

15 May 2014 | 8 pages

Household/Personal Care Products
North America | United States

Coty Inc (COTY)

We Want to Love2Love, but We Still Have Commitment Issues

■ Estimate Change

■ **One Step Forward (as Sales Growth Accelerates) but One Step Back (as Sales Growth Guidance Is Weaker Than Expected)** — COTY's pro forma EPS for fiscal 3Q14 of \$0.22 beat the Street's EPS forecast by 13 cents and our estimate by 12 cents—entirely due to a lower tax rate. The fundamentals of the business were largely as expected, with sales growth of +1% in local currency and operating margin -230 bps YoY. While sales growth improved sequentially in 3Q14 from fiscal 1H14, we were disappointed by mgmt's guidance that they expect fiscal 4Q14 sales growth to decelerate again, and be basically flat YoY. And, while mgmt expects sales "growth acceleration" in fiscal 1H15, they do not expect even then to meet their long-term target of 3%-4%, despite an easy comp to negative local currency sales growth in fiscal 1H14. This is still a business with a lot of top line challenges, both owing to a tough external environment and some COTY-specific issues.

■ **Lowering Our Estimates** — Given mgmt's 4Q sales guidance, and likely higher investment spending to come, we lower our fiscal 4Q14 pro forma EPS to 5 cents from 11 cents. Our new FY14 pro forma EPS estimate is \$0.83 (+2% YoY). While we are modeling 11% growth in EBIT in FY15 (which reflects 2% sales growth and 90 bps of operating margin expansion owing to COTY's cost savings programs), given our expectation now for a much-higher tax rate next year, our new pro forma EPS estimate is \$0.82 (-1% YoY).

■ **Maintain Neutral** — Given our new CY15 pro forma EPS of \$0.88, our belief that COTY should trade at a 20% premium to the market and Citi Research's 15x multiple on the S&P 500, we derive our target price of \$16. This represents less than 15% ETR, such that we maintain our Neutral rating. Overall, while there are some bright spots, notably: (i) prestige fragrance sales and improvements in Skin & Body Care (ex T Joy) sales, (ii) the restructuring program has kicked into a more aggressive mode and (iii) the company is acting with urgency on its new share repo authorization, we think the stock is likely to mark time for a while until the top line meaningfully improves.

Neutral	2
Price (14 May 14)	US\$15.77
Target price	US\$16.00
Expected share price return	1.5%
Expected dividend yield	1.3%
Expected total return	2.7%
Market Cap	US\$6,066M

Price Performance (RIC: COTY.N, BB: COTY US)



EPS	Q1	Q2	Q3	Q4	FY	FC Cons
2013A	0.30A	0.32A	0.17A	0.02A	0.82A	0.82A
2014E	0.28A	0.28A	0.22A	0.05E	0.83E	0.76E
Previous	0.28A	0.28A	0.10E	0.11E	0.77E	na
2015E	na	na	na	na	0.82E	0.86E
Previous	na	na	na	na	0.87E	na
2016E	na	na	na	na	0.91E	0.94E
Previous	na	na	na	na	0.97E	na

Source: Company Reports and dataCentral, Citi Research. FC Cons: First Call Consensus.

