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COTY - Q3 2017 Coty Inc Earnings Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen. My name is Shanelle, and I will be your conference operator today. At this time, I would like to welcome everyone to Coty's Third Quarter Fiscal 2017 Results Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded today, Wednesday, May 10. Thank you.

I would now like to turn the call over to Kevin Monaco, Coty's Senior Vice President, Treasurer and Investor Relations. Mr. Monaco, please go ahead.

Kevin Monaco - Coty Inc. - SVP of IR and Treasurer

Good morning, and 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, the discussion of our financial results and our expectations reflects 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 tables in the earnings release.

I would also like to point out that we have included in the appendix of the earnings release a quarterly reconciliation of reported net revenues to like-for-like net revenues by segment on a combined company basis.

I will now turn the call over to Camillo.



Camillo Pane - Coty Inc. - CEO and Director

Thank you, Kevin, and welcome, everybody, to Coty's third quarter conference call. Since we last spoke in February, progress continues to be made both on delivering an improvement in top line and bottom line trends as compared to the first half and on stable execution on my strategic vision for the company. However, it's very clear that fiscal 2017 remains a transitional year, and there is a lot of the work that needs to be done to fully address the challenges we are facing in some of our categories and brands.

So let me start with the recent performance of the business. Our Q3 underlying net revenue trends, excluding the contribution from ghd and Younique, improved sequentially to minus 2% at constant currency compared to a high single-digit decline in the first half. This improvement was driven by good growth in the Luxury division, flat performance in Professional Beauty and improvement but continued negative performance in the Consumer Beauty division. Including ghd, Younique and 1 month of the Brazil acquisition, our net revenue grew 6% at constant currency versus the combined net revenues of the prior year period.

From a profit point of view, our adjusted operating income more than doubled in Q3 versus the prior year period, which is a very solid performance that underlines the margin strength of our business. Patrice will talk more about our overall financial performance.

Focusing on the revenue trends. The momentum in the Luxury division, which grew 2% in the quarter, reflected the first impact of some of our initiatives that will bring us to a more sustainable performance in the future. Aided by the launches of Hugo Iced and Boss Tonic, Chloe Love Story Eau Sensuelle and Miu Miu L'Eau Bleue, several of our brands saw solid growth in the quarter. In addition, Gucci Guilty Absolute, which launched at the end of March, is off to a strong start.

Geographically, in North America, we're still facing some challenges. And we have recently transformed our field sales education and trade marketing functions to a more customer-centric approach. We are already seeing positive initial results from these changes, although it's still early in the process. In the rest of the world, we saw strong performance in Europe, ALMEA and travel retail. And this marks the third quarter in a row of Coty travel retail revenue growth outpacing the market.

In Professional, we have maintained the momentum in the salon hair portfolio, which grew low single digits, with consistent growth across all 3 regions. Wella continues its strong traction in its Contouring Collection, which uses color placement technique and products to alter the appearance of any face shape. We also saw continued success in the rollout of System Professional and with the in-market performance of the Nioxin brand.

On the other hand, OPI remained under pressure with encouraging growth in gels and long-wear more than offset by declines in lacquers. This is an area where we will need to deliver better performance in the near future, taking advantage of the deep capabilities we now have in business-to-business and the professional channel.

In Consumer Beauty, which declined 6% organically for the combined business, we've continued to see underlying challenges, especially in North America, driven by a combination of weak market trends across several of our categories and some reduction of shelf space for a few brands. The shelf space losses are primarily the results of the decision taken prior to Coty taking ownership of the former P&G Beauty Business. We are currently working with our key retailers presenting to them our new brand pipelines and programs in order to reinforce their confidence in the future prospect of these brands.

However, in the quarter, the Consumer Beauty division benefited from the strong performance of our Brazil business, which not only delivered double-digit sell-through growth and share gains in most brands, but also benefited from a low net revenue comparison in the prior year period. In addition to the strength in Brazil, we have seen a number of highlights in the Consumer Beauty portfolio, including share growth in the retail hair business in some emerging markets.

Consistent with our expectations that fiscal '17 will be a transitional year, the path to recovery will take some time and will not be a straight line. For example, we expect the constant currency net revenue trends in Q4, excluding Younique and ghd, to weaken sequentially versus Q3. Altogether, I'm pleased that we are delivering on our promise to gradually improve the sales performance of the business, even if the strategic efforts we're putting in place will take time to deliver results.

So let me take a moment to recap the strategy I outlined last quarter. Our first focus is to continue to strengthen and nurture our iconic global brands, including COVERGIRL, Rimmel and Clairol in Consumer Beauty; Calvin Klein, Hugo Boss and Gucci in Luxury; and Wella and OPI in Professional Beauty.

Our second focus is to cultivate and fuel the smaller 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. Our fourth focus is on continuing to expand the geographical reach of our strong portfolio as many of our brands still have substantial opportunity for geographical expansion, leveraging our global distribution footprint.

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. On this front, I'm very pleased that Laurent Kleitman will be joining Coty next week as President of Consumer Beauty. I believe Laurent is exceptionally qualified to take leadership of the Consumer Beauty division, given his extensive experience in the beauty industry, his strong operational background in both developed and emerging markets as well as track record with full P&L ownership.

