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# EDITED TRANSCRIPT

COTY - Q2 2018 Coty Inc Earnings Call

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## OVERVIEW:

Co. reported 2Q18 net revenues of \$2.6b and adjusted net income of \$237.2m or \$0.32 per share.



FEBRUARY 08, 2018 / 1:00PM, COTY - Q2 2018 Coty Inc Earnings Call

## CORPORATE PARTICIPANTS

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

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

**Patrice de Talhouët** *Coty Inc. - CFO*

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**Wendy Caroline Nicholson** *Citigroup Inc, Research Division - MD and Head of Global Consumer Staples Research*

## PRESENTATION

### Operator

Good morning. My name is Crystal, and I'll be your conference operator today. At this time, I would like to welcome everyone to Coty's quarterly earnings call. (Operator Instructions)

I'll now turn the conference over to Mr. Monaco. Mr. Monaco, you may begin your conference.

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

Good morning, and thank you for joining us. On today's call are Camillo Pane, Chief Executive Officer; and Patrice de Talhouët, 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. All commentary on organic net revenues reflect the comparison of combined net revenues at constant currency in both the current and prior year periods, excluding the impact of acquisitions other than the acquisition of the P&G Beauty Business. 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 can find the bridge from GAAP to non-GAAP results in the reconciliation tables in the earnings release.

I will now turn the call over to Camillo.

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### **Camillo Pane** - Coty Inc. - CEO & Director

Thank you, Kevin, and welcome, everyone to our fiscal 2018 second quarter earnings call. Q2 was a very strong quarter marked by Coty's return to organic top line growth. We delivered excellent growth in Luxury, an acceleration in positive momentum in Professional Beauty and a significant improvement in Consumer Beauty. This healthy net revenue performance, coupled with continued improvement on the cost structure resulted in significant improvement in profits. I'm very pleased with these achievements and the progress made so far. However, there is still much work to be done before we achieve the consistent results that we seek as we still need to relaunch many brands, deliver our synergies and continue with our integration of the P&G Beauty Business.

Moving on to our divisional performance, the Luxury division delivered outstanding 8.1% organic net revenue growth, marking the fourth consecutive quarter of very strong growth. This excellent performance was fueled by the continued success of our innovation pipeline, including several new launches leading to growth in all geographies, particularly in Travel Retail and ALMEA.

We continue building on 2 successful major new products introduced in the first quarter: Gucci Bloom and Tiffany's debut fragrance. I'm extremely proud that Gucci Bloom was one of the top-ranked fragrance launches in the Middle East, Africa and Asia. In China specifically, Bloom was the #1 fragrance launched in the country. In the U.S., Bloom also continued its excellent performance achieving a national top 10 woman's fragrance ranking in terms of sell out during the week of Christmas.

Our debut Tiffany's fragrance continued to perform exceptionally across all regions, achieving a top 3 new-product ranking in most of the doors we launched, an incredible accomplishment for a new brand just introduced into the market last quarter. Tiffany's strong results, particularly in the U.S., Asia and travel retail are extremely encouraging.

Separately, I'm thrilled to announce that philosophy's Purity Pore Extractor Mask was the #1 Prestige skincare launch in the U.S. in 2017. This is another tremendous accomplishment by the Luxury team.

Other highlights in Luxury include successful campaigns for Chloe Signature and CK ETERNITY with strong sell-through in several major markets. Our strong performance demonstrates Coty's expertise in developing and bringing Luxury beauty brands to market and speaks to our ability to successfully execute our strategy.

The acquisition of the iconic Burberry brand, closed this quarter, complements Coty's already strong Luxury portfolio. Our go-to-market strategy for Burberry is evolving as we move the brand from a third party distributor network to a direct go-to-market strategy in most markets. As expected, we have a high level of inventory that we have to work down, so the second half is anticipated to be a period of transition as we continue to integrate the brand into our Luxury portfolio.

In our Professional Beauty division, net revenue increased 2.0% organically, marking the fifth consecutive quarter of positive growth. OPI returned to growth globally, growing double-digit in every geographic region. Both gel and lacquer grew as a result of a very encouraging initial restage of our gel product line and the launch of a new color collection.

Wella Professional sustained its positive performance, benefiting from the recent Wellaplex launch. ghd also posted solid organic results boosted by strong e-commerce performance in its main holiday selling season.

In Consumer Beauty, net revenues declined 1.3% on an organic basis, a significant improvement from the prior quarter and year, and further evidence of a stabilizing trend for the business. It's worth reminding you, though, that Consumer Beauty benefited from a favorable comparison this quarter as the prior year period performance was negatively impacted by transitional issues in parts of the P&G business.

