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COTY - Q2 2017 Coty Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 09, 2017 / 1:00PM GMT

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PRESENTATION

Operator

Good morning ladies and gentlemen. My name is Candace, and I will be your operator today. At this time, I would like to welcome everyone to Coty's second-quarter FY17 results conference call.

(Operator Instructions)

As a reminder, this conference call is being recorded today, Thursday, February 9. Thank you. I will now 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 and IR*

Good morning, thank you for joining us. On today's call are Camillo Pane, Chief Executive Officer, and Patrice de Talhouet, Executive Vice President and Global Chief Financial Officer.

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 we list factors that could cause actual results to differ materially from these forward-looking statements.

In addition, except where noted, discussion of our financial results and our expectations reflect certain adjustments, as specified in the non-GAAP financial measures section of our earnings release. You can find the bridge from GAAP to non-GAAP results in the reconciliation table in the earnings release. I will now turn the call over to Camillo.

Camillo Pane - *Coty Inc. - CEO*

Thank you Kevin, and welcome, everybody to Coty's second-quarter conference call. I am delighted to be here speaking with you, leading my first earnings call as Coty's CEO.

Let me take a moment to reiterate for you Coty's ambition, as previously articulated by Bart, which I embrace, and will continue to use as the foundation of my strategic vision. Our ambition in beauty is to strive to become over time a global industry leader by being a clear challenger in beauty, delighting our consumers, which ultimately should translate into revenue growth, strong cash flow, and the creation of long-term shareholder value.

Having completed my first four months in the role, it's clear to me that the combination of our iconic and emerging brands, energized employees, and the comprehensive strategy we are laying out for the new organization will position us well to reach our ambitions. Today is our first time reporting as a combined Company, following the closing of the P&G Beauty transaction October 1.

Consistent with our comments on the last earnings call, Q2 was a challenging quarter. The business was impacted by significantly higher than anticipated inventory levels in the market, on the acquired P&G Beauty Business, competitive pressure in the Consumer Beauty division, and the distraction associated with integration efforts.

I want to be clear, that while the complexity of the merger, the sheer magnitude of this integration and simultaneous reorganization of our total Company has impacted of our organization and our short-term results, I have initiated additional changes, as I'm not satisfied with the underlying performance of several parts of the business. So although FY17 is a transitional year, as previously discussed, we have already started to tackle the growth challenges of our business.

As this is my first earnings call and an introduction to how I think about the business, I want to go into much more detail into the trends and strategies that I plan going forward. To reiterate my assessment from the last earnings call, the Coty business is composed of three divisions, in different states of evolution.

The Professional Beauty division is performing well overall, fueled by the continued success of the hair portfolio. The Luxury division has been improving its revenue trends, in parallel with decreasing wholesale distribution to create a healthy business. And we expect the momentum to continue in the coming quarters.

However, the Consumer Beauty division is facing a number of challenges. I will come back to Consumer Beauty in more detail later.

I will now discuss my strategic vision for the Company, and the specific actions we are implementing to continue the reshaping of our business in order to address the current challenges, and return the combined Company to growth. First and foremost, we have an amazing portfolio of iconic brands that are loved by millions of consumers throughout the world, including COVERGIRL, Rimmel and Clairol in Consumer Beauty; Calvin Klein, Hugo Boss and Gucci in Luxury; and Wella and OPI in Professional Beauty.

Our first focus on our established global brands is to continue to strengthen and nurture them. Particularly as some of them were previously essentially orphaned within a larger corporation.

Our second focus is to cultivate and fuel the brands with higher growth potential in our portfolio.

Our third focus is to stabilize the remaining brands, whether through active portfolio rationalization or other measures.

Finally, we are also completing the shaping of our new organization, including making sure we have the right talent in key roles, to drive growth in our brands.

We aim to achieve these objectives through four key pillars: First, we are repositioning some of the brands, in order to reconnect these brands with consumers, building on their already strong brand equity.

Second, we are making significant changes to our innovation and product development process in parts of the organization.

Third we are accelerating our end-to-end the digital transformation, including e-commerce.

And fourth, we are working to significantly ramp our in-store execution. I would like to also highlight that we see a substantial opportunity to use the strength of our broad portfolio brands to reach more and more consumers all over the world, as many of our brands still have substantial opportunity for geographical expansion, leveraging our global distribution footprint.

On the M&A front, we are continuing to strengthen the Coty portfolio, through highly strategic acquisitions and planned portfolio rationalization. Both ghd and Younique are expected to be accretive in Year One, on both net revenue growth and adjusted earnings. From a strategic perspective, ghd expands our assortment of premium products for the Salon channel. While the partnership with Younique leverages Younique's high-growth e-commerce platform, and social selling direct-to-consumer business model.

On the portfolio rationalization, we have identified the non-core portfolio brands, and are now exploring potential alternatives for these brands, including divestitures. So the comprehensive reshaping of our business for growth is continuing to pace.

I would now like to take some time to discuss each of Coty's new divisions, and the specific action we are implementing to address current challenges, and return the combined Company to growth.

I'll start with Consumer Beauty. This division represents approximately half of our combined portfolio net revenues, with around half of the division sales concentrated in color cosmetics, and the other half composed of retail hair, body care, and mass fragrances.

The Q2 results of the Consumer Beauty division were clearly disappointing, as I mentioned before. The main drivers behind these results are the fact that some of the key brands were orphaned in the previous large organization, the high competitive market pressure, and the changing market environment. Additionally, we are still working through highly elevated inventories that were built before the close of the P&G Beauty transaction.

