afternoon or good morning. Two quick questions for you. The follow up on the deal in Brazil, does that change your strategy or your thoughts about your joint venture with Avon in Brazil?

And will you continue to market their fragrances? And then my second question is on the gross margin expansion in the quarter, you talked about that being a function of your productivity savings, but I'm wondering if there was also a component of favorable mix shift in there? And can you remind us what the gross margin is for fragrance relative to color and skin?



Bart Becht - Coty Inc - Chairman & Interim CEO

So on Avon no, it doesn't really impact what we do with Avon. As you know, the business in Brazil from a market point of view is very much split between what happens door-to-door and what happens at retail.

So the Hypermarcas business, the current Coty business, and a big chunk of the P&G business is really a retail business. What we were doing with Avon is very much focused on different products in a different channel.

So they don't really impact each other. They might at some point in time, but certainly not for the time being. On the gross margin --

Patrice de Talhouet - Coty Inc - EVP & CFO

On the margin the vast majority of our margin is coming from the supply chain efforts you're seeing from the product duty program, which is part of the global efficiency plan that I referred to previously. Actually there is no mix which is favorable, and we're not going to comment and give you any details on the gross margin by segment. I think what we're doing is we're giving the operating margin, but we're not giving you any further details and I want to stick to that.

Wendy Nicholson - Citi Investment Research - Analyst

I know we'll see it once we get the Q, but can you comment directionally on just the A&P line, how much that changed year-over-year and whether that was a timing issue, or how much that contributed if you will to the first-quarter operating margin expansion?

Patrice de Talhouet - Coty Inc - EVP & CFO

Yes, good question. On that one we keep on going into our journey of shifting more money from [non-thriagic spend] to [thriagic spend]. In other words, the working media keeps on increasing quarter after quarter which is what we have to do in order to build a sustainable business.

So what you will see is that in constant rate the over [A&CP] line was slightly decreased, but actually the working media is increasing. And it's the non-working media actually where we keep on making efforts to generate some efficiency there.

Wendy Nicholson - Citi Investment Research - Analyst

Got it. Thank you.

Operator

And our next question comes from Nik Modi from RBC Capital Markets. Your line is open.

Nik Modi - RBC Capital Markets - Analyst

Yes, thanks for the question. Bart, I was wondering if maybe you can comment on organizational stress? You guys had been very busy, a lot of big initiatives going on.

Maybe you could just -- is this something you worry about and can you help us understand how you're managing all these moving pieces and all these balls in the air? Thanks.



Bart Becht - Coty Inc - Chairman & Interim CEO

Yes, and what you are -- this is a very good question. Clearly what you're seeing is a company which is in reconstruction mode. And that clearly is also from an organizational and a staffing point of view.

As I alluded to, we need to shift in essence on two main levers. One, is to move from a sell-in much more to a sellout in brand-building mode. And on the other side clearly from an organizational point of view and from a staffing point of view, we will continue to focus on upgrading the bench.

And clearly most of those efforts need to be seen in the context of the merger. And I think you've seen the first step of that at the first level, the executive committee level, where we have purposely looked for the best of both worlds and where we believe we need to complement that with an external candidate.

And you've seen this already at the executive committee level happening, is we will go outside to make sure that we get a very strong team, which ultimately is going to build this business over the long term. So a lot of our efforts at the moment, even though it is somewhat painful on a quarterly basis, are there to do the right thing and to build something which can become a true leader in the beauty industry.

Nik Modi - RBC Capital Markets - Analyst

Thanks.

Operator

And our next question comes from Stephanie Wissink from Piper Jaffray. Your line is open.

Stephanie Wissink - Piper Jaffray & Co. - Analyst

Thank you. Good morning, everyone. Just a couple of questions. First, if you could just talk a little bit about post-merger and the closure of Hypermarcas.

How should we think about the pro forma split between domestic and international, both on a sales and cost basis? And then on the fragrance side, I just want to follow up on Wendy's earlier question, how much of that maturation is tied to the contracts and the commitment to a certain number of fragrance launches per contract?

Is some of the work down related to contract exits or ending? Thank you.

Bart Becht - Coty Inc - Chairman & Interim CEO

You're going to have to clarify the second question for a second, because I'm not sure I really understood. Are you implying that fragrance launches are tied to contractual obligations to our licensors?

Stephanie Wissink - Piper Jaffray & Co. - Analyst

Yes, if there is such a structure, if you have committed to multiple fragrances over a period of time, if those contracts actually need to expire in order to work down from the inventory related to some of those earlier fragrances?

Bart Becht - Coty Inc - Chairman & Interim CEO

Okay. I will answer your questions. So first on Hypermarcas, so the entire business is in Brazil. There is no business outside of Brazil. So it's very, very clean.

So that's question one. The second question about fragrance launches, the launches of fragrance are decided between the licensor and Coty. And this is clearly -- when you have a licensed brand, you have a clear positioning of a brand and there's a discussion with the licensor within that context in terms of what we should launch over time.

