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COTY - Q1 2017 Coty Inc Earnings Call

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PRESENTATION

Operator

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

(Operator Instructions)

As a reminder this conference call is being recorded today, Wednesday, November 9. Thank you. I will now turn the call over to Kevin Monaco, Coty's Senior Vice President, Treasurer and Investor Relations. Mr. Monaco, please go ahead.

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

Good morning and thank you for joining us. On today's call are Bart Becht, Chairman of the Board, 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 do not reflect certain adjustments, as specified in the non-GAAP financial measures section of our earnings release. You can find the bridge from GAAP to non-GAAP results in the reconciliation table in the earnings release.

While we are pleased to have Camillo join us today on the call to provide his initial impressions on the combined business, the question-and-answer session will be limited to Bart and Patrice as they are the stewards of the business during the first-quarter period. I will now turn the call over to Bart.

Bart Becht - *Coty Inc. - Chairman of the Board*

Thank you, Kevin. And welcome, everybody, to Coty's first-quarter conference call. This morning we will take you through a summary of today's announcement and recent developments, and Camillo will offer his initial thoughts on the state of the business, and then we would be pleased to take your questions.

The last several months have been truly transformational for Coty. On October 1 we completed the merger of the P&G specialty beauty business into Coty with a $1 billion lower cash payment than anticipated at the announcement of the transaction. I would like to thank the teams involved from Coty and P&G for all their hard work over the last 15 months in creating the platform for Coty to become a global leader and challenger in the beauty industry.

I'm confident that we now have largely the right team, organizational structure and culture to make the vision of this merger a reality. Our new CEO, Camillo Pane, the executive team, and the divisional regional and country management teams are now in place and are working on exiting transitional service arrangements with P&G, while increasingly focusing on rebuilding business momentum.

As expected, the extensive work over the last 15 months on closing this transaction and merging the two businesses has come at a cost. As discussed prior to the closure, the resources, which normally work on the business, have also been working on closing the transaction and to set up in the future of the Combined Company. The resulting distraction as well as the recent change in management team in our headquarters, regions and countries have contributed to a decline in Coty standalone revenues and profits in Q1.

Reported and constant currency revenues declined moderately, and adjusted operating income declined by a mid teens percentage compared to the same period last year. While we are anticipating similar revenue trends into Q2, we are committed not only to real improvement in the trends in the second half excluding divestitures, but also to achieving further improvement for the Combined Company in the following fiscal years.

This Combined Company 2017 outlook replaces all prior FY17 outlooks. Importantly, we continue to target the total four-year synergies and working capital benefits of $750 million and $500 million, respectively, with no change to the operating cost to realize both. We also remain committed to our previously communicated adjusted EPS target of at least $1.53 for FY20 despite the profit impact of the current decline in revenues.

Additionally, we remain firmly committed to using Coty's expected strong post-merger cash flow to build Coty into a much stronger global leader and challenger in the beauty industry. In this respect, we are very happy with our recent acquisition of the Hypermarcas beauty business in Brazil and our pending acquisition of ghd, which we expect will continue to strengthen Coty's global portfolio, it's growth exposure and its profit and cash generation.

As departing Interim CEO and remaining Chairman, I believe the future of the new Coty under our new CEO Camillo Pane is a bright one. It certainly will be a journey to realizing the ambitions we have set for the Company. And while there may be challenges as we integrate and rebuild the business, we are firmly committed to realizing the ambitions we have and delivering value for all our shareholders.

I will now turn it over to Patrice to discuss the Q1 results in more detail.

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

Thank you, Bart. And good morning, everyone. Q1 net revenues declined 3% as reported and declined 2% at cost on currency. Excluding the 6% contribution from the Brazil acquisition, net revenues declined 8%.

Our adjusted gross margin declined 150 basis points to 58.8%, driven by the contribution of the lower gross margin Brazil acquisition as the gross margin of the remaining Coty business remains consistent year over year. The Q1 adjusted operating income declined 14% to $166.4 million, resulting in a 15.4% adjusted operating margin.

This decline was driven by two primary factors. First, the revenue declined from steady to lower adjusted gross and operating profit. Second, Q1 fixed costs increase on an absolute and percentage basis as we ramped up staffing and other investment in anticipation of the close of the P&G beauty transaction.

By segment, two of the segments, Skin & Body Care and Fragrance, showed solid profitability performance despite the broader top-line weakness. The Q1 Skin & Body Care adjusted operating margin improved 280 basis points to 9%, fueled by a mix-driven improvement in gross margin. The Fragrance-adjusted operating margin reached a solid 21.5%, marginally declining versus prior. The Color Cosmetics adjusted operating margin declined 460 basis points to 11.3% as we ramped up A&P investment despite the lower revenues.