And as we outlined the last quarter, we aim to achieve our strategic objectives through 4 key pillars. First, we are repositioning some of the brands, including COVERGIRL, Max Factor and Sally Hansen, in order to reconnect these brands with the consumers, building on their existing strong brand equity. We're already making great progress, and we have announced new creative agency for all the 3 brands, including Droga5 for COVERGIRL, adam&eveDDB for Max Factor and Anomaly for Sally Hansen. While the legacy agencies had supported the cosmetic brands for several decades, the transition to some of the world's leading and digitally forward creative agencies will bring new perspective and creativity to the brands. We've begun to share the detailed brand relaunch plans with our key customers and the retailer feedback has been very positive.

Speaking about the COVERGIRL relaunch. We plan to start introducing the new brand visuals this coming winter. And I want to emphasize that a 1-year brand relaunch time line for a category as complex as color cosmetics, with COVERGIRL alone distributed in over 60,000 doors, speaks to the improved organizational structure and ownership mentality of the new Coty organization. It would likely not have been possible at either Legacy-Coty or P&G Beauty.

Second, we're making significant changes to our innovation and product development process in parts of the organization, focused on supporting the trends early and slashing our average time to market which is currently about 12-18 months. On this front, we're actively setting up the necessary capabilities and structure throughout the organization. Our agency Beamy is already actively utilizing its digital, social listening and trend-spotting capabilities to fuel ideas to the marketing and product development teams.

Third, we are accelerating our end-to-end digital transformation including e-commerce. As a key step to our commitment to strengthen our e-commerce capabilities across the company, we recently appointed the Head of Global e-commerce, a newly created position for Coty with a new organizational structure behind him. At the same time, we are continuing our digital transformation efforts across our divisions and regions. From a regional perspective, I would like to highlight China as a strong example of Coty growing traction in e-commerce. E-commerce accounted for over 20% of Consumer Beauty revenues in China, driven by brands like Max Factor, Bourjois and adidas. In our direct-to-consumer efforts, COVERGIRL is seeing early success in tapping into consumers' desire for personalization and customization with the launch of the Custom Blend app. The app launch relies entirely on a digital, social and influencer-led go-to-market approach with COVERGIRL shipping customized foundations since the November launch.

Finally, I would like to highlight 2 recent launches in the Luxury division, which exemplify our digital-first mentality. The recent launch of Marc Jacobs Daisy pillar was supported by a holistic digital campaign, including influencer events, organic social coverage, activation across retailers' dot-com sites and the announcement of Kaia Gerber as the face of the brand, securing 600 million global media impressions. This has translated to exceptional early sell-through results for both Daisy and the Marc Jacobs brand across our key U.S. retailer partners.

And as announced last week, we've just begun the launch of Gucci Bloom, the first scent to be conceptualized by Gucci Creative Director, Alessandro Michele, with an inclusive and customer-centric communication strategy focused on millennials. I'm very excited about the prospect of this launch and the digital-first mentality that I now see becoming ingrained throughout the organization.



And fourth, we are working to significantly ramp our in-store execution. Several of our color cosmetic brands, including Bourjois and Rimmel, are already in the process of deploying new brand visuals across stores. Additionally, we are beginning to transition some legacy distributor businesses to our local affiliates, which I expect to steadily bring benefits to our execution and financials.

Finally, our M&A strategy, which Patrice will discuss in more detail, is delivering on the strategic objectives we have outlined for each of our divisions. I'm very satisfied with the revenue performance of our recent acquisitions, ghd and Younique, which are growth accretive to our business and I believe in their strong future potential.

Additionally, since we last talked in February, I'm proud to say we announced the agreement to acquire the Burberry Beauty business. Burberry is an iconic and beautiful luxury brand with global relevance and fits excellently into our strategy to continue to expand our premium offering in the prestige fragrances and cosmetics categories within our Luxury portfolio. As a global fragrance leader, we believe we are the ideal partner for Burberry. And I'm looking forward to having this great brand with us.

In summary, we're making solid progress. Fiscal 2017 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 will now turn you over to Patrice.

Patrice de Talhouet - Coty Inc. - CFO

Thank you, Camillo, and good morning, everyone. It has now been over 6 months since we closed on the P&G transaction and reorganized into a new focused divisional organization that combines the expertise and talents of executives from Coty, P&G Beauty Business and other leading companies. While the Reverse Morris Trust carve-out merger with the P&G Beauty Business remains incredibly complex, I am very pleased with the progress we have made to date on the creation of a new global leader and challenger in the beauty industry.

Let me begin with an update on the progress we have made integrating the 2 businesses. On May 1, we successfully completed the first stage of our 3-stage exit from the Transitional Service Agreement or TSA with P&G. Stage 1 was the exit for all of North America. This means that we have transferred and have now fully integrated the legacy P&G Beauty Business into Coty's system and processes for all business operations in the U.S., Canada, Mexico, Puerto Rico and Costa Rica.

To give you an appreciation of the scale and magnitude of the cutover from P&G to Coty, all production, orders, shipping and billing were halted in the North American P&G Beauty systems across 2 flagship factories and 7 distribution centers, including third-party manufacturing locations, while data, systems and infrastructure were cut over. We then began a controlled startup in the Coty systems across the region for production, orders, shipments, billing and finance transactions in the newly migrated sites.