This improved performance against a still weak global mass beauty market provides reassurance that the combination of brand initiatives, improving market execution and consumer-focused communication strategy is supporting the gradual improvement in consumer beauty revenue trends. And it's important to keep the focus of the organization on recovering the market share that has been lost over the last several quarters.



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Consumer Beauty North America remained under pressure, driven by the planned winding down of inventory in advance of our pending relaunches as well as distribution losses from last year, which will anniversary in the second half of fiscal '18. Our European business improved primarily as a result of stabilization in the base business. ALMEA grew strongly and continues to be a standout with double-digit growth across the majority of key geographies. In Australia, we saw growth in Color Cosmetics and a return to growth in hair driven by excellent in-store execution. In Mexico, we continue to gain share in retail hair achieving the highest share in 3 years as well as category captaincy in about 80% of the retailers where we are present. In Brazil, we also continue to gain share despite aggressive pricing strategies from competitors.

China's above-market growth is attributable to our new route-to-market strategy, to our own affiliate structure, the pipeline of country-specific innovations and a strong focus on e-commerce.

We have strong plans for several Consumer Beauty brands in the second half of fiscal '18, including COVERGIRL, Clairol and Max Factor among others. For COVERGIRL, the products and fixtures are just now beginning to be rolled out in the different retailers across the U.S. As a reminder, most of the U.S. retailers begin their annual spring shelf resets in mid January and continue into our fiscal fourth quarter. It's important to note, that all of our plans would be set in tune with the trade windows that are prepared by the retailers. Over the next few months, consumers would see new positioning, new creative, new packaging, new innovations and new store appearance for COVERGIRL.

In the second half of our fiscal year, we're also undertaking a profound relaunch of the Clairol brand and its key pillar Nice 'n Easy. The relaunch includes revisiting and refocusing a compelling and consumer insight-driven purpose in line with the roots of the brand, launching a new damage blocking technology, revising the architecture of the brand portfolio and addressing growth segments such as maintenance and artistry. The early feedback is very positive so far, and I look forward to sharing additional updates with you in the second half of fiscal '18 as new products and fixtures are fully rolled out onto shelves.

So, though Q2 has shown improvement for Consumer Beauty, it will still take time for the full recovery of the Consumer Beauty business, and results are likely to be uneven from quarter-to-quarter.

Now I would like to provide a brief update on the key growth pillar for the new Coty, which is the acceleration of our end-to-end digital transformation, including e-commerce. With Beamy's help, Coty continues to push the envelope on innovation in digital. In the second quarter, we launched artificial intelligence-powered tools on Boots.com in the U.K. which helps consumers select fragrances. And as of yesterday, on COVERGIRL.com in the U.S., users are now able to try on products virtually before purchasing them.

Secondly, we have teamed with Amazon to launch Let's Get Ready, a new visual skill designed for Amazon Echo Show. Let's Get Ready is a personalized beauty offering tool that can deliver up to over 2,000 unique combinations of hair, eye and skin cover curated looks and visual tutorials, along with recommended products from Coty's Consumer Beauty portfolio that users may add directly to their Alexa shopping lists.

Lastly and most importantly, all 3 divisions have seen strong and accelerating double-digit growth in e-commerce revenues year-to-date, ahead of market growth.

Yunique continues its very strong performance with double-digit sales growth in the quarter, with several countries increasing to triple-digit rates including France, Germany and Spain. As of December, Yunique has over 230,000 active presenters and over 20% increase versus the prior year. Now in its fifth year, Yunique continues to distinguish itself as a disruptive peer-to-peer pure-play e-commerce beauty platform with a highly scalable technology platform.

Across each of our businesses, we continue to see the positive results directly linked to our growth strategy, as discussed in previous quarters. This strategy includes relaunching new brands, actively engaging with retailers to amplify the in-store shopping experience to drive category growth, working on accelerating our time-to-market with on-trend collections and new products, accelerating our end-to-end digital transformation and driving our e-commerce efforts.

I told you that fiscal '18 will be a year of stabilization, and this is what our results have shown so far. There is still much to do as we need to relaunch many brands, deliver our synergies and continue with our integration of the P&G Beauty Business. We still have work to do here. I remain confident

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that the real progress we've seen year-to-date, coupled with our commitment to our growth strategy, will continue to move Coty gradually onto the path of full recovery.

Based on the much improved results to date, we have refined our revenue growth objectives for the remainder of the fiscal year. While revenue recovery will not be a straight line, we now aim to deliver positive, but modest, organic net revenue growth for the second half of the year. For margin, we continue to aim for a healthy improvement in the second half of the year versus the prior year, with most of the impact coming in Q4 as we continue to deliver on our merger synergies.