Finally, the Brazil acquisition reached an adjusted operating margin of 8.6%, largely reflecting the fact that Q1 is typically the lowest quarter seasonally for the Brazil business.

Moving down the P&L, our adjusted effective tax rate for the quarter was 30.1% compared to negative 38.4% in the prior year, reflecting the $113.3 million tax benefit in the prior-year period. Altogether, this drove an adjusted diluted EPS of $0.23.

During the quarter and prior to the close of the merger, we repurchased 1.4 million shares. As well, we returned additional cash to shareholders with the distribution of an annual dividend of $0.275 per share.

Turning to the capital structure, we ended the quarter with $4.1 billion in net debt. In October, we took the opportunity to successfully borrow an incremental $1.1 billion in term loans and used the proceeds to repay borrowings under our revolving credit facility. In addition, we refinanced approximately $1.6 billion in term loans to reduce annual interest expense by almost $10 million per year.

We also benefited from only $1.9 billion in assumed debt in the merger, which was $1 billion less than the assumed debt amount when we first announced the merger in July 2015. As far as the merger with the P&G specialty beauty business is concerned, we are confident about the potential of this merger to strengthen Coty's margin, earnings and cash generation profile. I'm happy to confirm the four-year synergies and working capital benefits of $750 million and $500 million, respectively, with no change to the operating costs we realized both.

We also remain committed to our previously communicated adjusted EPS targets of at least $1.53 for FY20. We remain confident in the long-term cash flow profile of the Company as well as the strength of our balance sheet, which will allow us to fulfill our long-term ambitions.

I will now turn it over to Camillo to offer his preliminary views on the business.

Camillo Pane - *Coty Inc. - CEO*

Thank you, Patrice, and good morning to everyone. It's my great privilege to take over the reins of leadership at such a transformational moment. With this merger we have brought together a powerful portfolio of beauty brands and some of the world's most talented people in beauty and consumer groups.

Being in the CEO role for a little over a month now I've been focused on three key priorities. First, I'm visiting many of the Coty key countries, meeting with the significant customers and reviewing the business with the country management teams. Second, I'm now reviewing in-depth the innovation pipeline for the next one to two years. Third, I continue to support the internal work in accelerating Coty's capabilities in digital communication, e-commerce and in-store.

While I will offer a more comprehensive assessment of our business on the next earnings call in February, I did want to take this opportunity to offer some initial thoughts. The substantial changes within Coty over the last year, from carving out the beauty business from P&G to introducing a new organizational structure and changing the management teams in a number of countries, have clearly impacted the organization. In the short term, this means some lumpiness quarter to quarter as everyone settles into their roles as the organization learns to run as one company.

However, I have a high level of confidence in the long-term outlook and fundamentals of the business. Within the combined Coty portfolio I see a lot of possibilities in professional beauty and luxury.

The salon hair business continues to perform well. And while still early, we are seeing early indication that the OPI nail brand is a very good space for distribution. And I believe this should result in much better meet to long-term growth momentum for OPI.

Speaking of the luxury division, this business is anchored by a number of leading brands, including Gucci, Calvin Klein, Hugo Boss and philosophy. And I'm encouraged by the pipeline of upcoming launches in the combined portfolio, including, of course, the launch of Tiffany.

Turning to consumer beauty, it's clear that this is a division that is facing a number of challenges. These challenges include the positioning of some of the brands, the strength of the pipeline, the in-store execution, as well as the competitive pressure in the market. We have begun our work to address these issues. And I will add more information to provide on the next call as to the steps we are taking to regain momentum in this business.

I'm very excited and encouraged by the progress we are making to communicate and engage with today's consumers who are increasingly living in a difficult world. Our digital capabilities were significantly enhanced by last year's acquisition of the digital marketing platform Beamly. Beamly is already helping us improve the social engagement of our brands through campaign optimization, social listening and deeper brand targeting. We have significantly increased the proportion of our media spending aimed at digital and I'm pleased with the results I've seen.

While a key focus in the near term will be on integrating the P&G specialty beauty business and improving our growth momentum, we believe there is space for selective M&A, where it can be managed without unduly disrupting our integration and growth focus, where it clearly benefits our future growth trajectory and delivers shareholder value.

With respect to our recent transactions, we continue to be encouraged by the in-market performance of the Brazil acquisition, with sell-through growing strong double digit in a market which is growing at high single digit.

