Company Name: Coty
Company Ticker: COTY US
Date: 2018-11-07
Event Description: Q1 2019 Earnings Call

Market Cap: 6,501.76
Current PX: 8.6566
YTD Change($): -10.9229
YTD Change(%): -55.787

Bloomberg Estimates - EPS
Current Quarter: 0.229
Current Year: 0.669
Bloomberg Estimates - Sales
Current Quarter: 2521.000
Current Year: 8907.308

Q1 2019 Earnings Call

Company Participants

- Camillo Pane

Other Participants

- Lauren R. Lieberman
- Robert Ottenstein
- Mark Stiefel Astrachan
- Faiza Alwy
- Olivia Tong
- Stephanie Wissink
- Joe B. Lachky
- Jonathan Feeney
- Linda Bolton Weiser

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. My name is Christy and I will be your conference operator today. At this time I would like to welcome everyone to Coty's Fiscal First Quarter 2019 Results Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions] As a reminder, this conference call is being recorded today, November 7, 2018. On today's call are Camillo Pane, Chief Executive Officer; and Ayesha Zafar, Interim Chief Financial Officer.

I would like to remind you that many of the comments today may contain forward-looking statements. Please refer to Coty's press release and reports filed with the SEC, where the company lists factors that could cause actual results to differ materially from these forward-looking statements. All commentary on organic net revenue reflects a comparison of the business at a constant currency in the current and prior year period, excluding the impact of acquisitions and divestitures. In addition, except where noted, the 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 combined the bridge from GAAP to non-GAAP results in the reconciliation table in the earnings release.

I will now turn the call over to Mr. Pane.

Camillo Pane

Thank you, Christy, and welcome everybody to Coty's fiscal 2019 first quarter conference call. We're very disappointed with the supply chain disruptions we have experienced over the last quarter and resulting for Q1 financial performance. While we had anticipated some level of disruption in the first quarter from warehousing and planning consolidation, the increased scope of the disruption resulted in much weaker results than previously expected.

We've been working hard to remedy the supply chain issues and expect temporary headwinds in the second quarter, and have them to be substantially resolved in the third quarter. Although, we do not expect to fully recover the Q1 financial impact in the balance of fiscal 2019.

As a result of these disruptions, we have decided to modify our distribution center consolidation plan for the remainder of the year to minimize these impacts. With a healthy synergy delivery already in Q1, these modifications should have no impact to our commitment of $225 million of synergies in fiscal 2019 and $750 million of synergies by the end of fiscal 2020.

By division, underlying consumer demand in Luxury and Professional Beauty remain strong, but the underlying performance of Consumer Beauty remains challenged. Our immediate focus in the business right now is threefold; first, to resolve the supply chain disruption; second, to improve underlying performance in Consumer Beauty; and third, to improve cash flow generation. So let's get into the results.

First quarter revenues declined 7.7% on a like-for-like basis, as we encountered temporary supply chain headwinds. Alongside the previously flagged supply chain issues affecting Consumer Beauty and Professional Beauty, our Luxury division was also impacted in Q1 by a disruption in European warehouse, by the U.S. hurricane, and by component shortages at certain external suppliers. All of these factors cumulatively impacted our top line by close to 5%. And without the drivers of disruption, we believe that our underlying net revenue would only have declined by about 2.5%. The adjusted gross margin of 60.4% decreased by 120 basis points in the first quarter, primarily driven by the impact of supply chain disruptions on both Consumer Beauty and Luxury.

Our A&CP investments remained in the range of 23% of net revenue in the quarter, only modesty below last year and consistent with our targeted trend. Importantly, we have made significant progress in the past few months in addressing our fixed cost base, with controllable fixed costs down mid-single digits during the first quarter versus the prior year on the back of the synergy programs. This supported a delivery of an adjusted operating income of $141 million, a decrease of 28% versus the prior year, which was driven by the net revenue and gross margin contraction, as well as the 4% headwinds on exchange rate.

The synergies delivered in the first quarter were in line with our target, but were more than offset by the supply chain-related headwinds, which we estimate impacted operating income by about $60 million by the underlying deterioration in Consumer Beauty. Total EPS for the quarter was $0.11, which reflects 10% growth versus last year, driven by favorable tax outcome, which added $0.04 to EPS.

Before moving to divisional results, I want to elaborate on the supply chain disruption that meaningfully impacted our performance this quarter. I would like to remind you that our [ph] end stage (00:05:29) design for our supply chain is intended to assure a streamlined, agile, and efficient organization, not only fit for future growth, but one which will serve as a long-term foundation for best-in-class operational efficiency.

To this end, during the last 24 months, we have shut down three factories, restructured a fourth one, consolidated several supply chain planning locations into three planning hubs, consolidated six distribution centers, and exited TSA agreements in over 30 countries.

To give you a perspective, the changes to our supply chain footprint implemented so far represent about 80% of the planned supply chain transformation following the merger. Frustratingly, towards the end of the fourth quarter of fiscal 2018, we started to encounter several supply chain challenges in two of our key locations in the U.S. and Europe, which includes the ramp-up of a Consumer Beauty planning hub and manufacturing plant in the UK, and the consolidation of a Professional Beauty distribution center in the U.S.

Additionally, in mid-September, we discovered a further issue related to the consolidation of a Luxury distribution center in Europe. Today, I want to focus my comments on the actual plans we've put into place to address each of these issues and contain the duration of the impact.