I will now turn the call over to Patrice.

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### **Patrice de Talhouët** - Coty Inc. - CFO

Thank you, Camillo, and good morning, everyone. Q2 was another quarter with solid results that gives us tangible signs that our strategy is starting to bear fruit. Our second quarter net revenues were \$2.6 billion, a 14.8% increase versus last year, including our acquisition with our organic net revenue growing a good 2.8% versus prior year.

Adjusted gross margin was 61.6%, a 200 basis point decrease year-over-year, attributable to the positive momentum in our emerging market Consumer Beauty business, which has lower gross margins, as well as the comparison to favorable impacts in the second quarter of fiscal '17 following the P&G Beauty Business acquisition.

Fixed cost control continues to be a priority of the company. As a result, our efforts continue to show progress and combined with the good revenue momentum, is fueling an adjusted operating income of \$347.5 million, or a 12.8% increase year-on-year, which represents a profitability of 13.2% of net revenues.

We have recorded this quarter an adjusted effective tax rate of 10.3%, which has been positively impacted by \$41.8 million of tax benefits upon settlement of certain tax positions.

And now a few words on the Tax Cuts and Jobs Act, which was enacted in December. Our current mix of profitability across the regions means that we expect a neutral impact from the tax rate change. As a result, we expect the adjusted effective tax rate for fiscal 2018 to remain at approximately 27%, excluding any one-time items. It is fair to say that in the future, the average tax rate could be positively impacted if the profits in the U.S. improve. We estimate that the "one-time deemed repatriation tax" to be neutral for Coty for both cash and P&L purposes, through the use and revaluation of deferred tax asset and liabilities.

The adjusted minority interest of \$17.3 million reflects the positive momentum of our partnerships, especially Younique, that we expect to continue in the second half.

All of the above resulted in adjusted net income of \$237.2 million, or an equivalent adjusted earnings per share of \$0.32.

Despite the high season that is usually working capital intensive for us, our continuous focus on cash is driving a healthy free cash flow generation of \$196 million this quarter, which bodes well for our intention to deleverage the business over time. During the quarter, we used existing cash on hand to acquire the Burberry Beauty license, as well we repaid more than \$320 million in debt.

Let me add a few details on our performance per division. First, in Luxury, our gross margin has improved year-on-year, thanks to accretive innovation and good productivity improvement in the supply chain. This, combined with a tight management of our cost structure, resulted in an operating income increase of 28.6% versus prior year despite the initial costs incurred for our Burberry license acquisition.

Our Consumer Beauty division has lifted its profitability by 19.4% versus last year to \$131.9 million, or 11.6% of net revenues, thanks to the good contribution of Younique as well as strong cost discipline.



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As far as our Professional division is concerned, the operating margin has been very healthy in Q2 at 16.5% on the back of a strong holiday season for ghd as well as tight cost structure management for the overall division. It is also worth mentioning that the operating income decline in Professional of 9.8% versus prior year is due mainly to go-to-market changes in OPI to strengthen our position in some key European markets.

We are still very much focusing on progressing on the integration of the P&G Beauty Business and realizing our synergies. I am pleased with the overall progress of the integration efforts as this is helping us to become much more efficient and will simplify our operating model. I am also pleased to report that our synergy delivery is on track to reach our \$750 million target over time.

Regarding our rationalization program, whether via divestiture or via discontinuation, it is fair to say that we are making progress, and we are on track with our expectation to announce before the close of fiscal 2018. As already mentioned, these initiatives should help to improve our revenue growth trajectory over time, while being dilutive to our profitability on a short term basis. We will elaborate further in due time.

To conclude, although there is still much work to be done, this quarter has been another milestone in the right direction with good financial performance that gives us confidence in our objective to deliver modest organic net revenue growth for the second half as well as healthy operating margin improvement in the second half of the year versus the prior year, with most of the positive impact in Q4.

Thank you. We'll now open the call for questions.

## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) And our first question will come from Olivia Tong from Bank of America Merrill Lynch.

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

Want to start with sales. I understand the revenue progression won't be a straight line but it's nice to see the fragrance acceleration and the change in Consumer Beauty nonetheless. So first on Luxury, were there any particular areas that stood out? Obviously, we know that Gucci and Tiffany were very strong, but was there shortage in travel retail or China or any other area relative to your expectations, or was there fairly strong performance across the board? And then on consumer, obviously lots going on in terms of the COVERGIRL launch, is there a need to clear inventory as you had discussions with retailers regarding COVERGIRL? What are they thinking? Are they swapping out the old for the new? Have you been able to get incremental shelf space in your existing doors or back into the doors that you've lost in the first place? And also do you expect to grow the market, while you do this?