We also announced on October 17 the signing of a definitive agreement to acquire ghd, the premium brand in high-end hairstyling appliances. We believe ghd's strong historical growth, driven by geographical expansion in channel diversification beyond salons, including a sizable e-commerce business, will only be enhanced by Wella's substantial distribution capabilities and complementary portfolio brands. The acquisition, which is expected to close prior to the end of this calendar year, is the first test in our strategy to gradually shift the market growth exposure of our combined portfolio close to the 3% to 4% global industry growth rate.

I'm very energized by the opportunities ahead for the new Coty and look forward to working with my new leadership team to drive Coty to profitable growth and to be a new global leader and challenger in the beauty industry.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Wendy Nicholson of Citi.

Wendy Nicholson - *Citi Investment Research - Analyst*

Two questions. In the near term, if the second quarter is going to be a continuation of the underlying sales growth we just saw now, I'm not sure what light switch flips as we go into the back half and revenue growth accelerates all that much. So, is it just the timing of new product launches or do you expect some underlying improvement in the market, which could help us have confidence that this really negative trend isn't going to push us through the entire year?

And then, second question, I know you said in your prepared comments that $1.53 for 2020 is still the target but it sounds like today it's a downward revision to the growth outlook for FY17. So, what's better in your forecast that helps you make up for that shortfall so you can still hit that $1.53? Thanks.

Bart Becht - *Coty Inc. - Chairman of the Board*

Maybe we can start with the growth outlook. Clearly what is impacting in Q2 are the same factors which are impacting in Q1. We should not forget that clearly FY17 is a year of transition. And the transition is largely taking place in the first six months and only gradually comes out in the back half.

Now, what do I mean by transition? Clearly we have a complete new organizational structure, which is different from either the Coty or the P&G structure. And we have many new people. So, the combination of the two means that a lot of people have new jobs in different locations at some point in time.

That has clearly created a substantial level of distraction. People are not necessarily fully focused on the business for a period of time because they are in transition or, alternatively, they are also helping out on the integration of the business. So, those two factors basically have caused distraction and have caused us to lose momentum, basically, in the business, which we believe we are in the process of addressing.

In addition to that, we believe that those factors will abate in the second half. In addition to that, we believe we have a good pipeline, or a better pipeline, on some of our brands in the second half, which makes us believe that the trends will improve in the second half, as well.

So, those are the two key factors -- some factors abating and at the same time pipeline improving, which should improve the momentum in the second six months.

In terms of the earnings per share, we believe basically that beyond the cost synergies of the business, there's also an improvement that we can have on the underlying business, and, therefore, we believe the $1.53 by FY20 is a doable and reachable number.

Wendy Nicholson - *Citi Investment Research - Analyst*

My question is, in terms of the disruption to the core business taking longer than you expect, again, I say, okay, that $1.53 number, was it that $1.53 target was just initially extremely conservative and now you think that you can do it because your recovery is going to be faster? Because it just seems like numbers are going to be coming down in the short term, so you are building in an even bigger hockey stick in the out years. And given recent trends, it seems like that's a heck of a leap of faith.

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

I think that to be able to answer this question we need to step back and look at the way we have built this $1.53. This $1.53 was the additive of the Coty business, the P&G business, and the whole level of synergies falling bottom line. That's the way we have $1.53, which is just the sum of these three pillars.

The $750 million synergies, we confirm that this is the target to achieve in year four and we remain very firmly committed to that. So, there is no reason while in year four we cannot achieve that. And I would like to take this opportunity to emphasize what we said during the road show, is that this is without any underlying improvement of the business and this is without Hypermarcas. So, it's clear that this $750 million are and remain, and in year four we still remain committed by this $1.53.

Operator

Lauren Lieberman of Barclays.

Lauren Lieberman - *Barclays Capital - Analyst*

Thanks, good morning. First, just to follow-up on that discussion, Patrice, no one has mentioned margins. So, I just wanted to confirm that the $1.53 that your vision of 19.5%-ish margin in 2020 also still holds, or if there's a view that there will be greater reinvestment needed over this time period.

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

The assumptions that we had when we build the slide with the margins are still there, and so this $1.53 are still compatible with the margin, which is 19.6%, is the number that we are quoting on the road show.

Lauren Lieberman - *Barclays Capital - Analyst*

Okay, great. And then on brands, I did want to talk a little bit about the Color Cosmetics business. There's been a surprising amount of news flow around the COVERGIRL and the Max factor brands in the last three months or so, Max factor relaunching in the US after leaving, I think, 10 years ago, and then COVERGIRL making some pretty bold moves in terms of their brand imagery representation and so on. Camillo, if you could talk a little bit about -- it doesn't feel like the management teams running those two brands have been asleep at the switch. They have been more active, arguably, than they have been in a while. To what degree was your team involved in that process? Or was this, they were throwing some stuff at the wall before the merger was complete? Thanks.