We are working swiftly to confine the majority of the impact of these temporary disruptions to the first half of fiscal 2019, although we expect some residual impact in the third quarter. Specifically, in the UK, we took action to move volume to other Consumer Beauty plants, and we expect the service level to be restored in the second quarter of fiscal 2019. In North America, we have implemented an action plan with our third-party warehouse partner to improve service level while [indiscernible] (00:07:29), and we also expect this to be largely resolved during the second quarter.

The Luxury warehouse issue is related to tight capacity and initial integration challenges, particularly impacting the travel retail channel. By using another warehousing [indiscernible] (00:07:47) and prioritizing key customers, we expect to have larger restored service level by the end of the second quarter. These internal headwinds, which account for about two-thirds of the supply chain-related profit impact in the first quarter, were compounded by two external factors that mainly impacted the Luxury division.

We are addressing the shortage of component parts in two key Luxury suppliers that provided pumps and glass bottles, and expect to resolve this issue during the third quarter of fiscal 2019. The impact of Hurricane Florence, which hit the U.S. in September and constrained our ability to move products to and from our distribution center in North Carolina, is expected to fully reverse in the second quarter. We estimate that the total impact of these supply-related headwinds was about $100 million on top line and approximately $6 million on operating profit.

Although, we clearly [ph] took a greater (00:08:47) risk by making many fundamental changes to our footprint over a short period, these latest disruptions have made us realize that we must carefully balance our remaining intervention plans within each of our division and customers. As a result, we have decided to modify our distribution center consolidation plan for the remainder of fiscal 2019 to minimize this disruption. With healthy synergy delivery already in Q1, this consolidation notification should have no impact on our commitment of $225 million of synergies in fiscal 2019 and $750 million by the end of fiscal 2020.

That said, we acknowledge the synergies captured during the first quarter did not allow for profit conversion, as the supply chain disruption, coupled with weakness in Consumer Beauty developed markets, more than offset the synergies captured. We expect the conversion rate of synergies into profit to increase in the remaining quarters of fiscal 2019.

While the impact of these factors has been significant to our first quarter results, I want to emphasize that the supply chain headwinds are a temporary setback in achieving our financial targets. Our confidence is underpinned by a strong underlying consumer demand in Luxury and Professional Beauty, where market share remain healthy and the fact that both divisions would have reported solid net revenue growth in Q1, consistent with their full year 2018 trend, if it not for the supply chain disruptions. However, underlying results for Consumer Beauty are nowhere they should be and we are accelerating a number of strategic interventions, which I will cover in a moment.

To that end, let me briefly remind you of the earnings model that underpins all of our strategic choices. Our target is to deliver flat-to-modest top line growth, combined with our ongoing focus on reducing cost, even after the synergies are fully delivered. And this underpins our medium-term target of achieving a high-teens adjusted operating margin over the next five years. We believe that each of our division plays a unique role in helping us to achieve this margin structure and profit growth.

Specifically, we look for Luxury to sustain its above-market top line expansion, fueled by our strong innovation capabilities, geographic expansion, and ongoing development of our prestige skincare and color cosmetic offerings. In Professional Beauty, we look to accelerate our growth by maximizing the untapped potential of OPI and ghd, while capitalizing on the market-leading position of Wella, our largest portfolio brand with over $1 billion in revenues. In Consumer Beauty, we aim to initially stabilize the division top line and improve the margins, and I will get into further details shortly.

Our strategy to drive growth continues to be focused on four distinct pillars, which are equally relevant for all three divisions. It includes focusing on brands will matter and have potential, on driving innovation and store execution much harder, on rapid expansion in the emerging ALMEA markets, and on digital transformation. On this last point, we saw continued momentum in e-commerce across all three divisions in the first quarter.

Now, let me dig deeper into our performance by division. Luxury net revenue declined by 2.1% like-for-like. This was fully driven by the internal and external temporary supply headwinds we experienced. Excluding these factors, we estimate Luxury like-for-like net revenue in the quarter would have grown close to 5%, consistent with fiscal 2018 performance.

Despite the supply chain headwinds, Luxury was still able to deliver 13% profit growth and 100 basis points of adjusted operating margin improvement. It's important to again emphasize that in-market performance of our brands confirms our view the momentum for our Luxury brand portfolio remains robust. Sell-through of our brand during the quarter was strong, and we're particularly pleased by the share gains we saw in Europe and across several brands, including Gucci, Tiffany, Marc Jacobs and Chloé, despite the fact that Gucci and Tiffany lack strong launches from the first quarter of last year.

As we enter second quarter, we had two important innovation lead in the market, including Hugo Boss The Scent and Burberry Her, both of which are off to a promising start. It's worth noting that in Q2 will be the first quarter when Burberry is included in our like-for-like numbers. Finally, I'm pleased with the very strong momentum we saw in Luxury e-commerce, with significant growth across nearly all of our leading brands.

In Professional Beauty, we experienced a similar dynamic as in Luxury, with the supply chain issues masking the strong in-market fundamentals of our brand portfolio. Professional Beauty net revenues declined 2.6% like-for-like in the quarter, with the disruption of service level at our North America distribution center having a significant negative impact on our North American hair and nail businesses.

Without these headwinds, we estimate like-for-like net revenue would have increased about 1.5% in the quarter, relatively consistent with the trend in the last seven quarters. We see no underlying change to customer demand for our brands in North America, which remained strong. We continue to see solid momentum in other parts of the division, with low single-digit growth in Europe and high single-digit growth in ALMEA and ghd.