### Camillo Pane - Coty Inc. - CEO & Director

Thanks, Olivia, for the question. Regarding the first one on Luxury, we feel very pleased with the performance of the quarter. There are -- the growth has been, I would say, positive and very good across all regions -- all the 3 regions. The one that stands out actually is ALMEA, so our emerging markets, and also travel retail. China has been clearly a country where we had very strong performance, both with some of the brands that we have in the portfolio like Marc Jacobs and Chlo  , but especially with the launches. So Bloom, I mentioned in the call that it's one of the top -- it's the top launch actually in China. And what I can tell you that actually Tiffany in China was launched just 11 days ago because of the Chinese New Year and the team just informed me that actually Tiffany, in the last 11 days - clearly with investments because we're in the launch period-but it is the #2 fragrance brand in China in the last 11 days. So this clearly speaks very highly about the strength of the brand but also the quality of the launch that the team is having in Luxury. And travel retail is also another area where we continue to have very strong performance in Luxury ahead of how the market is performing in travel retail, so that's definitely another highlight.



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Your second question was about COVERGIRL. So look, we are in the middle of basically resetting the shelves, so we have new positioning, new creative, new packaging and new set of innovations. And we now have reset the shelf in 3 of our top -- 4 top retailers in the U.S. and the last one is going to start in late February, early March, but the shelf reset initially just happened from mid-January onwards, so it's just a couple of weeks. And what I just want to mention is that the overall shelf space for COVERGIRL will remain flat, which for us is positive news after many years of shelf space distribution declining, all decisions which were taken prior to the merger. And we are excited about the plans that we have for COVERGIRL, not only for the innovation but also for the repositioning, so how COVERGIRL will look on the shelf and the new media, the new creative. Early signs are encouraging. We only have a week of data and a couple of customers, but, clearly, we have seen some improvement in the performance and therefore we are, of course, encouraged by that. And the other elements that I can say that when we went on air with the new creative in the months of November and December, although the shelf resets had not happened, we saw a significant spike in the sales of the product franchises which were put on air. So again, that's another positive sign that is encouraging for the coming months. It's clear that we expect an improvement more towards the -- at the end of the second half of 2018 for COVERGIRL.

### Operator

Our next question comes from Joe Lachky from Wells Fargo.

### Joseph Bernard Lachky - Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst

So first I just wanted to clarify your outlook on the top line. Previously, you'd said flat organic sales growth, and in the release you're calling for modest net revenue growth. So kind of going from organic to net. And I don't know, Camillo, maybe you mentioned organic; Patrice, you mentioned net revenue. I'm just ultimately -- is there any change to your organic sales outlook here in the second half?

### Camillo Pane - Coty Inc. - CEO & Director

Thanks, Joe, for the question. Yes, basically, based on the improved results that we've seen in Q2, we have slightly refined our organic net revenue growth objectives for the remainder of the fiscal year. And although net revenue recovery will not be a straight line, we now aim to deliver organic positive, but modest, net revenue growth for the second half of the year. So from a top line point of view, we have slightly refined our objective for the second half and yes, on an organic basis, just to clarify your question. On the other side, on margin, we just continue to aim for healthy improvement in second half versus the prior year with most of the impact coming in Q4 because it's in Q4 that we will continue to deliver on our merger synergies. And this objective has not really changed versus what we mentioned in the prior call.

### Joseph Bernard Lachky - Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst

Okay, that's very helpful. And then, I guess, my main question on Consumer Beauty, obviously, much improved this quarter. Can you quantify maybe how much of that was like a comp issue just the easier year-over-year comparison because it doesn't seem to be much improvement in the U.S. track channel data. So I was just wondering if you have any confidence that underlying results are improving here, and you could see continued improvement in the second half?

### Camillo Pane - Coty Inc. - CEO & Director

Yes, okay. Look, so to answer your question, Consumer Beauty declined 1.3%. We believe this is an improvement versus prior quarter and also versus year ago. And the business is stabilizing and is having improvements in several areas. Absolutely, what you mentioned is correct, which is that we do have a favorable comparison versus the prior year quarter, which was negatively impacted by the P&G transitional issues. But at the same time, this quarter, we have intentionally held back sales on a couple of big brands like COVERGIRL and Clairol in the U.S. because we wanted to make way for retailer shelves to replenish a bit of stock before our relaunches. So if you consider these 2 factors, we believe that we have sequential improvements this quarter versus the previous quarter in Consumer Beauty. Now there is another point, I think you mentioned, which is the Nielsen data in the U.S. What I would like to point out is that the U.S. data from Nielsen represents around 10% of total Coty consolidated net



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revenues, so this is because clearly of the size of our U.S. consumer business of the coverage and also the fact that Nielsen doesn't fully cover online and some specialty channels, which continue to grow. So if you look at this fact, we do have 90% of the company net revenues, which are not covered by Nielsen U.S. data. And also I don't think we should also point out that we are growing double-digit in ALMEA in our emerging markets across all the 3 divisions. And ALMEA is not really covered properly by Nielsen, nor NPD as a matter fact.