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COTY.N: Fiscal year end 30-Jun						Price: US\$15.77; TP: US\$16.00; Market Cap: US\$6,066m; Recomm: Neutral					
Profit & Loss (US\$m)	2012	2013	2014E	2015E	2016E	Valuation ratios	2012	2013	2014E	2015E	2016E
Sales revenue	4,611.3	4,649.1	4,573.4	4,681.5	4,842.7	PE (x)	20.2	19.3	19.0	19.2	17.3
Cost of sales	-1,824.0	-1,860.3	-1,846.5	-1,876.2	-1,935.9	PB (x)	5.0	3.9	4.2	3.6	3.1
Gross profit	2,787.3	2,788.8	2,726.9	2,805.3	2,906.8	EV/EBITDA (x)	12.8	11.8	24.4	9.9	9.0
Gross Margin (%)	60.4	60.0	59.6	59.9	60.0	FCF yield (%)	6.8	4.3	5.3	5.0	5.7
EBITDA (Adj)	633.8	674.5	317.9	756.2	804.1	Dividend yield (%)	1.0	1.0	1.3	1.3	1.4
EBITDA Margin (Adj) (%)	13.7	14.5	7.0	16.2	16.6	Payout ratio (%)	20	18	24	26	24
Depreciation	-145.9	-169.4	-251.5	-257.5	-266.3	ROE (%)	-26.9	13.2	-5.1	18.0	17.4
Amortisation	-100.1	-90.2	0	0	0	Cashflow (US\$m)	2012	2013	2014E	2015E	2016E
EBIT (Adj)	535.9	572.8	505.1	558.8	597.8	EBITDA	633.8	674.5	317.9	756.2	804.1
EBIT Margin (Adj) (%)	11.6	12.3	11.0	11.9	12.3	Working capital	33.2	-168.1	5.9	-60.4	-54.3
Net interest	-89.6	-76.5	-69.4	-72.0	-67.0	Other	-77.7	-42.5	207.0	-201.2	-209.2
Associates	0	0	0	0	0	Operating cashflow	589.3	463.9	530.8	494.6	540.6
Non-op/Except	-629.3	-19.7	2.3	2.1	2.1	Capex	-177.4	-193.9	-205.8	-187.3	-193.7
Pre-tax profit	-331.1	318.7	-0.7	428.9	472.9	Net acq/disposals	-129.1	-31.0	0	0	0
Tax	37.8	-116.8	-42.8	-131.3	-144.3	Other	-27.4	-5.0	0	0	0
Extraord./Min.Int./Pref.div.	-31.1	-33.9	-30.9	-28.0	-28.0	Investing cashflow	-333.9	-229.9	-205.8	-187.3	-193.7
Reported net profit	-324.4	168.0	-74.4	269.5	300.5	Dividends paid	0	-57.4	-76.9	-81.6	-85.7
Net Margin (%)	-7.0	3.6	-1.6	5.8	6.2	Financing cashflow	-97.7	69.0	121.6	116.9	112.8
Core NPAT	300.7	323.2	324.9	318.0	349.7	Net change in cash	98.6	311.0	446.6	424.2	459.8
Per share data	2012	2013	2014E	2015E	2016E	Free cashflow to s/holders	411.9	270.0	325.0	307.3	346.9
Reported EPS (\$)	-0.98	0.42	-0.20	0.70	0.79						
Core EPS (\$)	0.78	0.82	0.83	0.82	0.91						
DPS (\$)	0.15	0.15	0.20	0.21	0.22						
CFPS (\$)	1.53	1.17	1.35	1.28	1.41						
FCFPS (\$)	1.07	0.68	0.83	0.79	0.91						
BVPS (\$)	3.16	4.05	3.76	4.41	5.13						
Wtd avg ord shares (m)	329	373	369	364	360						
Wtd avg diluted shares (m)	385	396	392	387	383						
Growth rates	2012	2013	2014E	2015E	2016E						
Sales revenue (%)	12.9	0.8	-1.6	2.4	3.4						
EBIT (Adj) (%)	23.4	6.9	-11.8	10.6	7.0						
Core NPAT (%)	28.0	7.5	0.5	-2.1	10.0						
Core EPS (%)	12.8	4.3	1.6	-0.7	11.1						
Balance Sheet (US\$m)	2012	2013	2014E	2015E	2016E						
Cash & cash equiv.	609.4	920.4	1,367.0	1,791.3	2,251.0						
Accounts receivables	580.5	622.7	596.9	625.5	612.1						
Inventory	648.3	608.2	487.0	628.4	680.1						
Net fixed & other tangibles	520.5	553.3	507.6	437.3	364.7						
Goodwill & intangibles	3,524.4	3,499.8	3,182.9	3,182.9	3,182.9						
Financial & other assets	300.3	265.6	265.6	265.6	265.6						
Total assets	6,183.4	6,470.0	6,407.0	6,931.0	7,356.4						
Accounts payable	694.6	711.7	570.6	680.2	664.2						
Short-term debt	190.1	40.1	40.1	40.1	40.1						
Long-term debt	2,270.2	2,590.1	2,788.6	2,987.1	3,185.6						
Provisions & other liab	1,891.0	1,512.6	1,512.6	1,512.6	1,512.6						
Total liabilities	5,045.9	4,854.5	4,911.9	5,220.0	5,402.5						
Shareholders' equity	1,041.6	1,509.7	1,389.3	1,605.2	1,848.1						
Minority interests	95.9	105.8	105.8	105.8	105.8						
Total equity	1,137.5	1,615.5	1,495.1	1,711.0	1,953.9						
Net debt	1,850.9	1,709.8	1,461.7	1,235.9	974.7						
Net debt to equity (%)	162.7	105.8	97.8	72.2	49.9						

For definitions of the items in this table, please click [here](#).

Coty Inc

Company description

Founded in 1904 by François Coty, Coty (COTY) is a significant player in global beauty. The company sells products in the fragrances, color cosmetics (including nail care) and skin & body care categories, in more than 130 countries and territories, including the following brands (aka Coty's 10 "power brands"): adidas, Calvin Klein, Chloé, Davidoff, Marc Jacobs, OPI, philosophy, Playboy, Rimmel, and Sally Hansen. The company's annual sales are quickly approaching \$5 bn and Coty's pro forma operating margin is just shy of the low teens.