Bart Becht - *Coty Inc. - Chairman of the Board*

Camillo is not going to answer any questions, as we said earlier. He will do this in February. But I will answer the question. We've not been involved basically with the marketing efforts of P&G prior to the transaction because we were competitors, I might remind you. And, therefore, we had no influence in any of their programs.

And this business we've now owned for six weeks. So, we are basically digging into the details of this business to try to understand that. And when we come back in February, hopefully we will have a better picture on this business and we can answer all of your questions a little bit better than we can now.

What I can tell you is that Max Factor is not being relaunched in a major way in the United dates. There's a lot of activity on COVERGIRL. But, as Camillo already has alluded to, there's a lot of work that needs to be done on the Color Cosmetics brands, in particular on those two brands that you just mentioned. And we are in the process of understanding, analyzing and formulating new plans to tackle the issues on those two brands. But it is premature for us to make any concrete statements on that.

Lauren Lieberman - *Barclays Capital - Analyst*

Okay. The idea that all the transition the organization is going through, the people moving around, I understand all of that. But the level of impact on the brands -- when brands are healthy they can coast along for a bit with a little bit love and attention, and it would seem that these brands really took it on the chin when people, their focus changed. So, would you say that the performance in the last few weeks has made you feel a bit differently, not with the long-term potential about the brands but the actual level of the health of the brands today?

Bart Becht - *Coty Inc. - Chairman of the Board*

No, I remain very positive about the brands, to be honest with you, because I think it is a portfolio of a set of very strong brands. In particular, on the P&G business we should not forget that prior to the announcement, 18 months prior to the announcement of the transaction, it was known internally that this business would be divested. And between announcement and closure, there were 15 months. So, arguably this business has been in limbo for two to three years.

Clearly this is not very beneficial to any business, as you can imagine, because the focus comes off. There is a certain level of neglect that has happened, in particular, because not the entire organization has come with the P&G business. So, it's not like we are transferring an existing company with an existing management team into Coty because only part of the team is coming to us. So, there's been a material level of neglect on these businesses, which we are trying to understand and we are reformulating plans to react to all of these brands.

Having said that, I don't have to tell you that brands like COVERGIRL, Wella, Max Factor are fantastic brands. It's a great portfolio of brands. And there's an inherent strength, basically, in these brands and we just need to extract that. So, we are in the process of doing that.

Operator

Bill Schmitz of Deutsche Bank.

Bill Schmitz - *Deutsche Bank - Analyst*

Good morning, Bart. Can you just give us some more granularity on this back-half acceleration, category by category? I know it's been asked a couple times. Because I also wonder what are the retailers saying, because you look at a brand like COVERGIRL, which is pretty close to market leadership in US mass color cosmetics, and have a business like that down 8% or 9%, obviously the category is down so the buyer's job is at risk and you have all these moving pieces. So, I'm just curious, I know it's a long-winded question, but can we just go category by category and map out why you think we are going to get to that acceleration starting in that March quarter?

Bart Becht - *Coty Inc. - Chairman of the Board*

Let's just go back to the comments that Camillo made on the various businesses for the combined entity -- and I'm talking about the combined entity here. We believe that professional is in good shape and will show good momentum in the second half. The professional business has done pretty well over the more recent periods and will continue, in our minds, to show solid momentum.

And on top of it, it's going to have OPI folded into that, which we also believe is going to be very positive on OPI. Because, as you might remember, Coty did not have a professional division, and it had an OPI professional brand. And it was very difficult to manage that business because it had a skeleton infrastructure in order to do so. Now we have a full-fledged infrastructure and we believe it will be very healthy on the OPI business. So, we believe professional on the P&G and on the Coty side will show a very nice trend.

On the fragrant side, we believe that on our main brands -- Gucci, Hugo Boss, Calvin Klein, et cetera -- we have some very nice initiatives in order to steadily improve the momentum on that business relative to where we are today. I also would like to offer to you that in the first quarter, for sure, and potentially in the second quarter, there have been some rationalization of wholesale inventories taking place, which clearly also is going to gradually abate.

So, the number one challenge remains basically on the consumer beauty business, and this will take longer. We might see some improvement but there is a lot of things which need to be tackled. We already mentioned we have several large brands. Camillo already alluded to this.

Clearly we have challenges on COVERGIRL, Max Factor and Sally Hansen, all of which need to be addressed, and we are in the process of doing that. So, net-net, I think professional should see good momentum, and continued good momentum, I think, on luxury, which should be improving momentum. Consumer beauty will be the biggest challenge and I think that will take longer. We might see some improved results in the second half but it will take longer to address that.