So let me go a little deeper into each of these categories, starting with Color Cosmetics. The Color Cosmetics category has been growing on average, at a low single-digit pace in key regions. But the category has been rapidly changing with consumers focused much more on trends and ancillary products, and engaging much more online to discuss and determine what they purchase.

A lot of the growth has come from entry and smaller brands that are fast to respond to trends, and engage with their customers through digital platforms and innovative in-store activation.

We are behind on this curve, but we have already taken action, and we are working a multi-pronged approach.

First, we are revamping our product development as well as our communication process and programs. Aided by our own digital agency, Beamly, as well as more strategic partnership with our key partners' suppliers, the new innovation process is focused on spotting the trends early and slashing our average time-to-market, which is currently about 12 to 18 months.

In parallel, we are working to digitally transform our brands and overhaul our in-store presence to make sure we are present in the best way possible, where our consumers shop. As part of these efforts, we will be shifting more money from traditional media to digital media, and investment in the store. Finally, we are also working with retailers to improve our partnership relationships, bringing value to them and their customers.

From a brand perspective, we believe we have a strong portfolio of cosmetic brands, but we will be relaunching several of them to regain relevance with consumers. Specifically, we will be relaunching COVERGIRL and Max Factor in the coming fiscal year, with new brand positioning, new creative, new packaging, and new in-store appearance. We will also be enhancing Sally Hansen's market approach to build a strong emotional connection with the consumer.

While the full COVERGIRL and Max Factor brand relaunches will kick off in a few quarters, we have already seen some bright spots in the business. COVERGIRL's So Lashy launch is the biggest mascara launch of the season. The innovative product, strong consumer insights, and a marketing campaign featuring James Charles and Nura Afia, have given disproportionate engagement and above expected results for this novel mascara that works for all lash types.

This multi-pronged approach will take time to yield results, but we strongly believe that this is the right way to strengthen our business for the long-term.

Turning to Retail Hair, we believe that Coty has a real opportunity to revive the category through innovation, stronger in-store execution and consumer engagement. The category has been dormant for the last ten years, particularly in developed countries. We believe the biggest brands in the category, including Clairol, have been leveraging the category for profit, with no real innovation.

Our analysis indicates that consumers are intimidated by the difficulty of the shopping for hair color in stores, and the complexity of the hair coloring process at home. In turn, the category penetration has been going down, as consumers would rather go to their professional stylists. As a result of these category issues, retailers have been progressively cutting the shelf location which in turn has limited the color assortment, preventing many women from finding their shade.

Against this backdrop, we believe we have an exciting pipeline of innovation in the near future, that will revitalize the Retail Hair category and transform it into a beauty category instead of a functional category.

The Consumer Beauty division will take some time to return to growth and I am confident the strategic actions that we are putting in place are the right steps to strengthen Coty's position in these beauty categories.

Turning to the Luxury division, which accounts for approximately a third of the combined Company revenues, we believe we have a very strong portfolio of brands, which spans the spectrum of the prestige fragrance category from low-premium to ultra-premium, and we are continuing with our strategy of making our portfolio even more prestige.

Coty Luxury had strong results across several of our brands and pillars in Q2. However, the division's performance in Q2 versus last year was impacted by our continued wholesale distribution reduction, which is a positive for the health of the business, and by the difficult innovation comparisons versus the previous year.

On the positive side, we launched a new Hugo Boss fragrance, The Scent For Her, which marks the brand's successful entry into the female category. This was the number one launch in the UK and number two in Spain. The Gucci Guilty marketing campaign has also been very positive, driving market share growth in the Gucci Guilty franchise in both the US and Italy.

The Chloe brand continued to grow in-market across all key countries, supported by the Fleur de Parfum launch. Philosophy also continue to grow in the quarter, fueled by the direct-to-consumer platform.

From a go-to-market perspective, we are continuing to gain share in the Travel Retail channel, where we already have a disproportionate share of the fragrance category. We have also successfully established a local affiliate in China, steadily improving our distribution and in-market performance.

If we look to the second half of 2017, we remain excited by the robust pipeline of initiatives across the Hugo Boss, Gucci, and Calvin Klein brands, among others. While there is more to do on wholesale distribution, we do expect revenue trends in the Luxury division to continue to improve in the coming quarters.

In the Professional Beauty division, which accounts for approximately 1/5 of combined Company revenues, we are maintaining strong momentum in the Hair category, while broadening our portfolio with ghd within Hair appliances, and a critical adjacency in Nail with OPI. Our Salon Hair portfolio continued to grow low to mid single digits, consistent with the performance in the two previous fiscal years, and ahead of the Salon market, which is growing at approximately 1%. We are excited by the continued strong performance of the largest brand, Wella, as well as the System Professional brand, which is tapping into the premium care segment and the growing trends of customization and personalization with its Energy Cody technology.

ghd as the new key brand of the Professional Beauty portfolio, has performed well in its first few weeks within Coty, and we expect momentum to continue throughout the remainder of the fiscal year, notably building on its geographical footprint expansion beyond its core countries. Altogether, we expect the Professional Beauty division to see good growth on a combined Company basis, through the rest of the FY17 and beyond.

Following on the heels of the ghd acquisition, I'm excited about our partnership with Younique. I'm extremely pleased that both of the founders, Derek and Melanie, will continue to lead the business, which leverages the exponential potential of online peer-to-peer social selling. The partnership will combine Younique's high-growth e-commerce platform with Coty R&D and innovation know-how, as well as extensive manufacturing and supply chain capabilities.

And speaking of digitally focused investments, I would like to touch on the substantial efforts we are implementing to accelerate Coty's digital transformation. These actions span four major components. In marketing science, we are now able to understand and reach our consumers with far higher levels of targeting precision, thereby enabling a step change in our social listening and trend scanning capabilities, to better equip our brands and markets.