This is a tremendous achievement, with North America accounting for close to 1/3 of the combined company revenues. I want to thank all of the teams involved for all of their incredibly hard work in preparing for this transition and the work that is still underway to prepare for the Stage 2 exit TSA, in Europe, which is expected in the course of July, followed by ALMEA in September.

Now let me provide some of the highlights for the third quarter. Q3 net revenues of \$2.0 billion increased 115% as reported compared to Legacy-Coty and increased 6% at constant currency compared to combined Coty and P&G Beauty Business net revenues in the prior period. Excluding the contributions from ghd and Younique, our combined company organic net revenues declined 2%. As anticipated, we received a modest 1% boost in Q3 as a result of pre-shipments to customers ahead of the TSA cutover. At this point, we would anticipate that in Q4, the incremental negative from these North American TSA-related pull-forwards into Q3 will be generally offset by Europe TSA-related pull-forwards into Q4, resulting in a neutral overall impact.

By division, Luxury net revenues reported growth of 2% at constant currency compared to combined company revenues in the prior year. Professional Beauty net revenues grew 14% at constant currency compared to the combined company revenues in the prior year or flat performance excluding the contribution from ghd. While Professional Hair grew in the low single digits and ghd also saw mid-single-digit revenue growth versus prior

year, OPI remained under pressure. Consumer Beauty net revenues grew 5% at constant currency compared to combined company revenues in the prior year and declined 6% constant currency, excluding the contribution from Younique. The substantial sequential improvement in the Consumer Beauty organic sales trends relative to the approximately 10% decline reported last quarter, excluding the transitional impacts, reflected the benefits of the strong performance of our Brazil business. As Camillo discussed, our Consumer Beauty business in Brazil not only delivered double-digit sell-through growth but also benefited from a low net revenue comparison in the prior period as a result of trade term harmonization following the closing of the Hypermecas transaction.

Let's now go into the shape of the P&L. Our adjusted gross margin of 63.3% increased from 61.8% for Legacy-Coty in the prior year period, aided by the addition of the higher gross margin P&G Beauty and Younique businesses.

The Q3 adjusted operating income more than doubled to \$219 million on a constant-currency basis and \$208 million at actual rates from \$103 million for Legacy-Coty in the prior period.

The adjusted operating margin declined modestly by 10 basis points to 10.7% at constant rates from 10.8% for Legacy-Coty. We saw solid margin performance in the combined company affecting improved top line trends in the Consumer Beauty division and more normalized level of A&CP spend following the elevated A&CP pre-commitments in Q2.

From a segment perspective, Luxury reported an adjusted operating margin of 13.6%, consistent with the year-to-date trends and up 270 basis points versus Legacy-Coty, driven by strong gross margin expansion and reduced A&CP. Consumer Beauty posted an adjusted operating margin of 12.3% and up 350 basis points versus Legacy-Coty, with margin expansion in the combined company business further strengthened by the high margin contribution of Younique.

The Professional Beauty adjusted operating margin was slightly positive as the seasonally weak period in the salon market weighted on the margin profiles of both Salon Hair and ghd, and due to some nonrecurring cost items. Fueled by our strong adjusted operating income performance, we reported an adjusted diluted EPS of \$0.15, above the Legacy-Coty EPS of \$0.14.

With regard to the synergies, we have begun to roll out our restructuring efforts with a \$155.8 million restructuring charge booked in Q3 and another \$220 million to be booked in Q4. Plans have also been announced at a number of manufacturing facilities around the world, to rationalize those facilities as part of Coty's targeted manufacturing and distribution footprint. So as you can see, we have been active in both working towards the integration of the P&G business and achieving our targeted synergies. We have now realized close to \$100 million in synergies in fiscal '17 year-to-date versus the full year estimate of approximately \$150 million.

Now turning to our balance sheet and our cash profile. As anticipated, the increased acquisition-related operating and capital expenditure weighted on the cash generation this period with a Q3 free cash flow use of \$83 million, which still represented an improvement of \$26 million versus the prior year. We finished the third quarter with close to \$800 million in cash on the balance sheet and approximately \$6.4 billion in net debt.

Consistent with last quarter, our balance sheet is very solid with a moderate leverage after all the recent acquisitions made. I would like to point out that we still maintain our pro forma leverage profile of approximately 4x while adding ghd and Younique to our portfolio. The anticipated acquisition of the Burberry license in Q2 fiscal '18 should not have material impact on our leverage profile.

Altogether, I am extremely pleased with that we are executing on the M&A strategy we have outlined over the last few quarters of utilizing our strong cash flow and balance sheet to add businesses that improve the growth profile of the company and address whitespace opportunities in the portfolio, all while remaining disciplined on valuation.

As Camillo mentioned, the Burberry Beauty business is a great addition to the Luxury portfolio. The acquisition of a 60% stake in Younique expands our Consumer Beauty presence into a new channel, direct-to-consumer e-commerce. And as shown in the 8-K we filed on April 13th, Younique delivered 40% net revenue growth in calendar '16 with a very strong 28.5% operating margin for the year. The ghd acquisition expands the product assortment available for our professional go-to-market platform with the business continuing to outperform the market. And as I mentioned earlier,



our Hypermarcas business, which was acquired a year ago, has not only given Coty scale in an incredibly important global beauty market but continues to perform exceptionally well.