I'm very pleased with how the Professional Beauty team capitalized on a number of strong innovations in the quarter, including the restage of Wella Koleston Perfect with the breakthrough ME+ color technology, which was just launched in Europe and we'll roll out in other parts of the world over the course of fiscal 2019.

We're also excited about the debut of ghd Platinum+ styler, our first to incorporate predictive technology to consumers' hair size and styling approaches. Despite the supply chain headwinds, which impacted OPI's momentum, we're pleased with the strong performance of the brand's recent collections. We continue to see strong momentum in our e-commerce business, including the rollout of our new D2C platform, MyWellaStore.com in the U.S. and coming soon in several countries in Europe.

From a profitability standpoint, despite the supply chain disruptions, Professional Beauty grew adjusted operating income by 41% and delivered 190 basis points of margin improvements. The combination of several internal and external factors drove very weak results in Consumer Beauty, as the 14% like-for-like net revenue decline included close to 5% of headwinds from the supply chain disruption. Excluding this, top line would have declined by about 9%, a result that is still much weaker than our ambition for the division. The sequential deterioration in Consumer Beauty business trends reflected the knock-on effect of the supply chain disruption, as we invested more with our customers, including increased promotional activities, which reduced net revenues. Our results were partly impacted by the continued weakness in U.S. and Europe mass beauty categories, with previously flagged distribution losses, leading to a deterioration in share.

The net result of these top-line headwinds was the first quarter adjusted operating income was $14.8 million, a significant decline versus the prior year period, with a disappointing adjusted operating margin of 1.8%. Set against these overall results, there are a number of commercial highlights that I want to call out in the quarter.

Despite the supply chain disruption, which hampered Rimmel and Max Factor sales in all geographies, the ALMEA region was modestly positive. And importantly, our brands continue to gain share in this region, including our Brazilian business continuing to grow share and delivering strong top line growth, while driving a significant improvement in gross margin.

By category, in retail hair, our largest brand, Wella, experienced solid net revenue growth and share gains in a number of emerging markets, fueled by hair color and hair styling products. Our color cosmetics category experienced the biggest contraction in Q1, reflecting the significant impact of supply chain disruption and ongoing pressure on sales grew.

As we continue to strengthen CoverGirl after our relaunch, the brand improved its leadership position in face with TruBlend Matte Made becoming the number one face launch of the season and showed progress in earned media value, or EMV, in recent months, a key brand health indicator.

As we announced on Monday, CoverGirl became the largest cosmetic brand to earn the gold standard cruelty free certification by Cruelty Free International. This is a compelling proposition for our consumers, and we have received very positive feedback from our customers. And last, but not least, we're looking forward to the opening of our CoverGirl flagship store in Times Square at the end of this month.

For Younique, while sales trend improved sequentially, first quarter profit performance was below the business long-term trajectory, as strong presenter sponsorship and growth in overall revenues was more than offset by increased promotional activity and compensation plan adjustments. While these adjustments have not translated into improved presenter retention at the pace initially expected, we believe that traction in the new subscription and loyalty programs, [indiscernible] (00:19:32) compensation plan refinements and the continued broadening of the Younique portfolio will support strong momentum in Younique in the coming years.

In total, performance in the Consumer Beauty division remains well below our goals of stabilization and predictability. We have taken decisive action with a significant sense of urgency to shore up the division in the short-term. The critical first step here is strengthening operational discipline. We're particularly focused on restoring service level in the coming quarters, fortifying our innovation focus on execution, and [ph] driving negatively (00:20:13) in trade and promotional spend, particularly once supply chain headwinds abate.

Beyond that, we're first refocusing investment from the [indiscernible] (00:20:24) priority in brand-country combinations to a smaller subset of higher potential combination. Not surprisingly, this includes CoverGirl in the U.S. and our strong Wella business in ALMEA amongst others. We believe this reallocation would allow us to earn a higher return on our investments. Second, we're continuing to drive fiscal savings in line with the division top line trajectory. Third, we are accelerating investments towards new growth channels, including improvements to our e-commerce capabilities by adapting our supply chain, product assortment and creative assets.

We expect a positive impact from these actions over the course of fiscal 2019, though turnarounds [indiscernible] (00:21:14) and much work needs to be done to stabilize and hopefully to expand shares in Consumer Beauty.

I have already covered the most significant drivers of the operational results. So let me briefly touch on the other financial metrics, in particular the drivers of EPS and the increase in our leverage.

Our first quarter adjusted net income of $80.5 million grew 6% versus the prior year, primarily due to a one-time $32 million tax benefit in the quarter, coupled with lower interest expense, which was tied to higher euro borrowings during the first quarter.

In Q1, net cash provided by operating activities was negative $82 million and free cash flow was negative $215 million, primarily driven by continued pressure on working capital and over $15 million increase in onetime cash costs.

It's important to emphasize the impact of our supply chain headwinds on our net working capital as the need to shift production and build up safety stock pressured our inventories, while customer relationship [indiscernible] (00:22:26) optimization more difficult. As we work to quickly remediate the effects of the supply chain disruptions and drive profit improvement, we would expect our free cash flow and net working capital balances to improve over the course of the year.

Net debt of $7.6 billion on September 30, 2018 increased by $370 million from the balance of $7.292 billion on June 30, 2018, resulting in a last 12 months net debt to adjusted EBITDA ratio of 5.8 times, compared with our June 30, 2018 ratio of 5.3 times. This net debt increase which we had flat last quarter reflects negative free cash flow, the dividend payment of $94 million and the payment [indiscernible] (00:23:18).