In terms of brand content, we're testing creative to better align with target consumer segments, and drive higher non-working media effectiveness. In media optimization, we have continued the transition to digital from 21% to over 30% globally in just these past six months, while also outperforming engagement and cost benchmarks by up to 30%, driving further media efficiency. Looking at it as Omnichannel, we will begin to create new platforms for deeper personalization, including online and in-store activation programs.

With regard to the rest of FY17, we continue to expect the decline of the net revenue at constant currency, to slow down in the second half, excluding the contribution from Younique and ghd. From the P&G Beauty Business merger, the integration is progressing as expected with no major issues to date and we are reiterating our previously communicated $750 million synergy target by FY20.

If I can summarize, FY17 remains a challenging transitional year, but one that we believe is setting the stage for enormous potential as a global leader and challenger in beauty. I believe the new Coty is a much stronger Company then the two previous organizations running separately, and now that we have full control of the combined brand portfolio, I am even more confident about the great long-term potential of the new Coty. I will now turn it over to Patrice.

Patrice de Talhouet - *Coty Inc. - EVP and Global CFO*

Thank you, Camillo, and good morning, everyone. I'm excited to report our results for the first time as the new Coty since completing the acquisition of the P&G Beauty Business on October 1.

Coty today is a new Company, one that we have built on a bottom-up approach into a new focused divisional organization, and combines the expertise and talents of executives from Coty, P&G Beauty business, and other leading companies. Building the new organization bottom-up best positions the Company to advance Coty's global leadership position in beauty, and also provides the opportunity to drive substantial synergies.

We have created three new operating divisions, and therefore three new reporting segments which are: Consumer Beauty, Luxury, and Professional Beauty. This new organization structure is product category and channel focused, putting the consumer first, by specifically targeting how and where they shop, and what and why they purchase.

Each of the divisions has full end-to-end responsibility to optimize the consumer's beauty experience in their relevant categories and channels. We are convinced this new organizational design, with full P&L responsibility, will translate into profitable growth.

The Reverse Morris Trust carve-out merger with the P&G Beauty Business was and still is an enormously complex and challenging transaction globally. It is the largest beauty deal in history and the largest global merger to be successfully completed in the consumer sector.

First, from a carve-out standpoint, we continue to integrate worldwide P&G Beauty Business with a worldwide legacy Coty business from a systems and manufacturing perspective, which are currently operating under TSAs or transitional service agreements.

Turning now to the current integration efforts, our teams are working full speed to pave the way for a smooth integration, and are doing an extraordinary job on the day to day basis. As a result, it is progressing as expected, with no major issues to date. We are now in the process of preparing for the first stage exit from the TSA in North America, which should happen in the course of April.

It is worth noting that this first wave TSA exit is expected to provide some modest uplift through a pull forward of shipments to Q3. Europe should follow in the course of July, with then ALMEA in September.

This provides some additional context for why we have described FY17 as a transitional year for Coty.

Now, let me provide some of the highlights for the second quarter. Q2 net revenues of $2.3 billion increased 90% as reported, compared to legacy Coty, and decreased 4% at constant currency compared to combined Coty and P&G Beauty Business net revenues in the prior year period.

Our performance has been severely impacted by the negative transitional issues, especially including significant trade inventory build in Q1, in parts of the P&G business, costing more than 3 points of growth. Excluding these transitional issues, and a positive contribution from ghd and Hypermarcas, the combined Company net revenues at constant currency declined in the high single digits, and were slightly better than the output provided on the last earnings call.

By division, Professional Beauty net revenues grew 14% at constant currency compared to combined Company revenues in the prior year, or low single-digits excluding the contribution from ghd. Luxury net revenues declined 4% at constant currency, compared to combined Company revenues in the prior year.

Consumer Beauty net revenues declined 11% at constant currency, compared to combined Company revenues in the prior year. These declines reflected a high single-digit percentage negative impact from the transition issues discussed earlier, largely offset by the revenue contribution from the Brazil Acquisition. The in- market performance sell-through of the division was better, with a high single-digit decline.

Let us now go into the shape of the P&L. Our adjusted gross margin of 63.6% increased from 61.4% for legacy Coty in the prior year period, as we are adding a higher gross margin business from P&G.

The Q2 adjusted operating income increased 44% to $336 million on a constant currency basis, from $233 million for legacy Coty in the prior year period. The adjusted operating margin decreased to 14.3% at constant rates from 19.3% for legacy Coty, mainly driven by two key components.

First, we had negative operating income impact of over 200 basis points from the transitional issues, due to the merger. Second, we added the P&G Beauty Business which carried limited operating margin as a result of the substantial A&CP pre-commitments, which we could not reduce to line with the revenue trends, combined with the depressed dynamic within Consumer Beauty business.

From a segment perspective, Luxury reported an adjusting operating margin of 11.7%, reflecting the addition of a lower margin P&G business. Consumer Beauty posted an adjusted operating margin of 11% despite the depressed revenues, while Professional Beauty adjusted operating margin of 21.7% reflects a solid margin from our nail business, combined with improvement in salon hair, which also benefited from the seasonal strength in Q2.

Therefore, all the above combined with a quarterly tax rate of 8.8%, reflecting an adjusted tax benefit of $39 million, we reported an adjusted EPS of $0.30.

As far as the deal economics are concerned, we are pleased to confirm our previously communicated target of $750 million in synergies, $1.2 billion in one-time costs, $500 million working capital benefit, and $500 million one-time CapEx by FY20.

We remain committed to our previously-committed adjusted EPS target of $1.53 for FY20. This being said, there many different ways to get there, and it is fair to say we will also use our balance sheet to shift the growth profile part of the Company and hit the above target.