In conclusion, let me reaffirm the new Coty business has strong strategic and financial flexibility. And we are very confident in the free cash flow profile of the company and strength of the balance sheet. This financial flexibility will allow us to gradually shift the growth profile of the company to be well positioned as the new global leader and challenger in beauty.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first caution comes from the line of Dara Mohsenian of Morgan Stanley.

Dara Warren Mohsenian - *Morgan Stanley, Research Division - MD*

So first, just a detailed question. When you say organic sales trends will decelerate in Q4 versus Q3, are you using negative 2% as the basis for Q3? Or is it the negative 3% ex timing?

Patrice de Talhouet - *Coty Inc. - CFO*

No, what we are using is the minus 2% as a reference. And what we say is that we are going to see trends weaken, the top line in Q4. So it's really very much in line with the comment that Camillo made; that this journey is not a straight-line journey and we are still in the process of stabilizing the business. So I think the performance of Q3 was a good performance. But that doesn't prevail what's going to happen in the coming quarters. So we're not in a straight-line journey.

Dara Warren Mohsenian - *Morgan Stanley, Research Division - MD*

Okay. And I guess given that historical volatility you mentioned, can you give us a little more sense of what you're expecting in Q4 for organic revenue trends? Is it slightly worse than Q3? Or is it materially worse and more like the first half of the year? I'm just trying to get some kind of sense, given the volatility we've had historically the last few quarters.

Patrice de Talhouet - *Coty Inc. - CFO*

No. So Dara, we're not going to go into guidance mode, et cetera. So I think as you know, we are in build-up mode. We are currently stabilizing the business. Consumer Beauty is still facing severe headwinds. So we just point out the fact that you should not derive from Q3 what's going to happen in Q4. And you should expect some weakening in terms of top line, but we're not going to say more on this.

Dara Warren Mohsenian - *Morgan Stanley, Research Division - MD*

Okay. And then on the shelf space losses in the Consumer Beauty division, I assume that's basically going to continue to pressure the business for a few more quarters until you cycle it. So first, can you comment on that? And then second, as you look at the shelf space losses, are they more permanent in your mind? Or do you think as you implement some of the strategies and execution fixes, at some point, they could come back?



Camillo Pane - *Coty Inc. - CEO and Director*

Yes. So clearly, as you can imagine, the decision for the wall resets had been taken a while ago, several quarters ago actually by the retailers, before we controlled the P&G Beauty brands. And the distribution loss, which is primarily actually loss of shelf space, is not necessarily loss of doors, it's primarily focused on COVERGIRL, Clairol in the U.S. and Max Factor and a Germanic brand called Astor in Europe. The shelf loss space, as you said, will last for a while because it takes time to just prepare the programs and to change the trend in this sense. And all the decisions for the next few quarters have already been taken at the beginning of calendar 2017. So going back to your question, certainly, it will last for a few more quarters because, on one side, we will have to annualize the decisions that have been taken before. And on the other side, we are in the process of working very closely to our key retailers and presenting our products, new pipeline, the brand relaunches that I mentioned a few minutes ago and in order to just get back -- to gain back some of this space.

Operator

And our next question comes from the line of Faiza Alwy of Deutsche Bank.

Faiza Alwy - *Deutsche Bank AG, Research Division - Research Analyst*

So I just wanted to talk about Brazil a little bit more. I think you're the first company that's talked positively about Brazil so far. And I know that last year, you had inventory destocking. So could you maybe talk about trends, excluding the inventory destocking? And then if you could just quantify for us how much the Brazil impact helped Consumer Beauty organic sales growth.

Camillo Pane - *Coty Inc. - CEO and Director*

Yes. So we are having a very strong performance in Brazil. Our sellout -- so sell-through in market results is we're growing double digits versus a market that is growing in mid-single digits. So this is driven by the strength of the portfolio that we have there, which is a mix of local brands and international brands. And focusing for a second on the local brands that we have, these are very strong brands with a lot of heritage, which have very high quality and the right price positioning for the Brazilian consumers. So we are actually seeing growth in market share in most of our key brands there. And we hold quite a significant number of leading positions in Brazil. So for us, Brazil is a growing business and we're very pleased with it. But at the same time, Patrice mentioned in his speech that we're also benefiting from a low comparison in the quarter, same quarter in the prior year, because when we bought the business, we went through a transformation, the trade terms policy that we had in the business there. So clearly, this is the comparison. And Patrice will cover the...

Patrice de Talhouet - *Coty Inc. - CFO*

Yes. And if you want a quantification of this base comparison that has been favorable to this year, you can take for the Consumer Beauty trend 3 points for this quarter.

Operator

And our next question comes from the line of Olivia Tong of Bank of America Merrill Lynch.