Bill Schmitz - *Deutsche Bank - Analyst*

Okay, great. And then the internal distraction stuff, are you largely done with the meetings and who my boss is and where the boss is going to sit? It seems like that was what you attributed a lot of the softness in the quarter, maybe through the December quarter through. Are all those kind of initiatives done and people are like -- go out and go do your job now and forget these week-long meetings about who I'm reporting to and what my responsibilities are?

Bart Becht - *Coty Inc. - Chairman of the Board*

Clearly we have some wholesale movements of people into new jobs over the last couple of months, really starting at the end of the last fiscal year all the way through the most recent weeks. That's pretty much done now. So, people are in place, the teams are in place, and we are now focusing on, and extracting ourselves from, transitional service arrangements and rebuilding the growth momentum.

So, the teams are in place. They are sitting, in most cases, in the final locations -- not everywhere, but in most cases already in their final locations. So, we are pretty much getting there. From a team composition point of view, structure point of view, that's pretty much there. In the vast majority of cases they are already sitting in their final locations, so we now actually have and are starting to work on the business.

Operator

Stephanie Wissink of Piper Jaffray.

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

Thanks. Good morning, everyone. I just have another follow-up on the human capital versus the financial capital transitory risk. If we could just talk a little bit about what you think the investment in A&P might need to be over the next 6 to 12 months to really see some acceleration the business once you get past some of the human capital disruptions.

Bart Becht - *Coty Inc. - Chairman of the Board*

In A&P? Is that what you said?

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

Yes please. The A&P.

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

I really don't think there is a need to increase the level of A&P in this business. In the combined entity, we sit above industry average investment levels. So, the key question is not basically if there is the right money, the key question is do we have all the right initiatives and strategies in place in the various brands in order to accelerate the growth of the business. And that's what we are working on but there is no need for incremental A&P investment in the business.

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

And, Bart, maybe could you just talk about, then, where some of the pivots might be where you've invested historically and where you are looking to invest more? I know you talked about digital in your prepared remarks. So, maybe give us some sense of where we could see some of the movement within the dollar.

Bart Becht - *Coty Inc. - Chairman of the Board*

It is very clear the world is changing, the world is moving to a digital world. And you will see an acceleration over time of movement of traditional forms of media into digital. You will also see, from a sales point of view, moving more online which is e-commerce, but that might be with existing customers or with new customers.

So, there is a shift from a go-to-market point of view and a shift from an investment point of view into much more of a digital space. And there is clearly also an intensification of the focus now on creating a much stronger pipeline going forward in order to build momentum on the business. So, those are key areas of focus for the Company.

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

Thank you.

Operator

Olivia Tong of Bank of America Merrill Lynch.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Great. Thank you. Bart, maybe could you give an order of priority of how much of the second-half improvement is related to innovation versus abating factors. Because if you're not spending more money but you are expecting the hockey-stick change from first half to second half, maybe you could help us prioritize those various buckets that you've talked about in terms of what they are going to provide because I'm still struggling with what you mean by, quote-unquote, real improvement.

Bart Becht - *Coty Inc. - Chairman of the Board*

We are not going to put an exact number on real improvement for a very simple fact, is that we've owned the P&G business for six weeks. So, it is very difficult for us to give you an exact outlook on that part of the business.

On the Coty side of the business, we do have basically some very nice initiatives, and we are much more comfortable to make statements about real improvement in terms of the business trends. For instance, we have CK All, we have a clear basically breakthrough mascara on Rimmel. We have, in our minds, much better trends in OPI now that it's being managed by the new Coty professional business. So, so we have a number of factors which we believe will materially improve the trend.

We also don't have the distraction. The distraction in the first clearly has led to not just a reduction in wholesale but also in retail trade inventories in a number of places, which will also go away. So, it is a combination of certain factors not being there; on the other side, having a much stronger innovation pipeline behind the business.

Our feeling about the Coty business is clearly much stronger than about the P&G business simply because the P&G business is a new business. Having said that, to make basically statements about just the Coty business clearly going forward is not highly relevant since we own the total business. So, this is also why we've replaced the outlook statement.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it, thanks. And then you talked about Q2 revenue trends, but what about your thoughts on the operating results? How fast can you get your teams to get to work on that? And then, I guess I understand the distraction associated with getting the deal over the finish line, but why wouldn't there be a more equitable decline across categories and regions, assuming that there's not one group that's more distracted than the other? Why isn't there more an equitable distribution in terms of the distraction quotient?