With regard to synergies, with the two businesses now running together, allowing leadership better insight into their individual cost structures, we are refining the phasing of the $750 million synergies in order to take into account the business dynamics and to reflect the fiscal year P&L impact. As you may recall, our preliminary synergy phasing estimates had always been on an annualized basis, whereas in FY17, we recognized no synergies in Q1, as the transaction did not close until October 1. We now expect to cumulatively generate approximately 20% of the net $750 million synergies through FY17, roughly 50% through FY18, approximately 80% for FY19, and the full $750 million in FY20. Our focus is on having the right infrastructure in place to support the long-term growth.

Now, let us speak about the balance sheet and our cash profile. Q2 has been a very good quarter, with over $670 million in cash flow and $567 million in free cash flow during the quarter. This represented an increase of over $270 million in operating cash flow versus legacy Coty in the prior year, and is the result of a very strict cash discipline, and tight working capital management quarter after quarter.

This cash generation is critical in the current environment, and provides strong visibility to the progress we can further realize with the combined business. We finished the second quarter with over $900 million in cash on the balance sheet, and approximately $5.6 billion in net debt. And it is fair to say some of this cash will be used in the back half of the year while we execute the integration.

Our balance sheet is very solid, with a very moderate leverage after all the recent acquisitions made. I would like to point out that we still maintain our pro forma leverage profile of roughly 3.8 times, while adding ghd and Younique to our portfolio, which are meaningfully shifting the growth profile of our Company.

We are particularly pleased with the profitability profile of Younique, with an adjusted EBITDA margin of over 25%. We expect these two significant adds will be both accretive Year One from a growth and adjusted earnings standpoint, and allow us to be better positioned to be a serious challenger in the beauty industry.

We have identified the non-core portfolio of brands, which confirms our preliminary estimate of approximately 6% to 8% of the combined portfolio revenues. We are currently assessing what the potential alternatives regarding this portfolio of brands could be, including divestiture. But this will take some time, as we ensure we maximize shareholder value.

We are targeting to offset any earnings dilution from this portfolio rationalization with acquisitions. We continue to drive shareholder value to an 82% increase in dividends and transition to a quarterly dividend payout. This policy is a good reflection of the strong balance sheet and cash flow generation, and will likely remain unchanged in the short term.

We also retain our remaining $400 million share buyback authorization, and we will remain opportunistic, as we always have been, in the way we potentially use this. And we know we have the long-term support from our largest shareholder, JAB.

After the successful completion of the P&G Beauty Business merger, the business has strong strategies and financial flexibility, and we are extremely confident in the free cash flow profile of the Company, and strength of the balance sheet. This will allow us to gradually shift the growth profile of the Company to be well-positioned as anew global leader and challenger in the beauty industry.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Steph Wissink of Piper Jaffray.

Steph Wissink - *Piper Jaffray & Co. - Analyst*

Just a couple of questions, Camillo, regarding your comments on the reorganization. I'm wondering if you can talk a little bit about some of the changes in role definition that have been made, and when do you expect some of that to start to play out in the controls that you are seeing within the business segments? And then Patrice just as a follow-up on the $1.50-plus target and the commitment to use the balance sheet, can you give us a sense of what leverage ratio you would be comfortable going to at its peak, in order to offset some of the divestiture dilution, and some of those slower growth progress in the core business? Thank you.

Camillo Pane - *Coty Inc. - CEO*

Thanks Steph, for the question. Look, this is a bigger organization because both companies were not organized and structured this way prior to the merger. So, we have created three divisions, both Coty legacy and P&G beauty business were not managed this way. Clearly having them managed now - managing the Company with three and two end-to-end divisions where they have full responsibility for the entire portfolio and the P&L this is a clearly different way of working. This has been embedded in the organization at the moment.

Clearly, the way of working has changed for a lot of our people, both coming from the Coty legacy from P&G, or from the outside. Another key element of differentiation in our structure that we have chosen is that we have end to end responsibility within the division as I said, but also the P&L with the countries. This is also, I would say, significant departure from how the business was managed, especially in the P&G previous business, where the control of the P&L was more central, I would say. I don't know if I'm answering fully your question, but in my opinion, this is I would say are the two key elements that are making this reorganization complex, but at the same time, in my opinion, paving the way you know for the future success of the Company.

Patrice de Talhouet - *Coty Inc. - EVP and Global CFO*

Steph on the second part of your question regarding the leverage, so first I think one should remember that we are going to generate north of $1 billion of cash each and every year. Which once again plays into the cash flow profile of the Company, the strong balance sheet.

Second, the leverage that we are ready to go to highly depends on the profile of the target, and whether this target is very strategic or not. So I can't give you a definite answer. Its highly depends on where, whether it's strategic, the size of the acquisition. So it's very dependent on that.

But in terms of M&A strategy, the key which we look at it is clearly number one, very strong strategy. Number two value-adding for Coty, attractive to our growth and earnings profile.

And three, to provide a clear return to our shareholders. But once again, in terms of leverage, it clearly depends on the type of target and the strategy and the size of the target. Thank you.

Operator

Bill Schmitz of Deutsche Bank.

Bill Schmitz - *Deutsche Bank - Analyst*

I have two questions actually. The first one just has to do with the NPD and Nielsen data, and I guess it is also tied to COVERGIRL, because the trends have obviously been not very good. And it seems like some of the distribution is coming out, so I look at the ACV on COVERGIRL, it peaked at 74%, down to 71%, and looks like it is heading in the wrong direction. Wondering again when you think that the sell through data is going to start to firm up, and if you are scared about some of the distribution trends that are happening, especially at COVERGIRL?