Investment strategy

We rate the shares of COTY Neutral (2). We consider Coty to be a solid long-term growth story, and we suspect that Coty's growth will be fueled by (i) solid global beauty industry growth, (ii) market share gains as Coty expands its business into new markets and new categories, with both existing and yet-to-be acquired brands and (iii) the plans that the company has in place to improve its profit margins. But, with sales and EPS growth in fiscal 2013 having slowed a bit – due to both macro and company-specific factors, we rate COTY shares Neutral.

Valuation

Given our new CY15 EPS of \$0.88, our continued belief that COTY should trade at a 20% premium to the market (reflecting its strong portfolio of brands and what we perceive to be ample future growth opportunities for the company, offset somewhat by our lesser confidence in our FY14 EPS outlook), and Citi's updated ~15x multiple on the S&P 500, we set an unchanged target price of \$16.

Risks

The primary risk we see to our investment thesis for COTY is the heightened level of competition in the global cosmetics industry, across distribution channels, price points, brands, and geographies. As a result, in order to grow its top line, Coty relies on heavy investment spending, which we believe will continue to pressure the company's profit margins. What is more, Coty's acquisition track-record of the last couple of years has been spotty with some hits and some misses, and given that we expect more M&A to come, we hope that such deals are done with a greater level of conservatism regarding revenue potential. While we like that Coty has taken steps to reduce its costs, and has a new restructuring program likely underway, we are watchful of how successful the company is executing against its newest cost savings goals as prior public data is limited. In addition, we are watchful of Coty's increasing dependence on growth from inherently more volatile emerging markets (as we expect that expansion into these markets will be a growth driver going forward). If the impact on the company from any of these factors proves to be greater/less than we anticipate, we believe the stock will likely either have difficulty achieving our target price or could materially outperform it.

Appendix A-1

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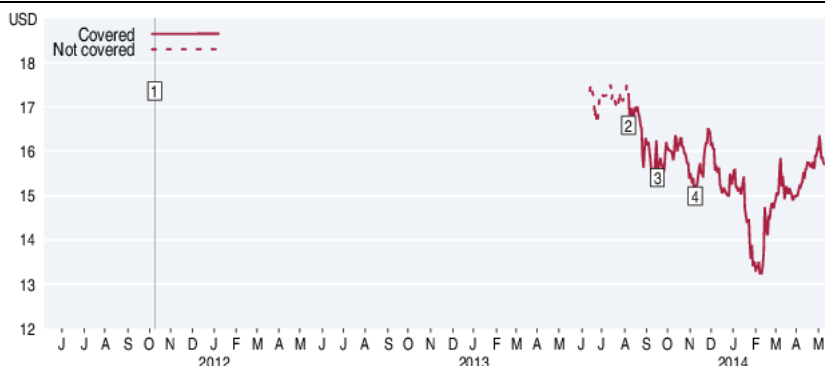
IMPORTANT DISCLOSURES

Coty Inc (COTY)

Ratings and Target Price History Fundamental Research

Analyst: Wendy Nicholson

Covered since August 7 2013



	Date	Rating	Target Price	Closing Price
1	8-Oct-11	Stock rating system changed		
2	7-Aug-13	*2	*19.00	17.28

* Indicates change

	Date	Rating	Target Price	Closing Price
3	17-Sep-13	2	*17.00	15.64
4	8-Nov-13	2	*16.00	14.99

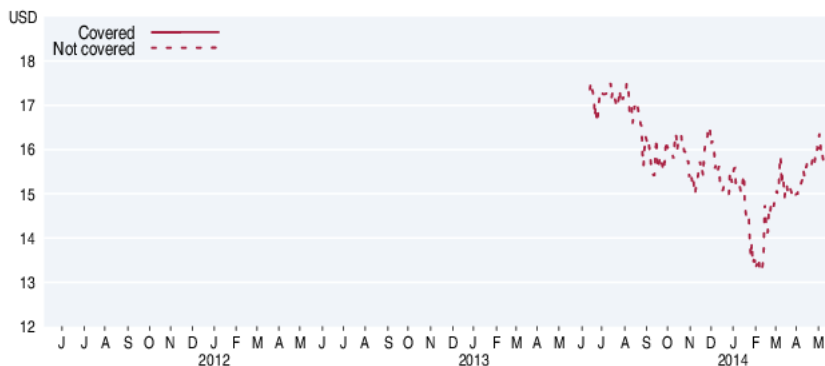
Rating/target price changes above reflect Eastern Standard Time

Coty Inc (COTY)

Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Wendy Nicholson

Covered since August 7 2013



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