Let's now turn to the outlook and how we see our business evolving in the second quarter and remainder of the year. In the second quarter, we expect underlying net revenue trends to improve versus first quarter across all three divisions, inclusive of expected supply chain headwinds. Specifically, we look for Luxury and Professional Beauty to return to like-for-like net revenue growth in the second quarter, while Consumer Beauty like-for-like trends should improve to a high single-digit decline.

On adjusted operating income, we expect Q2 adjusted operating income to be moderately lower versus a year ago, driven by the remaining supply chain impacts and FX headwinds. The second quarter adjusted EPS comparison versus the prior year will be pressured by the $42 million positive tax settlement recorded in Q2 of last year.

Looking to fiscal 2019, despite the supply chain headwinds, we continue to expect operating profit and margin growth in fiscal 2019, driven by significant progress in fixed cost reductions and synergy delivery. However, we need more time to assess the financial impacts of the continuing supply disruptions and at this stage we are not providing any further guidance, but expect to provide an update on our outlook on the next earnings call.

Deleveraging remains a top priority in fiscal 2019 and beyond. We remain committed to our target of achieving a net debt-to-adjusted-EBITDA ratio of below 4 times by the end of calendar 2020 and we expect positive free cash flow in the remaining quarters and overall in fiscal 2019.

Our liquidity position is substantial, with significant flexibility from over $2 billion of revolver availability. Our mid-term goals remains one of delivering consistent, modest net revenue growth with continuous margin expansion. This coupled with our dividend payout should drive a superior total shareholder return.

To conclude, Q1 was a setback in achieving our financial targets and [indiscernible] (00:25:42) strategic goals, driven by our temporary supply chain headwinds. However, we remain absolutely convinced that our fast-paced and ambitious transformational agenda including comprehensive changes to processes, systems, culture and people is ultimately building a much stronger Coty for the long term.

As we overcome the internal supply headwinds and complete all other major integration-related milestones, we will increasingly shift our focus from being larger internal to fully external. [indiscernible] (00:26:16) will be able to see improved performance across all areas. I'm proud of how the team is addressing the challenges with a very strong ownership mindset and I see tremendous potential for Coty to create significant value for our shareholders and consumers in the coming years.

Now, I'll turn the line back to Christy to open up the line for Q&A.

Q&A

Operator

Thank you. [Operator Instructions] And your first question is from Lauren Lieberman of Barclays.

<Q - Lauren R. Lieberman>: Thanks. Good morning, Camillo, and thank you for all that detail both in the release and going through your prepared remarks. It was really helpful. I wanted to ask first, just about the profit impact of these supply chain issues because, if I recall, coming into the fiscal year, we had talked about there being almost $100 million headwind from just the integration-related issues on supply chain and this quarter you called it being around $60 million. So is part of this – and any of this ties to the discussion of it being tough to forecast the financial impacts? But, was there some almost delay and things have slowed down but the cost is taking longer to work through it? There does seem to be a bit of a gap in how we're thinking about the impact on operating profits, what you said it was and what we expected it to be was the first question.

The second was on the Luxury component trade issue. Is there any reason to tie this to some of your cost savings efforts? So, whether it's a choice of suppliers, things that you've done and how you're working with those suppliers that ultimately [indiscernible] (00:28:00) ability to access the necessary component trade? Thanks.

<A - Camillo Pane>: Thanks, Lauren. Looking at your first question, which is the supply chain [ph] impact (00:28:10), what we said in the previous quarters, so at the end of 2018 in August is that we were expecting an overall full year impact from supply chain headwinds of $50 million on OI.

What happened in reality that we had $60 million just in Q1 and the realities at the time of the 2018 earnings that we knew of some of the supply chain disruptions and which of course drove our outlook that we gave. What happened [ph] is subsequently (00:28:40) we learned of new supply chain issues in the Luxury warehouse in Germany and we were also impacted by the U.S. hurricane in mid-September. Both of these were not known to us and together represent almost 60% of the impact that we suffered in Q1. So, of the $60 million, almost 60% comes out of these two headwinds which we were not aware.

We also need to remember that September is a peak demand month for Luxury and clearly this further exacerbated the impact of the supply chain disruption. We've laid a lot of actions, of course, to address and contain the duration of the impact. We're rebalancing the supply chain. We're rebalancing the production and the logistic within our network. We're working with our supply base better to ensure sufficient component supply. And I'll mention in a second your question there.

And one of the things we have done because of the disruptions and the magnitude of the disruption in Q1 is that we have made modifications to our consolidation plans for the remainder of the year. And we have delayed or modified three plant consolidations [indiscernible] (0029:54) we are going to have and we're going to have in the second part. And, of course, we did this to balance better the need to finalizing the integration with the needs of our customers and consumers and clearly minimize the business impact. And this is why we said that although it's possible that there might be some residual disruption in the second half, we're working swiftly to basically confine the impact of this disruption to the first half.

Looking at your second question which is the component issues. I think it's driven by a couple of things. Yes, it is true that we have, of course, streamlined our supply base because that's part of our journey to become more efficient, agile, and to decrease our cost base. But in this case, I would say the majority of problems came from two-folds. One is our increased demand. We're going well in Luxury and therefore, we are increasing demand of our components.

And then second there are [indiscernible] (00:30:50) suppliers specifically [indiscernible] (00:30:53) anchored into problems, into shortages, not only with us, but also in general with the industry. And the combination of our higher demand and these shortages from the suppliers meant that [indiscernible] (00:31:06) impact, which we didn't really realize that it would have been this significant.