And then the second one is just some further color on the timing if the synergy stuff, because it looks like a lot of it got pushed forward quite a bit. So that would be appreciated. Thank you.

Camillo Pane - *Coty Inc. - CEO*

Thanks Bill for the question. We believe that we have an amazing set of brands, and our brands are loved by millions. So our strategy and in terms of repositioning the brands and you mentioned COVERGIRL, is not just the only one, is key, to reconnect with the consumers.

I mentioned that I was not satisfied with some of the elements of the COVERGIRL position in the past, but actually now we're working on reinvigorating the innovation process, separating the packaging, the way it looks in store. We are going to be more modern, more focused on looks. Clearly we have a lot in our pipeline to relaunch the brand in the future.

I have to say that we have been also exposing some of our thoughts and ideas to retailers and actually the reaction is very positive. So going back to the distribution business, a temporary situation, but we are very confident that all the actions that we are going to put in place will actually allow COVERGIRL to retain the position that we want to have in the market, and improve. And as a matter of fact, COVERGIRL is still the brand with the strongest equity mass color cosmetic in the US. That gives us an enormous level of confidence for the future potential of going back to growth.

Patrice de Talhouet - *Coty Inc. - EVP and Global CFO*

So Bill, good morning. On your question regarding the synergies and the phasing of the synergies, I think you should remember that when we quoted the synergies before, we spoke on an annual basis, not on a fiscal basis so that plays a key role into the new phasing. And the second one is that clearly, while taking into account the business dynamics, and the management has much more now insight now into the different cost structures. So clearly we reconfirm the $750 million synergies, we are very confident about it. It will be fully implemented by FY20, and the phasing that now we are expecting, is 20% in FY17, 50% in FY18 and 80% in FY19.

Operator

Olivia Tong of Bank of America Merrill Lynch.

Olivia Tong - *BofA Merrill Lynch - Analyst*

First on the integration, hoping you can help clarify, because you are saying the integration is progressing as expected, but obviously pushing out the timing on the realization. I get fiscal the versus annual but is this also -- is there anything in terms of the initial costs that are transferring over, or ability to realize cost synergies that's playing in that, in terms of the delay and realization?

Because I'm a bit confused as to what gives you the confidence you can still reach that four-year synergy and working capital targets when they are obviously getting pushed out. And the other thing is obviously, it doesn't assume any of the deals are improving the underlying business, but did the prior targets assume this much of a step down before restoration? And then I have a follow-up, thanks.

Camillo Pane - *Coty Inc. - CEO*

Thanks for your question, Olivia. You should remember the way we came about the target is really based on the bottom-up organization design, function by function, country by country. That is the reason why we are very confident in the synergy target $750 million. So this is and remains and is not to be questioned.

Now, in terms of phasing as you pointed out, once the annual fiscal is being accrued, second we have to take into account the current business dynamics, especially in consumer beauty. It's not a question of integration difficulty, this is progressing as expected, and the guys doing a fabulous job on the field.

We have no surprise whatsoever on that, and now we are in the process of gradually exiting the TSAs, so this is progressing as planned and as expected, but now the synergies first are taking into account the fiscal versus the calendar annualization, and second, taking into account some of the business dynamics. So once again, we remain firmly committed on the $750 million synergy target.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Okay, what is going to impact the timing on the exit, the six to eight you talked about, and what are you doing with those businesses in the meantime and following up on the $1.53 EPS target that you reiterated, if you have an inventory stuffing issue that you have to comp next September quarter, it seems like some of these issues that you are dealing with for FY17 and calling it a transition year, seem to be bleeding into next fiscal year as well. Why is that still the right target over time?

Patrice de Talhouet - *Coty Inc. - EVP and Global CFO*

The timing of the divestiture was the first part of your question? So I think on the timing of the divestiture, what is really important to be reminded is that we are there to maximize the long-term shareholder value, and that's the reason why we are going to take time to ensure we maximize it. And there are different scenarios that are currently now at stake, including divestiture, in order to do that.

What is fair to say is that now we have identified the brand, which makes us confident about the ramp of 6% to 8% that we have mentioned before. And once again, so we are going to take some time on that widespread different scenario, and that's the reason why we are very confident in mentioning the fact that the potential EPS dilution that will come out of that is going to be fully offset by acquisition. And so fair to say that ghd and Younique are clearly fulfilling the role. I think that is on the one side.

Now on the $1.53 target, as we said, we remain committed on the previously communicated $1.53 target by FY20. And I think clearly now what we are saying is that it was made on the starting point. Coty is clearly still in evolving mode.

We are in build-up mode. We are currently building a platform, a formidable platform to be a sales channel in the beauty industry. That's going to take some time and because we are in building mode, now we can clearly say is that there are many ways to get there.

But the endpoint is exactly the same. It's $1.53 by FY20. But we will also use our balance sheet in order to get there.

Operator

Lauren Lieberman of Barclays.

Lauren Lieberman - *Barclays Capital - Analyst*

I want to talk a little bit about the reinvestment needs in the business. Talking about restaging on COVERGIRL and Max Factor, and also if you can clarify if that was a FY17 or FY18 plan for those two brands. But if these have been orphan brands, I would think there is something to be said for reinvestment needs.

Does spending go up versus what you maybe would expect in the first year or two? Or is there no change in that thought process on incremental spending? Thanks.

Camillo Pane - *Coty Inc. - CEO*

First, the plan to relaunch COVERGIRL and Max Factor are for FY18, I think this was a part of your question. Regarding the investment, I am actually convinced that we have enough funds to relaunch the brands, not just these two, but also the other brands. One thing that I would like to point out is the fact that actually the P&G brands we're spending a substantially higher level of marketing versus what we were spending in the Coty legacy. The combination of the funds that we have in the new Company around approximately 26% as a percent of net revenues, in my opinion are actually enough or more than enough to relaunch the brands, and because a lot of things we need to do are truly in terms of the way we connect with consumers.