Bart Becht - *Coty Inc. - Chairman of the Board*

What do you mean equitable? Does that mean like certain categories have more rights to decline than others, or what?

Olivia Tong - *BofA Merrill Lynch - Analyst*

No, the opposite. You would have expected an equitable amount of distraction across the categories, but obviously you are seeing different declines across segments and across geographies.

Bart Becht - *Coty Inc. - Chairman of the Board*

Yes, but you are seeing -- basically the declines are pretty much across the board, across the three main buckets in terms of Fragrances, Color Cosmetics and Body Care. There is really not one excluded. And I think that's what you would expect when there is massive distraction happening.

Again, FY17, I just want to reiterate, FY17 is going to be a year of transition. Having said that, at the same time we believe that the longer-term outlook remains the same. But I think in terms of categories all the categories have gone down.

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

To answer the first part of your question, Olivia, as you know, in 3Q we have not given any annual EPS guidance. But what we have said in the press release is that we remain committed to our previously communicated adjusted EPS target of $1.53 for FY20. So, there is no change to this and the expected accretion of the deal.

We are also continuing to discuss that there will be some dis-synergies of at least $50 million in year one as we step up to support the combined organization before we step down and recognize the other savings. In addition to that, the way you should think about the FY17 EPS drivers relative to FY16 is that there's going to be some incremental depreciation as we begin to spend the $500 million of CapEx, as well as higher interest line resulting from the incremental debt that we have. So, I think you should really think of it this way.

Operator

Mark Astrachan of Stifel.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Thanks and good morning. I just wanted to continue on that last line of thinking. So, if you take the consolidated results that you provided in the second 8-K this morning, before talking about the incremental depreciation of higher interest expense, the base is, call it, $0.95, take into account the $50 million of dis-synergies and to $0.90. Is that roughly what we should be thinking about as the earnings base before the decline in 2017?

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

We are not going to go into any guidance on that. But I think you should really come back to the previous statement I made, which are that you should factor into the way you should look at it, the additional depreciation, the interest line, the tax line, and the $50 million dis-synergies based on what we have seen in FY16. I think that will give you the answer to your question.

Mark Astrachan - *Stifel Nicolaus - Analyst*

All right. And then switching back to the sales growth numbers, could you talk about how both the legacy business and the Proctor brands are doing on an expectation basis in terms of that real improvement? And, in particular, if you look at the results that you disclosed in that same 8-K, Proctor brands looked like they were down marginally compared to the Coty business. So, is it fair to think that the Proctor business is performing better on whole than the Coty business?

And then just going back to the previous commentary, how then should we think about where the greatest relative improvement is going to come from on a go-forward basis, meaning through the year to that real improvement?

Bart Becht - *Coty Inc. - Chairman of the Board*

I'm not sure the P&G improvements on an underlying basis in terms of consumption is better or worse than the Coty business over the last 12 months. And if you look at it over a longer period of time, the trends are very similar. And we are still looking at the P&G businesses in detail, in particular also at the trade inventories which have been created on this business over the last couple months.

In terms of going forward, I come back to what I said before. On professional, we see basically continued good momentum and we believe that the incorporation of OPI will benefit OPI. So, we feel positive about professional.

On the luxury business, we believe that, based on what is coming to the market under the key brands, which are anywhere from Gucci, Calvin Klein, Hugo Boss, and a few smaller ones, we believe there should be improved momentum on the luxury business, with the main challenge remaining on the consumer beauty business. And there, there are several brands which are key, which is clearly COVERGIRL, Max Factor and Sally Hansen. Those are the three brands where we are working very hard in terms of improving the momentum.

And here we believe this will take a bit longer than the statements we've made just about luxury, and we are working on that. But we will have a much better understanding of these brands already when we come back on the call in February.

Operator

Joe Lackey of Wells Fargo Securities.

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

Real quick, just to clarify on the guidance, first off, on the $1.53 in 2020, I think you were pretty clear, Patrice, that getting to that number didn't require any improvement in the underlying business. Now it seems like, given the first-quarter results, that you do expect needing improvement in the underlying business in order to hit that $1.53. I just want to clarify that.

And then, also, on the second-half guidance, in the press release announcing the deal it reiterated that you were looking for growth in the second half, and now you're only looking for improvement in the recent trends. I just want to clarify that you aren't expecting any growth in either legacy Coty or P&G beauty in the second half. Thanks.

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

On the first one, what we said at the time is that the merger benefits, the mechanical impact of the merger benefits, would deliver $1.53, and that this does not reflect improvement on the underlying business or the Hypermarcas transaction. What we are saying now is that we are going to achieve at least $1.53 and that is on the combination of the merger benefits and on the line business improvement. But the emphasis that is on, that we are going to achieve at least $1.53. And that's the statement we are making.