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### Operator

And our next question comes from Faiza Alwy from Deutsche Bank.

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

So just a couple of questions from me. First of all, Camillo, could you talk about the increase in the organic growth estimate for the back half? And if there's one particular thing that's driving it or if it's a combination of several factors, so is it sort of your improved outlook on COVERGIRL? Is it ALMEA? Is it Luxury? What's driving that improved outlook in the back half? And then, just secondly, if you could comment broadly on how you think about direct to consumer because I thought it was curious sort of the new website that you launched yesterday for COVERGIRL, the Try It website that you decided to go with Walmart for that particular item. I just thought that was curious, if you could maybe comment on that and just how you think about DTC broadly?

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### Camillo Pane - Coty Inc. - CEO & Director

Yes, thanks, Faiza. Regarding the outlook. As you know, we don't give outlook by division, but I think it's fair to say that to achieve our overall objectives to help modest positive growth in the second half, this relies on Consumer Beauty having sequential improvement in the second half of fiscal '18. So I think that's probably sufficient to explain also, if you consider the continuous growth on Luxury and Professional Beauty, and you look at what I just said on Consumer Beauty, that probably explains why we've slightly refined our outlook for the second half. Regarding the direct-to-consumer, I think what is important to point out is that we are definitely seeing a much stronger focus on e-commerce since we have announced now few months ago that we were going to change drastically in the focus on e-commerce within the organization. So we're seeing excellent acceleration and double-digit growth ahead of the market in all the 3 divisions in e-commerce. And we are working very hard on digital innovation, which is an area, which we're putting a lot of focus with the help of our agency, Beamly, and when we announced the COVERGIRL, it's absolutely a way to increase connection with consumers and clearly also conversions. And the partnership with Walmart is a very strong partnership. Walmart is a very important customer for us. And in the case of this innovation on COVERGIRL, we have stuck with this partnership for virtual makeup look try on the new COVERGIRL website. But as I mentioned in my script, we have another partnership on fragrance with Boots.com and clearly we have many added with our customers, which we'll not mention at this time, but they are under work. So it's -- I would say, it's a wider type of acceleration on digital innovation.

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### Operator

Our next question comes from Wendy Nicholson from Citi Research.

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### Wendy Caroline Nicholson - Citigroup Inc, Research Division - MD and Head of Global Consumer Staples Research

I know you talked a little bit about the moving pieces of gross margin versus operating margin. But can you just remind us, number one, do you have a long-term target for gross margin? And sort of directionally, obviously, we know the margin split on the operating margin side across the segments. But how different are the gross margins by segment as well?





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**Patrice de Talhouët** - *Coty Inc. - CFO*

So thanks for the question. So on the gross margin, first, we don't give an indication of gross margin by division, and we don't also give any indication on our long-term target. This being said, it's fair to say that if we want to achieve the high teens of operating margin that we have declared already a few quarters ago, we're going to have to work on our gross margin, and it will be positively impacted by the synergies or so. Now on this specific quarter, what I would like to point out is a couple of things. First, this quarter is not indicative of our future gross margin expectation, particularly as our synergies are realized. Second, there is a decrease of the gross margin by 200 basis points, which is attributable to the positive momentum, as we said, of our emerging market in Consumer Beauty business, but also as comparison to favorable impact in fiscal '17. What I mean by this is that we inherited from a balance sheet, a positive manufacturing variance due to the very high volume that was triggered in Q1 last year and that we released in the Q2 fiscal '17 books of Coty. And so that really has created a positive impact in the gross margin in fiscal '17. So that's really the 2 that make up the bulk of the explanation. There's also a small explanation that has to do with the fact that we are doing all these new launches in Consumer Beauty, especially COVERGIRL that has a slight effect on the gross margin with a reset. So -- but once again, it's very important to point out that this quarter is not indicative of future gross margin expectation.

**Wendy Caroline Nicholson** - *Citigroup Inc, Research Division - MD and Head of Global Consumer Staples Research*

And just following up on that. So as the COVERGIRL relaunch, and we get Clairol and Max Factor, and other things as we go through the course of the year, is the promotional activity expected to tick up? I'm just wondering how much of a pressure on gross margin that might be in the second half.