Operator

Thank you. Your next question is from Robert Ottenstein of Evercore ISI.

<Q - Robert Ottenstein>: Great. Thank you very much. Two questions. Can you talk a little bit about how you're thinking about promotions on the consumer retail side? On the one hand if it doesn't seem like you have the products, then why are you doing the promotions or is it just to accelerate the cleanup of the old inventory in the U.S. mass retailers? And then just kind of stepping back in terms of the whole Consumer business, can you give us a little bit more of a sense of what the performance was on the topline for U.S. retail, European retail, Younique and Brazil? Thank you very much.

<A - Camillo Pane>: Thanks, Robert, for the questions. When I look at the promotional intensity, this is driven by a couple of issues. One is, yes, we do have supply chain headwinds and problems. And that basically means that we have more of a [indiscernible] (00:32:15) relationship with the retailers, which leads to penalties because we're not able to maintain the service level that we're supposed to. So that's one of the driver of the increase [indiscernible] (00:32:25).

The second one is that we wanted to increase the support to our brands in store while we were seeing the issue in the supply chain, but it's not like the supply chain issues were across the entire portfolio and this is why you had this effect.

In terms of the Consumer Beauty performance in the different region that you mentioned, let me start with the U.S. U.S. is a mixed equation because we do have an improvement in CoverGirl. CoverGirl continues to – had performance in the mid-single-digit decline, while the rest of the brand is more of a high single-digit decline in the U.S. And when I look at CoverGirl, there is a lot of also positive things which are happening on the brand, which are moving the performance progressively and sequentially towards a better and slower decline versus the past. And now I can potentially talk later about this.

In Europe, clearly we suffered. The majority of the supply chain headwinds did happen in Consumer Beauty in Europe because this is the stronghold region for both Max Factor and Rimmel, and the issue we had in our planning hubs in the UK were mostly related to Rimmel and Max Factor. So, again, high single-digit decline in Europe because of [indiscernible] (00:33:55) supply chain.

Brazil is a different story. In Brazil we're doing well. We are growing twice as fast our second competitor and we are the fastest growing multinational company in Beauty in Brazil. Our strategy that clearly impacted our results in 2018 is absolutely working because our market share continued to be very healthy. We're growing share across most categories, but at the same time now we have a much improved gross margin, which was absolutely our strategic intention when we had the pricing intervention in 2018.

And lastly regarding Younique, Younique trends had improved this last quarter, but from a profit point of view, we were disappointed by the results because what happened is we did implement new compensation plan adjustments and it takes time for the presenters to adapt their behavior and clearly have an impact on presenter recruitment through the new compensation plan. At the same time while doing this, the new compensation plan is in place and it clearly cost a lot of money.

Now to offset this, we had two programs which are doing very well in Younique. One is the loyalty program, which is helping to increase retention of presenters. And the second one is a subscription program, which we launched just in mid-August. And in just a couple of months, we have more than 70,000 consumers that had subscribed to our new subscription program for mascara. And, of course, these two programs give us also a lot of confidence for returning Younique to a very strong performance in the coming quarters because, of course, they do improve loyalty and predictability of the business over time.

Operator

Thank you. Your next question comes from Mark Astrachan of Stifel.

<Q - Mark Stiefel Astrachan>: Thanks, and good morning everybody. I guess couple sort of housekeeping questions. So, if you're going to get back much of the supply chain-related disruptions to the top line, why not keep the sales targets that you had outlined in conjunction with the fourth quarter results? And then sort of related to that, how do you think about given some of the challenges in Consumer Beauty that these supply chain disruptions don't have a more permanent impact on the business?

And then the same sort of comment on the Luxury business. So, you say you're getting that back, but obviously this part of the year is a pretty key part of the year. And so, why does that [ph] have (00:36:30) more of an impact on the business?

And then just lastly also somewhat related, given seasonality in the business and the profitability and cash flows in the first half of the year, is part of the withdrawal of guidance in sort of talking about updates next quarter because basically this year is now awash as you can consider it that you can never get back that level of profitability. So, we're basically looking at fiscal 2020 now as kind of the first year out where results meet whatever your expectations would be?

<A - Camillo Pane>: Thanks, Mark. I'll try to answer all your questions in the order that you gave to me. The first one is for the outlook of 2019. Of course, we're working very hard to contain the impact of the supply chain disruption to the first half, but there is potential [ph] for residual (00:37:25) impacts in the second half, and therefore we have limited visibility to the overall impact on 2019 revenues and profit.

And we want to take more time to have this assessment and this is why we told you that we would like to come back next quarter. Despite the headwinds, we continue to expect operating profit and margin improvement and growth in 2019 because we do see significant progress in fixed cost reductions, and we are delivering the synergies. And that's why we are just saying that we will come to the next quarter.

Now, when I look at the specific in the divisions, the first one I think you asked is Luxury. It is true absolutely that we are entering into the highest season, but we do have [indiscernible] (00:38:20) and it's not like that the supply chain headwinds that we're having will stop us from having a strong season. And this is why we have reaffirmed that we will grow revenues and profit in Q2 in Luxury and of course, we believe in the underlying strong demand for the Luxury business. And, of course, we got impacted by the headwinds and the hurricane, so both internal and external and the component shortages, but the underlying demand is strong, and we believe we will be able to deliver on our outlook.