In terms of the statement for the second half, we have to make a statement on the combined entity business for the second half because we own all the brands and not half to brands. So, it would be irrelevant just to make a statement about just the Coty business no matter how positive we might feel about this. So, the statement is the statement.

We own the business now for six weeks and we've only been able to dig into the business in all its details for six weeks, so we cannot make a statement beyond that. It's just not possible. None of you on the call would do that because you don't have enough understanding of the business. So, it is not possible to make a different statement than that.

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

Did your outlook for the legacy Coty business change for the second half then?

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

No, we are not going to have this discussion because it's an irrelevant discussion. We are making the statement that is in the press release.

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

Okay. And then just one question on the Fragrance -- obviously very weak. Can you maybe go into some of the drivers? Obviously you mentioned the inventory decline in the wholesale channel, but it sounds like maybe that was impacted by the distraction. I think you mentioned that. So, I'm a little bit confused on who is driving that inventory decline in wholesale. Maybe were you guys proactively accelerating your pullback in the non-core brands? Maybe just a little bit more detail there. Thanks

Bart Becht - *Coty Inc. - Chairman of the Board*

I would say, on the Fragrance brand, we have continuous effort basically to gradually clean up some of the wholesale or gray market inventories in order to strengthen the equity of the brands, which clearly, when people are distracted and changing jobs, if anything, that accelerates on its own for a very simple reason -- when people aren't there for a while or changing jobs or in between things, some of the business goes away automatically. So, yes, there has been an acceleration of the decline in the wholesale inventories.

Operator

Dara Mohsenian of Morgan Stanley.

Dara Mohsenian - *Morgan Stanley - Analyst*

Hey, guys, the first one was just on M&A. Patrice, can you give us detail on when you expect to earn your cost of capital in the P&G deal, or what level of returns you're expecting on the deal through FY20/

And then, Bart, you emphasized in the release that you'd continue to participate in industry consolidation going forward. As you look back on M&A historically over the last few years in terms of TJoy and philosophy, the Avon bid, perhaps even P&G so far, a bear could quibble that acquisitions haven't worked out that successfully in terms of driving shareholder value. So, any thoughts on your ability to add value going forward and what the past, how that informs that ability. Thanks.

Bart Becht - *Coty Inc. - Chairman of the Board*

Clearly we have just confirmed basically the benefits of the merger with P&G. And based on that, clearly we would expect a return which is very attractive and well ahead of the cost of capital because otherwise we would not have done the transaction in the first place. So, we just confirmed to you basically all the underlying financial assumptions which makes this transaction very attractive. That's on the P&G deal.

On the Hypermarcas deal, you have seen, and we have seen, very positive results, both in market and financially, and we are very confident about that. The same for the Bourjois deal, the same for OPI, the same for Manhattan, the same for philosophy. They are all basically good transactions. The one which you could argue with is the TJoy transaction in China, which was a complete debacle. So, I would agree with you, but that's like one out of half a dozen transactions.

Dara Mohsenian - *Morgan Stanley - Analyst*

And what year are you expecting to earn your cost of capital in terms of returns from the P&G deal?

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

No, we are not going there because going to have to practically outline to you all the underlying basically profit and cash flow assumptions, and we are not going to do that here.

Dara Mohsenian - *Morgan Stanley - Analyst*

Okay, thanks.

Operator

Jason Gere of KeyBanc Capital Markets.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Thanks. Just two questions. One, maybe just continuing on the M&A but the other side. I think you've talked about potential asset sales. So, just with some of the recent performances I'm wondering if there are any other brands that may not fit the Combined Company? Just wondering if you could provide any color in terms of the portfolio rationalization.

Bart Becht - *Coty Inc. - Chairman of the Board*

We have previously announced that we would divest 6% to 8% of the combined entity portfolio. We have pretty much finalized the list which sits behind that. We are working basically on the process which is associated with that. We remain convinced that we will make this announcement regarding the divestiture well ahead prior to the end of the year. The process is pretty much on track and will unfold itself in due time.

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

So, there is no change.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Okay. And then the second question, just going back to the innovation, with 15 months of knowing this combination was coming, can you maybe talk about some of the cross collaboration opportunities that are out there between Coty side, P&G side, where you see learning from best practices, just maybe, on a more upbeat note, thinking about the opportunity for really enhanced innovation that comes through over the next couple of years?