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

Look, we have strong promotional plans for, I would say the 3 major brands we're relaunching, which are the ones you mentioned, so COVERGIRL, Clairol and Max Factor. But we don't expect overall a total company to have an effect on gross margin that is significant by the, I would say, additional strong effort. Without any doubt, in what we expect is clearly a strong investment behind these brands for the second half of '18, as you would expect. We will relaunch them across different markets and in different parts of the brand itself with the retailers. And therefore, there will be strong investment.

**Operator**

Our next question comes from Shannon Coyne from BMO Capital Markets.

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

Can you talk about the progress you're making with the influencer community, specifically, in COVERGIRL. I know you're replacing 25% of the product line with new products. Do you think that's enough? Have you gotten any feedback from the influencer community on that? And then secondly, I was just wondering if you could give us an update on any entry into the prestige cosmetics market with Gucci and Burberry in China or in the U.S.?

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

In terms of the innovation that we have in COVERGIRL, we have strong feedback, in general, from consumers. As you can imagine, we do extensive testing as well before deciding where to allocate our investment and of course what to launch. And so when I think about the Vitalist Foundation or the Katy Kat lip gloss or the 305 mascara, they all been received positively and that includes also influencers. Within our process we always work with the influencers and actually, we are strengthening our effort to do partner with influencers in the preparation of launches as well as, of course, in our communication strategy. Regarding the prestige cosmetic market, so in Luxury, we have 2 brands where we're playing in prestige cosmetics,



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so that's Gucci prestige cosmetics and now we also have Burberry within our portfolio, and it's fair to say that we're going to work on strengthening our plans on these 2 brands over the next quarters.

### Operator

Our next question comes from Mark Astrachan from Stifel.

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

Wanted to ask about how we should think about current debt levels and the time line for deleverage, including -- so you can you give some color into expectations as we head into next year, maybe relative to some of the investments that you had outlined about a year ago in terms of how to think about cash conversion. And then I guess more broadly, even with some paydown, debt levels are still going to be pretty high relative to perhaps some other companies, I suppose. How do you think that about from a flexibility standpoint to go out and do meaningful M&As you've talked about? And would you consider creative solutions I suppose in terms of being able to pay out debt or do deals in the future?

### Patrice de Talhouët - Coty Inc. - CFO

Thanks for your question, Mark. So as you know, we are not going to comment on our M&A journey and on potential structure. What I can comment is on our current level of debt and the leverage. So first, you will have noticed that in Q2, we have already paid down \$320 million of debt. So this is a clear signal that we are sending that we are very much focusing on deleveraging the business. This being said, the current leverage that we have is at 4 times. That gives us still some flexibility. But it's very important to point out, as I've already mentioned in the previous quarters, that one of our focus for the time being is to deleverage the business, and so we have started to that in Q2, and we keep on doing that in the coming years.

### Operator

Our next question comes from Lauren Lieberman from Barclays.

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

I wanted to ask a little bit about emerging markets. So the performance this quarter was obviously great and some of it, I think, hasn't really been discussed much before as an enormous area of focus. So I was hoping, one, if you could share with us roughly how big China is now? I know Max Factor launched on JD.com in the fall. Was Max Factor a well-established brand already in China or was that really kind of the brand launch? And then also for Bourjois, which I think is going on the JD as well, same kind of question, is that already an established brand or is that really a new launch? And then in Brazil, you'd mentioned price competition and I was just curious if that was from other local players or from more global brands in the market?

### Camillo Pane - Coty Inc. - CEO & Director

Thanks, Lauren. Yes, we're having very strong growth in emerging markets. We're very pleased with it. We have decided to focus much more with our merger on specific countries, and we're seeing very interesting fruits from our investments and the changes we made. I think if I focus on China for a second. First of all, I would like to remind you that we have changed our go-to-market strategy moving from a distributor network to affiliate, so our own organization in both Luxury and Consumer Beauty at the time of the merger, in both divisions, which was very a bold move but definitely is paying the results. And so we are seeing accelerated growth in both divisions. Actually as a matter fact in all the 3 divisions in China.



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Going to your question regarding Consumer Beauty, Max Factor was an established brand in China, but clearly has -- was not necessarily performing well under previous management or ownership, let's say, because also the distributor network that I was mentioning before. So under the stewardship and leadership of our team it is now performing incredibly well, including an acceleration in e-commerce because we have strengthened the capabilities in the area. On the other side, Bourjois is a new brand, which has just got launched in China just a few weeks ago. So this is all new and we have encouraging results from the first couple of weeks. We have seen we have new in-store execution in different department stores and different malls, and so far we're seeing encouraging results. And I also want to mention in the Luxury division, Philosophy, which is also a new brand in China, we launched it on Tmall 3 months ago, I think, it is now, and we also opened a store in Shanghai and results are ahead of expectation. So it's a mix of revitalizing established brands and launching new ones. Regarding Brazil, the comment that I made in terms of competitive pressure on pricing that was referred to the deodorant segments where we have been enjoying very high level of growth and market share gain which clearly has made our competitors both multinationals and local react to our strategy. And this is 2 particular brand, but the main one is called Monange, which I have highlighted in the press release.