And that's an ongoing discussion, and it is not -- that's not really a contractual discussion, it is a discussion how to best basically manage their brand in the cosmetics arena. And that involves not just launches, but it clearly also involves how we execute basically in the market. It's not a contractual obligation discussion.

Stephanie Wissink - Piper Jaffray & Co. - Analyst

Okay that is helpful. And related to the other question related to the close merger and closure of Hypermarcas, can you talk about Procter plus the Brazilian business and your business; how we should think about the split domestic versus international both on a cost and sales basis?

What I'm trying to understand I think is the centralization versus the localization of cost. How should we think about the FX hedging and some of your exposure on a global basis? Thanks.

Bart Becht - Coty Inc - Chairman & Interim CEO

Okay. I'm not going to disclose specific data. What I can tell you is that between the three businesses Hypermarcas is the largest business, P&G is the second largest business, and Coty is the third largest business. And Coty has a relatively small business area today.

Then within that clearly we have a fragrance and skin business. We will have which we'll call a luxury business. Then clearly we have a consumer beauty business, which is all everything which is in color cosmetics, hair retailing, and body care which will be the biggest chunk of what sits in Brazil.

And then finally we have a salon business. So the biggest challenge will sit in the middle in the Coty consumer beauty business.

The second biggest business will fit in salon, and the third largest business will fit in the fragrance and skin care business. That gives you a rough idea. In terms of size, Hypermarcas is one, P&G is two, Coty is three.

Patrice de Talhouet - Coty Inc - EVP & CFO

To add on that, clearly the reason why we acquired Hypermarcas is really to have a platform in terms of manufacturing and go-to-market capabilities. In terms of localizing our costs -- our cost of operating, it clearly gives you the answer there.

Bart Becht - Coty Inc - Chairman & Interim CEO

Just to be clear, without the transaction to absorb the P&G business we would've had substantial FX exposure. And this is clearly another motivating reason why we did the transaction. Because I don't have to tell you when you have to import into Brazil, you have a raft of issues well beyond even the FX.

Stephanie Wissink - Piper Jaffray & Co. - Analyst

Very helpful. Thanks, guys.

Operator

(Operator Instructions)

And our next question comes from Jason Gere from KeyBanc. Your line is open.

Jason Gere - KeyBanc Capital Markets - Analyst

Thanks. I just have two questions and they're not about Brazil. The first one I guess I just wanted to get your perspective on some of the channel disruptions in food, drug, and mass.

We've heard about Walmart and some of the announcements, SKU rationalization, Walgreens and Rite Aid combining, maybe some store closures. I recognize that in nine months you guys will be in a better position of strength with P&G in the full.

But I was just wondering if I can get your perspective on just the food, drug, and mass channel, what you see happening over the next year? And then just tying in how e-commerce could come in and serve as a little more of a panacea to that? And then I have a follow up.

Bart Becht - Coty Inc - Chairman & Interim CEO

Yes, so the last point is the major disruption. So the two disruptions which are happening in the consumer goods space is one, is in terms of digital communication with the consumer and the other one is e-commerce. Those are the two disruptive factors.

The other factors that you're highlighting, which you're talking about inventory management at Walmart and Walgreens, is a discussion which we've had for the last probably 10 years. And that will continue to happen.

Every single time that any of our retailers sees an increase in inventory it's because they're ordering ahead. Because of the sellout trend they will immediately pare back from an inventory point of view. And that will happen from time to time.

Normally that happens for us in the second quarter. It might happen again. So those types of things are more the ongoing normal discussion.

In terms of -- so I would highlight on your key discussions, what is happening from an e-commerce point of view. And that could be e-commerce on your traditional retailers or our new retailers because that is where the growth is of the entire market. There is very little growth in the bricks and mortar segment.

Jason Gere - KeyBanc Capital Markets - Analyst

Okay. And then I guess just in terms of the context of -- with Walmart and the drug stores, how do you think about the tail brands kind of surviving through some of this?

I know that you are managing those more for cash. I was just wondering, is that built into your expectations for maybe the next two years, like these brands could get pushed aside but hopefully the power brands will step up and overcompensate?



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

Yes, so on the tail brands, some of them over time will not survive. Some of them will survive.

So that is kind of like building what we have said about this fiscal year in terms of the longer term, we are and we will be going through a full portfolio review on the merged entity, and then we'll communicate to market in due time. But that is a work in progress.

That is not completed. So that is really something which we'll be discussing with you sometime next year.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Okay. And then the question, when you guys announced the P&G merger you gave a pro forma number. So obviously there's a lot of moving parts since that date; P&G's numbers, the change in your structure, acquisitions, et cetera.

When do you think you might be able to provide us a little bit more clarity on what the go forward pro forma number might look like, or a little bit more context that we can put into the numbers into our modeling? Thank you.

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

Yes, I can give you a very broad answer. Sometime next year. (laughter)

So you have to understand how this process works. We have just appointed the executive committee. Clearly we are working on the next level, and then we will work on the levels below that.