And one of the key shifts is going to be really going from traditional TV, traditional media to digital engagement. And there as you know, moving that actually creates a lot of efficiencies. It's not just a matter of spending more, but it's a matter of spending better, and connecting better with the consumers.

Making sure that we speak to them in the right way, where they are. And a lot of times they are not necessarily watching TV but they are on digital different platforms.

Lauren Lieberman - *Barclays Capital - Analyst*

That's really helpful. And then I am also curious on the legacy Coty portfolio, some of the work that you had initiated, going back probably two Christmas seasons ago, cleaning up the promotional activity on some of the fragrance brands can you talk a little bit about further progress made this season and how those brands performed? If you think you are yet reset to where we have a good base to work from, as you go forward to next holiday season? Thanks.

Camillo Pane - *Coty Inc. - CEO*

I believe that we are making a lot of great progress in preparing strong actions for the luxury division to return to growth in the next few quarters. We have a strong pipeline coming. Yes, in the last Christmas we also had an unfavorable benchmark versus the previous innovation from the past year, so the market for Marc Jacobs Decadence which was success in the previous season or the Hugo Boss, the Scent For Him which was also a big success.

But if I look at the some of the elements and some of the things we have done, I am actually quite pleased because Hugo Boss, The Scent For Her which really marks the entry of Hugo Boss in the female segment has been a success with number one in the UK, number two in Spain. Chloe continues to do very well, and we have a lot of brands which actually are performing very well in the market, and outperforming the markets. So we are confident about the actions we are putting in place for the luxury division.

Operator

Joe Lackey of Wells Fargo Securities.

Joe Lackey - *Wells Fargo Securities, LLC - Analyst*

First on M&A, I guess given the weaker results obviously you have a bigger gap to fill to hit your long-term EPS target. And obviously you are looking to offset dilution from portfolio divestitures, through M&A. So it sounds like, given the recent results have been weaker than you expected, you are probably going to have to be maybe a little bit more aggressive with M&A.

So how do you balance that, given the competitive environment for acquisitions? So that you don't overreach either operationally, take too much on your plate given the transitions you are going through, or over pay for acquisitions? Thanks.

Camillo Pane - *Coty Inc. - CEO*

Joe thanks for the question, great question. I think that you can see in the recent track record that we have in the M&A, some elements of your answer, the way we approach M&A, the way we execute M&A, and the new discipline that we have put, that is the reason why I speak only about the recent acquisitions, which is only in the last two years. Boirjois, Hypermarcas, P&G, ghd, Beamly, Younique, have been done in a very disciplined way.

This being said, we are for the time being in stabilization mode and our priority number one is to return the business into organic growth. We have already a big integration to do with P&G and we are going to remain focused on that for the time being. So that is very clear in the prioritization.

The second thing I would say is that I usually do not comment on M&A, , so I have shared a little bit on our M&A strategy, but I am of the opinion that the more you talk, the less you do. So I will remain relatively mute on that, and I think not talking too much about it, and the last few years have done quite a bit.

Joe Lackey - *Wells Fargo Securities, LLC - Analyst*

Just one follow-up, I guess you had mentioned three big headwinds for the top line. You talked about the organic, or the inventory, excuse me, and the market. How long do you think that will take to clear through? You also mention competitive activity, and then disruption from the integration. So I was wondering maybe if you could better quantify the impact each one of those had, and how long you expect those to continue to be a headwind going forward? Thank you.

Camillo Pane - *Coty Inc. - CEO*

Joe, we will not quantify specifically the impact of each of them, although Patrice has mentioned that the overall impact has been 300 basis points on our growth, in our Q2. So in terms of details, I will not be able to give it to you.

What we can say is that we expect our revenues to decline in the second half of 2017, to slow down, and of course, we expect improvements afterwards. And it's also quite important that we look at the fact that we had three divisions, and the three divisions are in a different state of evolution, because professional beauty is actually growing and the hair portfolio is growing even faster.

Last year, as I said, is improving the trends because Q2 was already better than Q1, despite we are starting wholesale distribution reduction, and we expect the business of course to be healthy and to continue to improve in the next few quarters. And it will take time to really return to growth in consumer beauty, which is where we have the biggest challenges, as I explained before.

Operator

Dara Mohsenian of Morgan Stanley.

Dara Mohsenian - *Morgan Stanley - Analyst*

Just want to follow-up on Bill's question on COVERGIRL. I was hoping you could also discuss shelf space trends across your business to the other brands? And my worry is with some of the over revenue declines and distractions from the deal, that you could lose shelf space going forward, and it becomes a bit of a perpetuating cycle. So can you give us an update on your expectations for the balance of 2017 after spring resets from the shelf space standpoint? And is that a big risk factor in your mind?

Camillo Pane - *Coty Inc. - CEO*

I don't believe this is a big risk factor, and I will explain why in a second, Dara. I believe that now that we are the owner of the entire portfolio, we have finally been able to engage with our customers, with the retailers, in a much stronger way.

I truly believe in partnership. I believe partnerships is when there is a win/win situation for both parties. And myself and the team are keenly focused on establishing a much stronger partnership level with the key retailers.

We are in the process of doing that. We are engaging with all the key retailers. You asked about also in the other markets, and the reaction and the spirit is actually very good, because they are seeing the plans that we are putting in place, we are engaging with them, and in some cases we are working together of course, in preparing these plans.