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

Okay, that's great. And then assuming that the standout performance in emerging markets this quarter is something that is more than the beginning of a trend, and you mentioned it as a pressure point on gross margins. Why wouldn't that continue? Was there anything particular to the quarter with the mix of emerging markets growth that it was more of an issue?

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**Patrice de Talhouët** - *Coty Inc. - CFO*

So first, Lauren, so on that specific question on the pressure in emerging markets, that is true. This being said, what you need to factor into the equation is that you're going to start to see all the synergies from manufacturing footprint and logistic footprint kicking in and this is going to provide us quite some support in terms of gross margin, point one. Point two, we are gradually premiumizing our business with innovation, and you see that, for instance, in the Luxury segments where the innovations are quite accretive from a gross margin standpoint. Some of our acquisitions are quite accretive from gross margin, if I think about Burberry, for instance. So these are things that we are currently building in order to make sure that we have a premiumization of our gross margin going forward. The other point that I'd like to mention is on this emerging market infrastructure. We have deliberately made the decision to take some hits in some of the previous quarters in terms of cost structure because we were convinced that from a long-term standpoint, we have to capture the growth rate and especially in emerging markets, and we didn't have the right infrastructure. As a result of that, we have built the right infrastructure either by acquisition, with Hypermarcas or organically by going to affiliates and, this is now started to pay off. So it's very, very important that everybody factor that into the equation.

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**Operator**

Our next question comes from Andrea Teixeira from JPMorgan.

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

I just wanted to focus on the advertisement on the back-end of this year. And so are you going to see more reinvestment of the synergies in marketing to support the brands relaunch? So can you give us an update on the pace of the synergies? I understand it's going to be more back loaded into the fourth quarter, but it will be helpful to see how we are going to be seeing that either reinvested or flow into the bottom line. And also a clarification on the previous question. You said that maintaining shelf space intact for COVERGIRL, which is obviously positive but can you comment also on the other brands like Sally Hansen, Rimmel and also including the hair color? And if Coty, as a whole, has been able to maintain shelf space or still be some of the other color cosmetics brand losing space in order to give more shelf to COVERGIRL?



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### **Camillo Pane** - Coty Inc. - CEO & Director

Thanks, Andrea. Regarding the advertising for the second half, it's fair to say that especially on COVERGIRL and Clairol and Max Factor, we will invest more heavily in Q3 and Q4. But overall, when you look at our overall portfolio, we don't expect our advertising investment to drastically go up versus the level that we mentioned in the past of 25%, 26%. The second point that I will cover is shelf space and then I will give -- Patrice will cover synergies. When I look at that shelf space for total Coty, actually in the U.S., we expect our shelf space to be overall flat. And you mentioned a couple of other brands, so I'll cover that as well. On Clairol, we now know clearly because we're in February, all the shelf reset has been decided, let's say, although not fully implemented, but on Clairol we also expected our shelf space to be flat. The same is on Sally Hansen and probably there would be a slight decline on Rimmel, but it's a very minimal, it is driven mainly by one customer, which doesn't represent a big percentage of the brand globally and also in the U.S. And Rimmel, I wanted to remind that 85% of the sales of Rimmel are clearly made in Europe and in emerging markets where Rimmel is a very large brand. So overall, in total Coty, as I said, is flat and for me this is a good performance, and I'm pleased with the achievement of the team because this comes after especially on the ex-P&G brands for many years of shelf space reduction and distribution losses. And as I said, decisions which we've taken prior to the merger which, in the space of 14/15 months, we've been able to revert and stop this decline through the work of the team on the productive campaigns and positioning, and so on. Patrice, synergies.

### **Patrice de Talhouët** - Coty Inc. - CFO

Yes, on the synergies. So the phasing is still the same. So we have -- we are going to achieve 50% of the synergies by the end of fiscal '18, 80% by the end of fiscal '19 and 100% afterwards, by 2020. So this is not changing. What we said also is that Q4 is going to be positively impacted by the synergies being realized. Now on the way, our investment thesis is that the synergies would fall to the bottom line, but it could be that 1 quarter or a couple of quarter, we're going to dial it up in order to be able to fuel the top line. We've done that in the past and this is the right thing to do, so we are going to remain opportunistic. This being said, it's clear that from a manual trend standpoint, the A&CP is roughly at 25%, 26%, but we are going to keep on being opportunistic quarter after quarter depending on how we see the innovation and in order to further fuel the top line if we think this is the right thing to do.