Olivia Tong - *BofA Merrill Lynch, Research Division - Director*

First, a short-term, and then a more longer-term question. But first, on the short term, in terms of the Q4 sales outlook, I'm trying to understand sort of a delta of Q3 relative to Q4. I totally appreciate the fact that it's not going to be a straight-line improvement. But as we talked through sort of some of the things that we're going through in Luxury, you have the addition of some fairly prestigious brand names as time progresses, Tiffany, Burberry, et cetera, in consumer. Other than the Hypermarcas sort of comp issue, it sounds like there's not terribly a whole bunch that's changing,



except perhaps maybe some more incremental shelf space losses in the legacy P&G brands while Professional doesn't sound like there's a whole lot changing. So I was just trying to understand sort of the puts and takes as we -- in sort of a nearer-term outlook, first.

Camillo Pane - *Coty Inc. - CEO and Director*

As Patrice said, Olivia, we are in the process of stabilizing the business. And this is why it's not going to be a straight line because we still have headwinds and we are working through all the challenges that we just mentioned a few minutes ago. The divisions are in different states. So Luxury, I expect the improvement in Luxury to continue but to be an improvement versus H1, first half. Professional, I believe Professional will consistently have positive performance. But Consumer Beauty will take time. And we're not going to talk here about how long it's going to take to turn around this business for all the reasons that I mentioned before. One of them is still the distribution losses that we just described and -- but also because the strategic actions that we have put in place will bear fruit at a later stage. And I'm referring, of course, to the repositioning of some of the brands, to the changes on the innovation process and the core strengthening of our pipeline and, of course, the digital transformation and the revamping of the in-store execution. These are really significant undertaking that will not be able to bring fruit in the short term. And this is why Consumer Beauty will take time.

Olivia Tong - *BofA Merrill Lynch, Research Division - Director*

Got it, okay. In terms of Consumer Beauty, I know you've been talking to your existing retailers about your goals in mass beauty. But are you in a position yet where you can talk to new distribution? Because at the end of the day, even if you improve your existing -- your business at existing mass retail, that channel has come under a fair bit of pressure and (inaudible) in many cases, smaller competitors are gaining traction in a couple of other channels.

Camillo Pane - *Coty Inc. - CEO and Director*

Well, of course, we are talking to retailers about stabilizing the business. But at the same time, we are seeing all the shifts that consumers are making towards e-commerce. And so e-commerce is such an important point of our strategy, of my strategy and it's actually an important channel. As a matter of fact, we just announced a new Head of e-commerce with the new organization behind him, with a much higher level of accountability. So we're focusing quite a lot on working on -- with our customers on e-retailing but at the same time, we're making sure that e-commerce becomes a much bigger focus for us. And let's not forget what's really Younique for us is a new business that is solely focused on e-commerce. It's a D2C, direct-to-consumers channel, which holds so clearly covers social selling because we have 250,000 presenters which every day sell color cosmetics under the Younique brand to their contacts and social contacts, so.

Operator

And our next question comes from the line of Lauren Lieberman of Barclays.

Lauren Rae Lieberman - *Barclays PLC, Research Division - MD and Senior Research Analyst*

In the discussion of the Luxury business, it sounded from the way that the release was written that Calvin Klein grew in the quarter, which I feel like maybe the first time Calvin Klein brand has grown in frankly several years. So could you just talk about whether or not you think that brand has hit an inflection point, whether it was a timing of new launch activity versus the degree of kind of proactive cleanup of inventory in the channel you are working on? I'm just quite curious on the trajectory for that business, in particular.



Camillo Pane - *Coty Inc. - CEO and Director*

Thanks, Lauren. Actually, a few brands, not just Calvin Klein, grew in the quarter. Focusing on -- and I mentioned some of them a few minutes ago. Focusing on Calvin Klein, we had a good quarter. And we had a couple of launches, CK All and CK Eternity Intense that had some early good results. But I cannot say that the journey of recovery on Calvin Klein is progressing in the way that I want. On the contrary, Calvin Klein, we still have a lot of work to do. And we are in the process of changing it. And I think also it's quite important to say that the fashion house is also having a new momentum with Raf Simons. And of course, we're working very well together to prepare new programs. But these new programs have not been reached the shelf for the consumers yet. Talking about the wholesale distribution reductions, this is a long-term program that we are undertaking. We're very serious about it. This is a focus of the new Coty and -- but by no means is finished this quarter and will continue for the next few quarters. We don't really comment on the size, but I can tell you that we are very keen to continue this journey and make substantial progresses.

Lauren Rae Lieberman - *Barclays PLC, Research Division - MD and Senior Research Analyst*

Okay. And, Camillo, do you feel like that cleanup process of the wholesale inventory, one, is that sort of a 1-year, 2-year? I mean, how should we think about that? Will it be kind of heavier typically in the first half of your fiscal year, just given relatively the fragrance business that time of year? And then also, is there a risk that not having that distributive trade completely cleaned up dilutes some of the brand equity work that you're doing? So the new, exciting, positive work you're doing gets sort of diminished in the consumers' or retailers' mind by there still being discounting on some of the legacy products within those brand franchises?

Camillo Pane - *Coty Inc. - CEO and Director*

I'll start with answering the second, then I'll go to the first because I think the first is consequential to the other one. So first of all, yes, I believe that the heavy presence in wholesale distribution of gray markets by some of our brands is detrimental to the equity of the brands. And this is why we have decided to step up in the effort of cleaning up or reducing the wholesale distribution. So the answer is yes on the negative effect on our brands. But this is an industry problem. It's not just a Coty issue. And what I can tell you is that we are very serious and we have started this process with a different level of intensity. But it's not going to be just a few quarters. This is probably a few years type of process because again, it needs to be done in the right way with the right pace.