In Consumer Beauty, as I said, the supply chain really impacted the Rimmel and Max Factor. So it is different. This is a mix of supply chain issues and underlying performance of our business. And [indiscernible] (00:39:11) a lot what are the action plan that we're doing to turnaround Consumer Beauty. We need to be focused absolutely on strengthening operational discipline in Consumer Beauty. That's our first focus plus doing those other strategic changes that I mentioned, including reallocating capital.

Now in terms of profitability, your last question was, I think I answered your last question in terms of why we're not giving guidance and we're going to wait one more quarter, because [indiscernible] (00:39:44) the profit. And it's the same for cash flow at the end of the day. So the two things are related. They're very much interlinked. So we do expect positive free cash flow in the next three quarters and, of course, positive free cash flow in 2019. But because of the impacts, we want to wait to give specific level of details and we will do it in the next quarter.

Operator

Thank you. Next question comes from Faiza Alwy of Deutsche Bank.

<Q - Faiza Alwy>: Yes, hi. Good morning. So just two questions for me. One is on the ALMEA performance within Consumer Beauty. So, Camillo, I'd love your take on was that in line with expectations, because it seems to me that that business may have decelerated a little bit, and if you could just focus your comments sort of outside of Brazil.

And then my second question is just around – like, I understand the specific supply chain issues, but it seems to me that since the P&G acquisition, there have been a number of like integration-related distractions. So I wonder if you've put any new, like, internal processes, changes, anything – like is there a specific team that's now going to be responsible for some of these execution integration actions. Because it seems to me that there's been a lot of focus on just synergy realization and perhaps a less so on just the execution.

And I understand that you've delayed some of these. We've modified your plans and delayed some of this transition. But how do we know that when you do go forward with these consolidation plans, you're not going to encounter sort of similar issues. So just would love your perspective on both those things. Thanks.

<A - Camillo Pane>: Thanks, Faiza. Looking at ALMEA, I think I mentioned Brazil quite extensively, so we're very pleased with that. Look, actually the driver of ALMEA was moderately positive. So we grew in ALMEA in Consumer Beauty in the quarter and with a couple of different dynamics. Brazil was very good, as I mentioned. Mexico was also very good. We continue to grow share especially in hair color in Wella, which remains our stronger brand there. Middle East also we had very good growth. There we had Bourjois, which is the number one cosmetic brand in Middle East, and we're doing a lot of very strong things there.

And also we grew in China, but in China we had a deceleration of growth, but we continue to remain confident on our business in China. I think the overall health of our Chinese business across all divisions actually is very strong, and we have a size there that allow us for a lot of opportunities again in the future.

One of the countries which slowed down in ALMEA, which is actually a very sizable country for us, is Australia. This is where – Australia performed very, very well in 2018, but Q1 2019 I think some executional issues didn't allow Australia to grow. On the contrary, we declined there. And Australia is actually quite sizable for us, so is driving down the performance of ALMEA in Consumer Beauty.

We believe this is temporary, because we have high level of confidence on the health and the potential for continued growth, healthy growth in ALMEA in Consumer Beauty, as we mentioned in our earnings model and also in our previous call in August.

Looking at the supply chain integration disruption, I think what is important is first to really remind what we're trying to build is really a streamlined, agile, very strong supply organization, which would really gives us a foundation for best-in-class operational efficiency. So, we always [ph] got to keep in mind (00:43:31) the complexity and the ambition of the journey, and the fact that until we are these last three internal issues that I mentioned in the call, [indiscernible] (00:43:41) things without having any issue.

Now, looking at the current issues, the three headwinds that we had in Q1, absolutely, we are reviewing the entire planning process of the company to make it much stronger and more robust and fit for an organization that has many new people, because [ph] we don't have to (00:44:03) forget that we have also many new people that came from the outside, because we had to [indiscernible] (00:44:08) some of the organization during the merger.

Now with this, where we are right now is that we have done 80% of the integration, so it's [indiscernible] (00:44:17). And for the remaining 20%, as you mentioned, we have decided to do some modification and to derisk some of the consolidation. Based on the new plans, we're actually confident that we're going to finish the integration by fiscal 2019 with a much lower level of reschedule. Regarding your question about specific teams, we do, yes have specific teams that now are in – clearly looking at this training process and the consolidation plan with the level of details and scrutiny that clearly we have never had before.

Operator

Thank you. Your next question is from Olivia Tong of Bank of America Merrill Lynch.

<Q - Olivia Tong>: Great, thanks. First, just a clarification in terms of your supply chain issues, and I'm a bit confused on how – you have all these supply chain issues that have popped up more recently. You're delaying some of the consolidation in terms of the manufacturing. You're delaying some of the consolidation, yet it doesn't impact the delivery of synergies. Why is that the case?

<A - Camillo Pane>: Thanks for the question. Because the – first of all, as we said, we've done 80%, it's remaining 20%. Out of the remaining 20%, the one that we have the risk, they were mostly driving simplification rather than having a lot of cost savings attached to it. Nor every single project has large cost savings attached to it, but many of the projects are to drive simplification for us, but also for our customers, because we're trying to achieve what we call internally 1/1/1, which is one order, one invoice, and one distribution point – one shipments point. And so because of the – basically the answer to your question is, it's the simplification, the growth there that is driving some of these plans. And the impact on synergies is truly minimal and it completely gets absorbed by the old programs that we are absolutely delivering on target.

<Q - Olivia Tong>: Got it. And if I could just follow-up with two more unrelated. I know you've jettisoned a lot of the challenged fragrance brands and made a lot of portfolio changes, but does there need to be more paring back of the portfolio to get to where you want to get to? And then just one housekeeping, if you could help us in terms of your updated expectations on full year interest expense and tax rate? Thank you.