When you approach a partnership this way, and in this case we are also working on the relaunching the very iconic brands which are loved by consumers in all their respective markets. Retailers are really appreciative of some of these plans, and before I see the future in a bright way, because I believe the relaunches of the brands will bring us success in the market.

Dara Mohsenian - *Morgan Stanley - Analyst*

Okay. And with those relaunches of some of those plans , I'm still surprised you aren't planning to boost advertising spending, and obviously you touched on an earlier in this call. But can you take me through your thought process there, and what gives you confidence that you really can revitalize this portfolio without spending more? Particularly, given you've got this huge synergy bucket from P&G, it seems like an odd decision not to spend more behind the business to drive reinvigoration.

Camillo Pane - *Coty Inc. - CEO*

Dara, I think actually that one of the key things we need to do is also to look at the investment strategy, and readjust the investments among the different brands. There will be some brands that want to have high growth potential that will receive more investment, and some others that eventually well receive a bit less. We're in the process of exactly doing this, and I think it's very important financial discipline to also look at return on investment.

Regarding on your question on spending more overall, I want to go back to my previous answer, which is that when you start shifting the traditional media to digital you actually have way more money to play with, and to invest to be able to reach more consumers. Consumers are truly spending a disproportionate amount of time on social media, on social platforms, and I believe that some of our brands have not played the right role in the social engagement. And by shifting the investment actually, we will achieve not only the consumers that we want to achieve but also in the right place and the right time. And the overall connection with the brand will improve. And this is clearly part of the logic of why I answered before that we believe we have enough funds for our future success and relaunches.

Patrice de Talhouet - *Coty Inc. - EVP and Global CFO*

And to build on that, Dara, the other point is that when you look at our Q2 results, our operating margin has been impacted by all the level of the A&CP pre-commitment that we receive, and as a result, once again it's not a question of size of the bucket. It's a question of how would you use the bucket in a much more efficient way which is exactly what Camillo has emphasized.

Operator

Wendy Nicholson of Citi Research.

Wendy Nicholson - *Citi Investment Research - Analyst*

Just to clarify on the inventory issue, of the acquired Proctor brands, I'm a little surprised because I feel that is a regular thing, that when you acquire a business you assume that the prior owner had stuffed the inventory. I'm surprised you didn't catch that in the due diligence process and maybe adjust the purchase price for that or whatever.

But my question is, are you sure that the inventory was actually all that high? Or is it just that your sales and the velocity of turning that inventory and getting it through the retail channel has just been moreslower than you expected? If you could make the distinction as opposed to exactly what that problem was, that would be great.

And then my second question just has to do, this is the second quarter in a row where you have called out the level of distraction in the organization, obviously you've got a ton going on, and it seems like the level of activity is kind of increasing, not decreasing with the incremental acquisitions. But can you comment qualitatively on your management team?

Do you have the right people in the right places? Do you think you have the right org structure? So that the level of distraction can stop being such a big headwind, and you can really get down to basics. Okay, thanks.

Camillo Pane - *Coty Inc. - CEO*

First, regarding the inventory, Wendy. We need to put this in a bit of perspective, of the fact that we announced the acquisition of P&G in July 2015, and we closed the deal in October 2016. That's a 15 months period in which we were not able to actually work on any of the P&G brands. We were two competing companies, and we were basically not working at all on that.

It's a long time for brands to be announced that would be sold, but still be in the hands of the previous owners. That really can cause a higher inventory, and we are not going to know details specifically at the level. But I think Patrice has explained that all the business transition issues which includes significantly higher inventory, were around 300 basis points of growth, so it was clearly quantified.

And in terms of distractions, clearly this is a big reorganization. This is not just putting together two companies, because at the same time, we have decided to manage the Company in a divisional structure. The choice with a divisional structure in my opinion is absolutely the right choice for the future, because it does allow a level of focus and capabilities and competencies, which are dedicated to specific categories and channels.

So fragrance and skin care in the prestige channel, in the luxury, and clearly color cosmetic and hair color and so on in the mass market, and hair and nail in professional. This is, the level of change is quite large, and this is why it's quoted as a distraction, because at the same time we are in middle of the integration of the system, which Patrice mentioned. We have not really fully performed, and Patrice, I think, mentioned the timing of the exit from the TSAs.

Regarding having all the people in the right places, we had clearly this reorganization clearly meant that a lot of people had new jobs so they had to move from different places to start the new job on October 3. And I believe that we have now a much stronger set of leaders in place. Of course, we always look to continue to improve the bench, and that's part of what we need to do to be successful in the future.

Operator

Mark Astrachan of Stifel.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Yes, thanks. I guess I am still curious on the distinction of the synergy phasing. You are trying to tell us that there was a less pronounced change on a calendar year basis than what was previously anticipated? And then what specifically was seen when owning the whole business, that caused the push out of synergies? Is there a component of anticipated reinvestment? And then where should synergies hit by segment and geography, so that we have some clue of how to track what is going on?

Patrice de Talhouet - *Coty Inc. - EVP and Global CFO*

Thanks for the question, Mark. We are not going to go into a level of detail of synergy by segment, and by region. As I mentioned once again, the synergies that were communicated so far were on an annual basis, and now they're on a fiscal year basis. This is already been half of the push.

The other part is clearly that some of the synergies are on the SG&A front, and with the current dynamics, we are taking that into account and placing it appropriately. Once again, what you really need to retain is that this organization has been built on a bottom-up basis in a very precise way, by function, by country. We took a lot of time, we benchmarked that.