Operator

And our next question comes from the line of Shannon Coyne of BMO Capital Markets.

Shannon Elizabeth Coyne - *BMO Capital Markets Equity Research - Analyst*

I was wondering about, could you talk about the changes going on in the fragrance category, overall market growth, the change in trend (inaudible) and all and what you're doing to address that? And I guess in that vein, you mentioned the Gucci Bloom launch. Can you give us an early read on that and anything you're doing -- anything else you're doing to capitalize on the surge in the Gucci brand? It's been really strong. Just wondering if maybe there's something you're doing -- you can capitalize that in the cosmetic space.

Camillo Pane - *Coty Inc. - CEO and Director*

So without a doubt, well, there are different trends. So I'll focus -- I'll start first on Gucci. I mean, clearly, we are very confident and hopeful about the Gucci Bloom launch because the fashion house is growing incredibly well. You guys have all seen the exceptional results they have. And for us, this is the first scent that actually has been conceptualized by the Creative Director, Alessandro Michele. And we just launched last week, so I don't have an early read. I'll be very happy to provide it when we have it. What I can say is that this is going to be a very strong launch for us, and we are very -- we're preparing a very, very strong launch plan for the season, I guess. And it's going to be launched in the next couple of months. And one of the focus is going to be an inclusive and customer-centric communication strategy on millennials, which will include some element of



personalization and customization. So this is a launch that's going to have a very strong digital drive, I would say, component. And I cannot really disclose much more, but I'm looking forward to see this in the market and to see the reaction and the consumers really loving it.

Shannon Elizabeth Coyne - *BMO Capital Markets Equity Research - Analyst*

Okay. And then you talked a lot about digital. Can you talk about the shift, the amount of money -- the amount of dollars you've been able to shift toward digital media away from traditional and maybe perhaps what you're doing to increase organic content versus paid content with the major beauty influencers in the beauty and the cosmetic space?

Camillo Pane - *Coty Inc. - CEO and Director*

Yes, absolutely. So overall, as total company, we are now in the range of 30% in terms of digital spending as a percentage of total media. But on some of the brands, on the color cosmetic brands, we're actually above 50% because clearly, we are spending where consumers are now spending their time, which I think is very important. In terms of the way we are approaching the digital transformation, so the end-to-end approach, let's say, we're doing a couple of things which are different versus how we did it in the past. First of all, we have now a trend lab, where we're trying to understand better consumer insight, consumer trend. We do this 24/7, so we're able to really provide a much stronger level of insight and trends to the marketers. And that really leads to several things. So one of them, it leads to creating better content. And better content, the results of the right content for the right consumers so that we can target better. But also, the right content for the right platform because clearly, consumer spend and different behavior on the different platform. And this is really allowing us to optimize and to get early strongly -- strong, early results, I would say. I think that probably answers your questions unless you have a different angle that I'm not covering.

Operator

And our next question comes from the line of Joe Lachky of Wells Fargo Securities.

Joe Lachky - *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

Just wanted to quickly go back to Q4 organic sales growth. And obviously, I understand during this transition period, you're going to have some choppy results. But from that standpoint, I guess that could imply both sequential improvements or a sequential decline. So obviously, you have some sort of visibility into Q4, indicating that there's some sort of decline going on. And I'm just wondering, maybe it is driven by category weakness or something else? And if you won't talk specifically to Q4, maybe if you could talk to Q3 about maybe what came in a little bit higher than expected. I guess, obviously, the comp was real easy in Brazil, maybe that's getting harder in Q4. Is there any sort of granularity you could give us into the reason you're expecting this slowdown in Q4?

Camillo Pane - *Coty Inc. - CEO and Director*

In terms of Q4, Joe, I will say basically what you said because we are in the process of stabilizing the business. And I just mentioned before, we expect Q4 to be worse than Q3. And it's driven by the different dynamics that we have in the division. So Luxury will show an improvement compared to H1. Professional will continue to have consistent positive performance. But Consumer Beauty will take time. And the different challenges that we are facing, it means that it will take time for us to turn around this business. Focusing on the second part of your questions, areas where we are having success that I would like to highlight is, for example, in Luxury, which is the business that has grown 2% on the last quarter. Travel retail is having a very, very strong performance. This is for us really good. We recently changed the way that we manage travel retail in the sense that we created higher accountability. We now treat travel retail as an independent channel. And this is bringing stronger results in markets through the work of the team but also better execution, I would say. At the same time in Luxury, we're having a good performance in China. One of the things that I mentioned in one of the previous call is that we recently moved from distributor to affiliates. So we have built our own in-house team in China to take care of the go-to-market. And we're starting having some good results. So there are the focus of success in Luxury besides innovation that is driving the good performance in Q3.



Joe Lachky - Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst

And then just one follow-up on the strategy in Consumer Beauty. I guess, maybe if you could talk a little bit why you're making the management change this early into the transition and what the new President brings to the business that you didn't have before. And I guess you're making this transition to a new President of the division while there's a lot of changes going on in the business, and then, obviously, struggles. And you have a lot of strategic initiatives in place. I mean, do you expect additional strategic initiatives on top of the ones that are already in motion, maybe adding to some complexity of this turnaround process in Consumer Beauty?