<A - Camillo Pane>: Olivia, can I ask to repeat the question? Because unfortunately your line is not the best. I couldn't hear you very well. Could you repeat it again? Yes.

<Q - Olivia Tong>: Okay. I just picked up my phone. But the first one was just around your portfolio, because I know you've, obviously, gotten rid of quite a few of the challenged fragrance brands, but does there need to be more paring back of the portfolio in order to get to where you want to get to? And then just a housekeeping one was around your updated expectations for the full year on interest expense and tax rate.

<A - Camillo Pane>: Okay. So, on the portfolio, I think we have done our portfolio rationalization. And as you mentioned, we have pruned back some of the fragrance brands, and we don't expect to have any more rationalization at this point. We're happy with our portfolio and our focus is absolutely to continue to drive strong growth from last year in Professional Beauty and the focus clearly is to turnaround the Consumer Beauty with the action plan that I mentioned before.

So in terms of interest rate and tax rate, so the first one is – from a tax rate, we expect in the low 20s, around 22%. So that's our estimate we have given in the last earnings call and we continue to be committed to this. And in terms of interest expense, we're putting in our model around [ph] $310 million (00:48:12).

Operator

Thank you. Your next question is from Steph Wissink of Jefferies.

<Q - Stephanie Wissink>: Thanks. Good morning, everyone. I want to come back to Mark's earlier question on the guidance and just the track line here. In your second quarter, Camillo, you're expecting Lux and Pro to return to positive, and I think you mentioned down high single digits in Consumer. Can you just help us bridge the transition from Q1 to Q2 and what's remediation of supply chain versus what your expectations are for underlying improvement? And then also update us on any shelf space changes or adjustments to your planned promotions or programs, and any impact from the supply chain? Thank you.

<A - Camillo Pane>: Yeah. So, from a guidance point of you, yes, you're correct. So we expect the Luxury and Professional Beauty to go back to more or less approximately the same trend that we had in 2018, basically to revert to growth, because the supply chain headwinds will abate. Although we will still have some supply chain headwinds in Q2, but we believe that our underlying strong demand will be able to offset that one and we're confident with that.

And Consumer Beauty, we said – we're saying about high single-digit decline. This is driven by, first of all, the resolution or the improvement of the supply chain headwinds, which, of course, will benefit Consumer Beauty as well from a service level point of view. Plus we're putting in place this action that I mentioned before, and one important one is clearly a much stronger management of our trade spending and [indiscernible] (00:49:54) was, as I mentioned, before impacted by the penalties with customers, impacted by all these additional promotion activities. Once the supply chain headwinds will abate, we will be able to manage better the trade spending. And then, of course, we'll have a positive impact on the net revenue decline.

And then, of course, is the entire turnaround plan of Consumer Beauty that I mentioned before. So the operational discipline, that we have additional investments, the stronger growth of e-commerce that I mentioned before, and all this will be – will also benefit from lesser headwinds on supply chain. I don't think we should underestimate the impact on the commercial organization from supply chain headwinds of the nature that we'll be dealing with. And this will reverse, will improve in Q2, and will eventually reverse in the second half of 2019.

Regarding your second question, which I think was about shelf space, I want to go back to what I said in the last earnings call. So, first of all, our focus is on driving consumption productivity on shelves. And one thing I want to say, which is positive, is the fact that we've seen actually positive progression in productivity and innovation performance, especially in CoverGirl, but also in the regional in the U.S. CoverGirl productivity [indiscernible] (00:51:17) distribution losses actually has been improving and growing across most of the customers in the U.S. for practically four months in a row. And this is really, really positive.

Now, this productivity growth is very good news and it shows that the brand is reacting to all the programs that we're putting behind into the relaunch. But this productivity growth is still insufficient to offset the distribution headwinds.

And this is why we have already flagged that distribution headwinds will continue in the remaining of the year and also in the second half of 2019, [indiscernible] (00:51:58) by most of the retailers. And our objective is truly to continue increasing the productivity on our brands. That's the way that we are going to at some point, of course, stop these distribution losses and stabilize our business in North America.

I'm, of course, reassured by what I'm seeing in CoverGirl and Rimmel, but there is much work to do. I think one of the program that I want to mention is the cruelty free, so the certification by Cruelty Free International that we received for CoverGirl. Tons of work has gone behind this, because we had full external audit of our supply chain, including all our suppliers in order to obtain this certification. So this is truly the gold standard in cruelty free certification, and we also committed to regular audit every year, which again is another sign of strict control and commitment to this.

And we also have committed to have another brand that will become certified by CFI, Cruelty Free International, by the fiscal 2020. The reaction of the customers to this new certification trend has been really, really positive, so we're encouraged by this. Of course, we just announced just few days ago that is another program that we believe will help CoverGirl to return – of course, to continue to be the top leader in color cosmetics in the U.S., but also to return much better performance.

Operator

Thank you. Your next question is from Joe Lachky of Wells Fargo Securities.

<Q - Joe B. Lachky>: Thanks. I was hoping you could talk through your free cash flow and how much you think the supply chain issues impacted your working capital in the quarter. And then thinking about free cash flow for the full year, I guess, how confident are you in getting growth in positive free cash flow for the full year? And then considering the challenges facing you regarding cash flow and your need to focus on deleveraging, how committed are you to the dividend?