Bart Becht - *Coty Inc. - Chairman of the Board*

There's a number of very clear benefits other than the pure cost and cash benefits that Patrice already has outlined. Just to give you some very clear examples of that, first of all, there is the geographical benefit. In a number of countries, either party or both parties were relatively marginal players and combined they are basically critical mass players. Countries like Mexico, et cetera, are classic examples of this. So, we will have a real infrastructure to build from.

That clearly is only going to really materialize post the actions of transitional service arrangements, implementing all the restructuring programs, et cetera. But there is a real benefit that we can build off that.

We will have the benefit of moving, as part of that, from distributors into full-fledged operational entities, which there is a clear benefit, for sure, on the top line but also on the bottom line from doing that, moving out of these distributors. There's the benefit of OPI brand being managed by the professional division, which there is a clear benefit of that because Coty only had a skeleton infrastructure to manage that and I believe that it's a very good news for OPI on a global basis for it to be managed by the professional business.

There are benefits in terms of cross-fertilization on the R&D side. P&G has certain skill sets in terms of fragrances, which Coty doesn't have; and Coty has certain skill sets in the R&D, particularly in the packaging area, which P&G doesn't have. So, there's a clear synergistic benefit between the two. Clearly there is best practice benchmarking in terms of cost of goods and manufacturing and operating costs, which is starting to happen, as we speak So, there are clear basically benefits in these areas, as well.

In addition to that there are clearly all the financial benefits from a procurement point of view, which we already alluded to. There are synergistic benefits, in particular, I would say, in R&D, in manufacturing, in basically go to market, and in terms of scale and emerging markets.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Okay, great. I appreciate the update. Thanks.

Operator

Linda Bolton Weiser, B. Riley.

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

Thanks. I was wondering if you could give some color on whether your product line rationalizations have started already in earnest. And is there any way to quantify the impact of that on the negative 8% like-for-like sales growth in the quarter?

Bart Becht - *Coty Inc. - Chairman of the Board*

Product rationalization, are you talking about divestitures?

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

Yes, I thought that even apart from divestitures you were looking at pruning SKUs and certain product lines, maybe even exit, apart from the divestitures.

Bart Becht - *Coty Inc. - Chairman of the Board*

No, that is not a main focus of the business for design meetings. Divestitures, yes. We are pruning the portfolios from a number of brands point of view, which is leading to the 6% to 8% divestiture program. But there is not basically, other than the normal churn which we have in this is anyway, because there is a substantial number of SKUs which get replaced every single year, the pruning happens every year. You create new SKUs and you prune old ones. That is part of the beauty industry.

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

Okay. And then I think when you had originally talked about the synergies and were giving more information, in the first year there's really not net synergies being realized because there's some investment. Can you give some idea as to what the cadence of that investment will be like as we progress through the fiscal year? Is it going to hit right away or is it going to take a while to figure out where those investment things need to occur?

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

On the synergies in year one, what we said is that we have $300 million synergies, which was the combination of the $350 million gross synergies minus $50 million of dis-synergies. This $350 million of gross synergies were due to the carveout and then being transferred. What we can see is that clearly this amount that has been transferred to us is lower because P&G has actually anticipated some cost savings already on their structure.

As we are now, as we speak, we are firming up the phasing of the synergies as we balance our focus on driving long-term margin improvement while we need to improve the growth trend of the business. This being said, we are not far from the $300 million. And we clearly confirm that we are targeting our realizing the $750 million in the next four years.

Operator

Lauren Lieberman of Barclays.

Lauren Lieberman - *Barclays Capital - Analyst*

I just wanted to follow up on the restated financials, if there's any time lines for when you are going to be giving those to us with the new segments.

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

Actually what we've done so far, Lauren, is that you have a form 8-K when we have shared the top-line momentum in FY16 as well as the profitability on the combined entity and the profitability of P&G and Coty. So, you can see that the adjusted operating margin of Coty is 14.3% and the P&G specialty business is 7.6%. That information that we have already given, I think that was already a help for you guys. On the combined, I think that's going to be another couple of months before we can share that.

Lauren Lieberman - *Barclays Capital - Analyst*

Okay. So, it will be a couple of months before we get the new segment breakdown.

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

No. The new segment breakdown will be at the occasion of our next earnings call.

Lauren Lieberman - *Barclays Capital - Analyst*

Okay, perfect. That's what I needed. Thank you so much.

Bart Becht - *Coty Inc. - Chairman of the Board*

Very good. And I just thank all of you for being on the call. It's been a good discussion. The future for Coty remains very bright in my mind. And I'm very happy that we have a new team in place, welcoming Camillo, basically, as the new CEO. I'll be a listener at the next call when you can ask him all the questions in February. So, thank you for being on the call. Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program and you may all disconnect. Have a great day, everyone.

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