Camillo Pane - Coty Inc. - CEO and Director

No, I'm very pleased that Laurent Kleitman is coming onboard as Esi has done a very good job in helping us through this transition and the setup for the Consumer Beauty. But I'm really looking forward for Laurent to come onboard. I mean, he has truly extensive experience in beauty, especially in hair. That's the business that's -- a very large business that he used to manage in Unilever. Plus he has worked both in developed and developing markets, so experience of having lived truly in the countries, in the different regions, therefore, understanding consumers from different angles. And he has managed very, very large P&Ls. So to me, he has absolutely the right leadership to lead the turnaround of our largest division. I'm very confident of the benefit that he will bring us to coming onboard. In terms of changes in the strategy that Laurent could bring, I don't expect much to change in the strategy because it's very clear that we have a 4-pillar strategy. And we are progressing on all the 4 pillars, as I mentioned before. And I'm pleased with the progress. But at the same time, of course, a new leader, I hope that he brings us a new fresh set of ideas that could complement all the things that we're doing and help us to be successful.

Operator

And our next question comes from the line of Mark Astrachan of Stifel.

Mark S. Astrachan - Stifel, Nicolaus & Company, Incorporated, Research Division - Director

Wanted to ask a housekeeping question first. Is there any update on total synergies, phasing or planned reinvestment?

Patrice de Talhouet - Coty Inc. - CFO

No, there is no update on that.

Mark S. Astrachan - Stifel, Nicolaus & Company, Incorporated, Research Division - Director

Okay. And anything on the divestitures as well in terms of timing or size of those?

Patrice de Talhouet - Coty Inc. - CFO

No, as we said -- as I've said before, this is a long process. We are currently handling that. So I think all that I've said before remains true is that the scope has been defined. And now we are in the process of assessing the different options and started to prepare for it. So I think more to come.

Mark S. Astrachan - Stifel, Nicolaus & Company, Incorporated, Research Division - Director

Got it. And then just a broader question, so when you talk about the relaunch of COVERGIRL, what gives confidence that, that relaunch can change the sales trajectory of the brand? Is there anything that you can specifically point to that gives confidence that what you're doing or will do will



work? And can you cite examples of big brands within the space that have had success with relaunches? I mean, there's some confidence that this is just even possible relative to trends sort of moving away from the big brands to smaller, niche brands.

Camillo Pane - *Coty Inc. - CEO and Director*

Yes, I think that we are confident because clearly, we have seen the plans. This is new positioning, new creative, new packaging, a new in-store look. This is quite a significant transformation and changes toward the brand. At the same time, we will, of course, respect some of the element of the history of COVERGIRL. But we're going to become way more modern and more in touch with the consumers based on what's happening right now. The confidence comes also from having presented this plan to all the top retailers in the U.S., including I was personally on CBS recently, just a few weeks ago, a couple of weeks ago in Arizona. And I can tell you that the reaction from all the retailers has been very positive to COVERGIRL, and in general, I would say, positive on the progress that we are making, Coty, in just in the space of 6 months. And I think the feedback has been positive unanimously by all the retailers. So this just helps our, of course, internal confidence because we believe that the brands are very strong. At the same time, we are also not only changing the content and the way that COVERGIRL will talk to consumers but also the way that we invest our money, the shift that we will do to digital. And we've already started some work with COVERGIRL, in our opinion, will bear specific fruits. And let's not forget that all our data tells us, all our research data tells us that COVERGIRL is still the most loved brand in color cosmetic mass in the United States. And that is a big equity piece that will help us definitely to turn around this brand in the future.

Operator

And our next question comes from the line of Jason Gere of KeyBanc Capital Markets.

Jason Matthew Gere - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

I guess the first question I was going to ask is on the professional hair care, the success you had in this quarter when some of your competitors, including L'Oreal, talked about softer trends out there. So I was just wondering if you could talk maybe a little bit about what's happening in the marketplace. Are you expecting any type of reaction from the competition to kind of maybe regain some share that they may have lost? So I was wondering if you can give a little perspective on that.

Camillo Pane - *Coty Inc. - CEO and Director*

In the professional, as I mentioned, there is kind of 2 sides. So clearly, we're doing well. We have low single-digit growth in the hair portfolio. And this is driven by a very stable and confident, very highly skilled organization that we have that continues to work with our customers to gain doors and also to roll out some of the strong initiatives we have in the pipeline. And Nioxin did very well. Wella color continues to do very well. And we are rolling out System Professional, which is a customized line of hair care, so shampoos and other type of solutions, hair solutions, and this goes -- continues to go very well. So for us, it's a positive momentum. We know that the market is actually not growing much in the professional area. But we continue with our strategy, which, for us, is on a positive track. On the other side, clearly, I'm not happy with the performance of OPI. OPI is a new brand for the division. And we're going -- we have some headwinds. We're going through some challenges, which is partly driven by having to absorb integrated brand and also changing, in some cases, the go-to-market because in some cases, we're also working to change from distributors to a different type of go-to-market that is more led by us. So I expect OPI, clearly, we're preparing very strong plans and expect OPI to have some improvement in their performance in the next few quarters.