We know what we are doing, we have done that before, and the $750 million are going to be realized, but I think it's fair to say that the current business is having an impact, and we are functioning and phasing accordingly. But we're still going to realize 80% by the end of FY19.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Got it okay. Switching back to the commentary on this M&A focus, not new, but the reemphasis. On the recent acquisition you did of Younique, I want to understand a bit better why buying a direct selling business makes sense for branded beauty company? How you think about that in the context of M&A being a focus going forward, and how can you have confidence in growth rates after call it year two given the volatility historically in direct selling businesses.

Camillo Pane - *Coty Inc. - CEO*

Let me comment on that Mark, on Younique. I believe Younique is highly strategic. And I believe that the online peer-to-peer social selling has a lot of potential. And our choice is driven clearly by wanting to partner with a Company that has developed a very, very successful business in this area. And of course by our ambition of growing this business by also looking at geographical expansion and further category expansion.

If you think that Younique is mainly - it's a business, is a brand with color cosmetics, I believe that this brand and in general the platform has the potential to be expanded more. And so plus, I think that e-commerce for us is a key focus for the future. And the acquisition of the partnership with Younique is a stepping stone for us to improve our capability, strengthen our capability in eCommerce.

Operator

Jason Gere of KeyBanc.

Jason Gere - *KeyBanc Capital Markets - Analyst*

I don't mean to belabor the point, but I will, just on COVERGIRL and Max Factor. When you talk about taking an orphan brand and really trying to turn it around, we have seen in the industry there been some successes like Old Spice or Oil of Olay type of things. Just wondering how you're going to be aggressive of changing the perception of the brand or the in-store execution that you're going to be using, just because you've seen a lot of growth with mass prestige brands in the mass channels, NYX or e.l.f., things like that. Appreciate the work that is going into that, but I'm just wondering, should be expecting something more dramatic than just a step up in investments and some of the innovation behind us. So I was wondering if you could provide a little bit more context to that question.

Camillo Pane - *Coty Inc. - CEO*

Absolutely, thank you Jason for the question. So when we think about COVERGIRL, first of all, as I mentioned before, the brand, COVERGIRL still has the number one equity in the US in the mass color cosmetics. I think it's quite important to remind ourselves as well, that we're talking about a brands which is iconic and loved by millions of consumers in the US.

Looking at what we plan to do, first of all, we plan to build on the COVERGIRL roots. I think you know thinking about the old positioning, every woman can feel that she is a covergirl, it's quite important that we don't completely depart from there. But we reinterpret the positioning in a much more modern way, in a more sophisticated way, so that we connect again and more with the consumers.

Within the relaunch, we are looking at clearly upgrading the packaging and the way we look in the store, in a more modern way, and a more sophisticated way and in a way that would allow for ease of navigation. So going back to your question, it's not just a matter of spending and choosing the right platform to connect, but it is also how we connect and how we communicate with the consumers across all the different touchpoints.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Okay, great. And just one other question. Considering that the new Coty brings in talent from three different organizations, how do you think about putting the right people in the right positions, meaning that if you think about what P&G has done in the past, they were always known for taking some of their talent and moving them -- cross fertilizing ideas to other divisions.

So internally, I guess the question is internally, are you considering moving people from division to division, just to make sure you have the right execution, and maybe some of the underperforming businesses? And secondly, would you still look to hire from the outside just to strengthen those teams, as well? Thank you very much for the question.

Camillo Pane - *Coty Inc. - CEO*

I will start with your second question, and move back to the first. In terms of how, I think and operate in terms of hiring from the outside, I believe that we always need to have a mix between internal promotion and hiring from the outside. Whenever the capability is not present internally, it is always good to tap into the amazing talent that are out there. At the same time, if we have the talent in the house, that is clearly very, very good. And this is different from how other companies have done in the past because some companies just privilege the promotion from inside.

Regarding your first question which is about the mobility and the cross fertilization across the different divisions. First of all I think we need to say that the three divisions require a level of expertise, because the knowledge of the capacity in the channels is very important. This is why also we have decided to structure ourselves with the three divisions.

That being said, I also believe that people will have to move across divisions in order to fertilize on success and learnings and on capabilities. So it's going to be a mix of both in answering your first question, as well.

Operator

Linda Bolton Weiser, B. Riley.

Linda Bolton Weiser - *B. Riley & Co. - Analyst*

Your interim CEO had made some comments about his assessment of the mass fragrance category, and the structure of that industry. Do you have any updated thoughts on that? And can you give us an update on the dynamics of the mass fragrance category and the ability of the mass retailers to be able to merchandise fragrance in that channel? Thanks.

Camillo Pane - *Coty Inc. - CEO*

In terms of mass fragrance, Linda, the mass fragrance clearly is suffering as a category overall because of certain dynamics. One of the key elements that I think is affecting the mass Fragrance is the fact that it's very difficult at the store environment to smell the Fragrance, the juice. That is one of the key drivers for trying the new fragrances, and that's really a key barrier there. I think this is an issue that we in the industry all need to work together with the retailers to try to overcome this barrier.

The second point is that within mass fragrance I think we need to distinguish between celebrities and other lifestyle brands. Within celebrities, it is fair to say that the -- I would say the lifespan of the celebrity brand has decreased significantly, just because the brand name, and the hype behind the celebrity is now shorter. Just that is what is happening.

When you look at the other side, on the lifestyle brands, we have Robanne or adidas or Max, which are actually great brands that we plan to focus in countries like Germany, Russia, these are brands that are doing well. They are again iconic brands in the lifestyle, mass fragrance in specific the countries. And we believe that they have potential. So again, it's a mixed sort of dynamic within the category.

Linda Bolton Weiser - *B. Riley & Co. - Analyst*

Thank you.

Operator

Thank you. That concludes our question-and-answer session for today. Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Have a great day, everyone.