<A - Camillo Pane>: So, thanks, Joe. I think the first question is about the free cash flow. Yeah, the impact on the net working capital from the supply chain is actually quite severe. If you think about it, we are going to manage better our inventories, but at the same time we're going to restore safety stock, because our service level got hit by the supply headwinds. That's a very difficult task for the teams to manage better the inventory when we are building new one, so we're building safety stock.

Second one is on receivable. As you can imagine, improving our trade terms becomes more challenging for all our commercial teams when we are having a debate and discussions, because of the service level not being where it should be. So without any doubt, the net working capital got hit severely by the supply chain headwinds and consequentially the ability to deliver the free cash flow, of course, gets impacted.

Now, despite that, we are truly focusing the organization on cash, which is something that was not as pronounced strong in the past, especially during the first year or two of the integration. And that's why we believe that we're going to have positive free cash flow in the remaining quarter and in the total year. We're confident also, because we're having a big attention to our CapEx and to our one-off. Although all these programs, of course, have started a while ago, we are focusing [indiscernible] (00:55:42) much more on that, and we even changed the incentive scheme of all our leaders to make sure the net working capital, cash one-offs, and CapEx are now included in their incentive.

The dividends, I think you asked about the dividends. Well, the dividends is – well, my opinion is that we believe cutting the dividend sends a signal to the market that we have a terminal cash flow problem, which is absolutely not the case. Free cash flow, as I said, should improve in the remainder of 2019 and also in 2020 we will have a material positive benefit by the fact that CapEx and especially one-time cash cost will drop – will decrease significantly. And this is why, I think, it's important to underline that it's just a temporary problem and not a permanent one.

Operator

Thank you. Your next question is from Jonathan Feeney of Consumer Edge Research.

<Q - Jonathan Feeney>: Thanks very much. I just wanted to maybe follow-up on line of questioning earlier about, I guess, what gives you the confidence that the supply chain issues haven't really set back the sales process, especially as it relates to Consumer Beauty. You talked about that being contained to [ph] running (00:57:08) Q2, maybe Q3. But can you talk to me about what retailer feedback is then? And how do you go about positioning like this execution issue and convincing people that it's not something that's ongoing? Even though you have a great analytics and the products performing on shelf, how do you get the retailer comfortable it's going to be there? Thanks.

<A - Camillo Pane>: I think it's a matter of building strong partnership with the retailers. First of all, I'd say, it's about transparency as well. I think we have been very transparent with the retailers explaining the type of issues we were dealing with and doing it in a very timely manner. The one that we knew that I already mentioned in the August call were completely disclosed, of course, to the retailers with a different timeline of returning to proper service level. And the one in Luxury that we had through the hurricane and through the late warehouse issues, to be honest; we went to the retailers and explained the situation, because this was unexpected for us as well.

But at the end of the day, it's all about partnership. It's all about transparency. It's all about having strong programs to drive consumer demands. And just going back, in Luxury and Professional Beauty, our consumer demand is very strong. So, of course, it's incredibly frustrating for everybody, for us and for the retailers or the customers. But they do know that our customer demand is strong. And if we show them plans of restoring service level in the next two, three months, retailers do understand that. We've been [ph] together plans (00:58:53) on how we deal with the shortages and really adjusted the promotional plans or the launch plans in a way that get – taking in consideration the headwinds.

In Consumer Beauty, it's clearly more difficult, because this is a mix between the supply issues, but also the fact that some of the brands are not performing where they are. And this is why we need to do better in the programs we're putting into place, in the executional renovation, in the discipline that I mentioned before, and that is absolutely a big, big focus and priority for me and for the Consumer Beauty team, absolutely.

Operator

Thank you. Your next question is from Linda Bolton Weiser of D.A. Davidson.

<Q - Linda Bolton Weiser>: Hi. So I was curious if you could just update us on the CFO search and how is that going. And also, how is the morale in the company? Because you brought in a lot of new executives anyways, and then you have these issues developing. So how is the morale in the company? Thanks.

<A - Camillo Pane>: Yeah. So, look, CFO search, what I can update you is we had lot of very strong candidates that we've been evaluating. And we are between the middle and towards the end of our selection processes, so we'll be able to update you soon on this one. But we're pleased with the quality of the candidates. There is very high level of interest into our journey and a lot of candidates really with very strong background [ph] there is still (01:00:26) with our needs and our journey.

In terms of morale, it's different within divisions, to be crystal clear, because in Luxury and Professional Beauty we do have two very high performing business, beating the market growth rate and beating expectations. In Consumer Beauty, we do have, clearly, a mixed morale, because, of course, the performance have not been, I would say, close to the expectation now for a while. But this is something that we're working with the leaders. I mean, yes, we do have a new leadership team that is quite recent or quite new into Consumer Beauty. We'll continue to drive for the right cultural fit and the right skills to perform the turnaround.

And when I look at the morale, one of the things that we have done is that we had changed the vesting periods of some of our [ph] OCI (01:01:29) program to progress vesting between three, four, and five years, which I think would also help with the retention of key talent. So, overall, what is important is that we do focus on the turnaround of Consumer Beauty, which remains our priority, and there is a huge belief in the company, in our partners, and in our long-term journey. And this is also very, very reassuring for me and for my colleague [ph] in the industry (01:01:56). We continue to see very, very high level of loyalty and belief in our journey, because everybody is aware that these are temporary headwinds that we're dealing with. We did a very complex integration, but the benefit of the new Coty and the value that we're creating for the future is absolutely not a doubt.

Operator

Thank you. We have reached our allotted times for today's Q&A session. We thank you for joining today's call. Please disconnect your lines at this time and have a wonderful day.