As you're working your way down into the organization, you are essentially also creating the cost structure associated with that. So the progress in terms of clarifying the specific synergy number and confirming the synergy numbers which we've given to the market or providing any perspective around that, is it happens as we are going through this process. So it will happen, hopefully will happen sometime in the first half, but it is premature to give you a firm date on that.

Operator

And our next question comes from Mark Astrachan with Stifel. Your line is open.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Yes, thanks and hello, everybody. I'm curious, Bart, has your strategy evolved on managing luxury in the mass businesses?

And if yes what has changed? And related to that, how much overlap is there between managing luxury fragrances and other categories together?

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

So I think you can see our thinking in this area on display in terms of what we have announced relative to the new structure of the organization. So we clearly have three divisions. And the first of the divisions are fragrances, and skin care is a very large focus in that category.

It's predominately a prestige and license business. In terms of the mass fragrance which sits in there, we will basically -- they will manage that because from a consumer point of view there is very little difference if they buy a mass fragrance or a prestige fragrance.



Trust me, the consumer does not think about buying a mass fragrance or a prestige fragrance. The fundamental thinking should sit in that division. And we will continue basically to leave that with them to manage from a consumer point of view both the mass as well as the luxury part of the fragrance.

Having said that, going forward we have to be very clear, this is 80% plus is going to be a prestige license side business in the fragrance area. So the mass will be part of that but will be the smaller part. So the thinking is going to be more towards the upper end than the bottom end of the market.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Got it. Okay. And just a clarification, commentary on synergies, did something change there or are the expectations both for organic as well as the acquired businesses the same as they were?

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

There is no change to our commentary so far on the synergies with respect to the P&G merger. This was the question before; when we get an update on that -- and that will happen sometime next year.

But for the time being, it is what it is. There's differently no reason to believe it should be higher or lower. It is what it is.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Okay. And then lastly on personnel, do you anticipate any more major leadership changes at this point, comings and goings? Or is what we see what it will be plus whatever backfill to go behind those folks?

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

No. Like I said, for the merged entity we are very focused on getting the best and the most basically and certainly the best of the two companies where needed. We will complement this with external candidates.

But are going through this process as we speak. Right now we're recruiting and we are working with both the P&G and Coty organizations to get the best on Level II. That will be announced in due time.

Operator

And our next question comes from Javier Escalante's from Consumer Edge Research. Your line is open.

Javier Escalante - *Consumer Edge Research - Analyst*

Hi, good morning, everyone. I have a follow up with regards to earnings. And I understand perfectly that your progression for 2016 and 2017 remains a work in progress because of the moving pieces.

But could you ballpark the incremental overhead cost to manage the Procter brands? And with this I mean what is the ongoing SG&A? This is beyond one-time spendings on CapEx.

This is point number one; and have you considered slowing down or perhaps holding your pre-merger cost-cutting plan to harmonize it with these broader changes that you're making given all these acquisitions? And have a follow-up question.

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

In terms of the global efficiency programs, they will continue as we've outlined. There is absolutely zero reason to stop any of what we're doing in that area because of the P&G merger.

The P&G merger will provide additional opportunities, from an efficiency point of view, there's no question about that. And they're very clearly identified in many pockets, be it in supply chain or in the SG&A area.

So there is a very clear plan. Now the question will be is really as we go through the process is to update all the assumptions and to make sure that we are going to achieve the numbers that we've outlined.

In terms of incremental overhead cost to manage the P&G brands; so clearly we are not going to have the Coty SG&A to manage the larger organization, There will be incremental SG&A.

That's not the question. The question is really the sum of the two basically will drive certain synergies. And we have clearly communicated what we believe the synergies are. So for the time being there's no update on that.

Javier Escalante - *Consumer Edge Research - Analyst*

Thank you. And the second question is that I noticed that your title remains Interim CEO. (laughter) Is there a CEO search -- hello?

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

Yes we can hear you.

Javier Escalante - *Consumer Edge Research - Analyst*

Sorry for that. I was on the speaker. So basically is there a CEO search and if you can tell us whether you are considering to bring in someone with operating experience in beauty, if that is a requisite, and what is the timeframe for that search?

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

There is no search. So at some point in time there might be a search but there is no search. And the reason why there is no search is that with the Board we have decided at the time, which was in June or July of this year, that I should stay in place and very much make sure that we are going to gradually transform the Coty business and make the merger a success.

Once we get to a situation where we believe that we have reason to believe that that's going to be the case, we will come back to this. So that might mean that I'll become one of the longest-serving interim CEOs, but so be it. So it is not really time-dependent it's really KPI dependent, the CEO situation.

Operator

And our next question comes from Dara Mohsenian from Morgan Stanley. Your line is open.



Dara Mohsenian - *Morgan Stanley - Analyst*

I'm actually all set. Thanks.

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

Considering no further questions, can I just thank all of you for your attendance on the call. And I'm sure we will have another session like this in about three months. Thank you very much.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does end your conference call for today. You may now disconnect and have a great day.

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

Thank you.

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

Thanks.

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