Jason Matthew Gere - *KeyBanc Capital Markets Inc., Research Division - MD and Equity Research Analyst*

Okay, great. And then I guess the next question is really on just the slower traffic that we're seeing at brick-and-mortar retail, whether it's the mass business -- and obviously, you've seen probably some of it with Consumer Beauty, but even the specialty where you're selling some of hair care products. Can you talk maybe a little bit about some of the dialogues that you're having with those retailers as you're seeing sales getting shifted



a little bit more to online in terms of merchandising support, if they're coming to you and asking for more cooperation or more partnership in terms of trying to drive traffic back in the store? And I guess a little bit of update and color on that would be appreciated.

Camillo Pane - *Coty Inc. - CEO and Director*

So I'll start with the shift to online, yes, so to e-commerce. It's no doubt that we are intensifying our conversation with the customers in terms of working with the -- on the e-retailing part of it. So I would say maybe in the past, there could not have been a strong focus within all the conversation. Now you can see conversation for all the progress we put place in the brick-and-mortar [pair] but similar level of type focused conversation on the progress that we bring to the e-commerce. So without any doubt, this means more time, more resources, more allocation, more investments. So this is probably a good piece of the answer of your questions. The other question is how to drive traffic to the brick-and-mortar. No doubt that that's part of our job. So it's our role as well. So this is not only our partners, retailers, customers talking to us about it, but also, it's about our teams going there with ideas on how to drive more traffic into the retailers. And e-store executions, connecting more with millennials, doing exclusive programs and tailor-made, more targeted programs to specific target consumers, clearly all these type of conversations are going to help to -- yes, to revert some of these performances.

Operator

And our next question comes from the line of Rosie Edwards of Berenberg.

Rosie Edwards - *Berenberg, Research Division - Analyst*

Just 2 quick ones from me. Just firstly on online, could you just give us an idea how much of the combined business it currently represents as a percentage of sales and what its current growth rate is? I think you said in China, it was over 20%. But anything you can give on the group, that would be very helpful. And then secondly, just going back to professional. It seemed like the profit in salon hair was also under pressure despite, obviously, the fairly good top line growth that we've just discussed. So just trying to understand what was weighing on pressure there -- on profit there, sorry?

Camillo Pane - *Coty Inc. - CEO and Director*

I'll cover the first question. Patrice will cover the second. In terms of e-commerce sales as a percentage of our sales, we actually don't disclose the percentage or our go-forward targets. But I want to confirm that this is a major focus for me and for the organization. And as I said before in one of the other questions is we have recently announced our new Head of e-commerce, a new organizational structure. And therefore, I expect a much stronger focus and improvement in the trajectory of this channel. And do you want to talk about the rest?

Patrice de Talhouet - *Coty Inc. - CFO*

Yes. So good question on the professional profitability. So actually, a significant chunk of the decline in profitability is really related to the seasonality of the business. So this is something that we are learning on the professional side of the business, that we are in everything. And this seasonality is true not only for the hair part of the salon but as well as for ghd. And this is much higher than what we thought initially. And so we are currently working to mitigate these quarterly fluctuations in the near future. The other reason why is due to a couple of one-offs, nonrecurring cost items that we should not see in the coming quarters.

Operator

And our next question comes from the line of Andrea Teixeira of JP Morgan.



Andrea Faria Teixeira - *JP Morgan Chase & Co, Research Division - MD*

I was just trying to go back to some of the headlines crossing about inventory levels at the trade, saying you have a lot more inventory to digest. So I was hoping to get some color on the levels and if you would expect greater than the 1% impact of the advance sales, especially in the U.S. And bolting into that, just on the back of the comment in Brazil, I just want the clarify that you mentioned 300 basis points benefit that would imply close to double digits in the Consumer Beauty business overall, a declining close to double digits. Is that correct? And if -- well, I know Brazil is on a big recession, and you launched some nail polish there, but I was hoping to see some if you can comment. As you normalize, the fourth quarter will likely normalize, which is the second quarter calendar in Brazil, because of these launches and because of destocking. So if you can go back to that comment just to clarify if that is actually building into your comment about the fourth quarter being weaker than the third.

Patrice de Talhouet - *Coty Inc. - CFO*

So I will just start by giving you the answer on the base comparison effect of Brazil. This is indeed a positive of 300 basis points for the quarter for Consumer Beauty only, okay? So that's the answer to your question. Then I will now leave the floor to Camillo to answer the other part of your question.

Camillo Pane - *Coty Inc. - CEO and Director*

Your first question, Andrea, was about inventory level. And the fact that in Q2, we suffered from a very high inventory level from Q1. So clearly, we have now had another quarter, so Q3, in which we flushed out. I would say a good part of the inventory buildup that we had to deal in Q2 is not finished and we still have a bit to do, which we hopefully will be able to flush through in Q4, so Q4 will be slightly impacted there as well. But I'm pleased with the performance in Q3 because we were able at least to take care of a good part of the problem that we had inherited in the previous quarter.

Operator

Thank you. And that concludes our Q&A session. Ladies and gentlemen, thanks for participating in today's conference. This concludes today's program. You may all disconnect. Everyone, have a great day.

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