### **Operator**

Our next question comes from Steph Wissink from Jefferies.

### **Stephanie Marie Schiller Wissink** - Jefferies LLC, Research Division - Equity Analyst

Just a quick clarification question on the Luxury segment. I know you talked about several fragrance launches over the last couple of quarters. Can you give us an insight into the pipeline for the second half of the fiscal year? And then I wanted to also follow up on the comments regarding your direct-to-consumer. I think that was largely focused in the Consumer segment and potentially Luxury. But how about the Professional segment, is that an area where you could leverage some of that platform investments and build may be a direct to Professional business like some of your peers, I'm thinking about brands like Wella? Are there opportunities to go direct and maybe work around the traditional distributor network?

### **Camillo Pane** - Coty Inc. - CEO & Director

Thanks Steph. so regarding the Luxury pipeline for the second half, we believe -- I personally believe, that this is strong. We just announced the launch of Chloé Nomade and we just launched actually Gucci Guilty Absolute for female where we have encouraging results from travel retail but also from several department stores with the new campaign on CK One which just got launched and with the continuation of the ETERNITY campaign, which is going well. So there's a lot of things going on. And clearly, there will be more announcement to come, which I will not disclose in this call over the end of Q4. Regarding the direct-to-consumers, as I mentioned, we are seeing accelerated double-digit growth ahead of market across the 3 divisions. Now focusing on the Professional which is the one you mentioned, we have 2 areas where we are investing, which are giving us -- encouraging significant results. One is mywellastore.com, which is our B2B platform where we engage directly with stylists and hairdressers, and we are seeing significant growth in this platform, not only in the U.S. but also in other European markets and other markets where we are launching that, and we of course continue to with a roll out -- we plan to continue with a roll out. And the second one is ghd, ghd has a significant



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percentage of sales net revenues coming from B2C and in Q2, this part of this channel of the e-commerce sales both on the ghdhair.com, but also on the hair retailers and pure players has been very positive. So the combination of both is helping the e-commerce for Professionals to go well as well.

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### Operator

And our next question comes from Jonathan Feeney from Consumer Edge.

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### **Jonathan Patrick Feeney** - *Consumer Edge Research, LLC - Senior Analyst of Food & HPC and Managing Partner*

Just in Consumer Beauty. Is it fair to say that your North America versus international business, just focusing in on North America, was better than your expectations because of the fact that you cited in a couple -- despite some of the actions you took in advance of the COVERGIRL refresh? And as part of that, as we look to the second of the year, would you expect that at some point to inflect positive, because it sounds like you have, in effect, pulled -- pushed out some sales. So should that North America piece really start to turn positive at some point in the next couple of quarters?

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### **Camillo Pane** - *Coty Inc. - CEO & Director*

Thanks, Jonathan. The North American sales for Consumer Beauty in Q2 were definitely affected by an intentional decrease of our inventory. And we decided to do this, which I had mentioned already in the previous call, so it was in our plans to make space and reduce the inventory ahead of the relaunch of COVERGIRL, and Clairol as well. We did that because, clearly, we wanted to accelerate the arrival of the new packaging and the new innovation on shelves across all the different retailers. That said, it's important to remember that we are not doing a hard cut over across all the SKUs for COVERGIRL. We're doing that just for around 25%, which is the innovation. So the rest is going to be a gradual phase in, which will take time. So we don't expect to have all the new SKUs of COVERGIRL with the new packaging, the new look to be across all retailers before Q1 fiscal '19, just to clarify that. So that was your one question. The second part is, could we expect North American sales improving. Yes, of course, we are relaunching the 2 major brand that we have in North America, so COVERGIRL and Clairol, and we do expect a sequential improvement of North America Consumer Beauty in the second half of 2018.

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### **Jonathan Patrick Feeney** - *Consumer Edge Research, LLC - Senior Analyst of Food & HPC and Managing Partner*

But would you expect them to be up year-over-year?

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### **Camillo Pane** - *Coty Inc. - CEO & Director*

As you know, we're launching -- we're making several relaunchees in the same time. So we're putting a lot of investment behind many changes in the same time. But this sequential improvement, we expect at some point on specific brands to bring -- some of the brands to positive growth. But I am not going to comment on the overall North American business, which is a much larger business than these specific brands.

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### Operator

And I'm showing no further questions from our phone lines. I would now like to turn the conference back over to management for any closing remarks.

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### **Camillo Pane** - *Coty Inc. - CEO & Director*

I would like to thank everybody for having attended the call. Thank you very much.



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**Operator**

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

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