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COTY - Q3 2016 Coty Inc Earnings Call

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CORPORATE PARTICIPANTS

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

Bart Becht *Coty Inc. - Chairman & Interim CEO*

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

CONFERENCE CALL PARTICIPANTS

Dara Mohsenian *Morgan Stanley - Analyst*

Steph Wissink *Piper Jaffray & Company - Analyst*

Bill Schmitz *Deutsche Bank - Analyst*

Olivia Tong *BofA Merrill Lynch - Analyst*

Jason Gere *KeyBanc Capital Markets - Analyst*

John Faucher *JPMorgan - Analyst*

Joe Lackey *Wells Fargo Securities - Analyst*

Wendy Nicholson *Citigroup - Analyst*

Lauren Lieberman *Barclays Capital - Analyst*

Mark Astrachan *Stifel Nicolaus - Analyst*

Javier Escalante *Consumer Edge Research - Analyst*

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

PRESENTATION

Operator

Good morning, ladies and gentlemen. My name is Stephanie, and I will be your conference operator today. At this time, I would like to welcome everyone to Coty's conference call discussing third-quarter FY16 financial results and providing an update on its anticipated P&G Beauty Brands transaction.

(Operator Instructions)

As a reminder, this conference call is being recorded today, Tuesday, May 3. 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 & IR*

Good morning, and thank you for joining us. On today's call are Bart Becht, Chairman and Interim CEO; and Patrice de Talhouet, Executive Vice President and Chief Financial Officer.

I would like to take a moment to discuss the format of this morning's call. For the first 30 minutes, we will provide a short overview of the quarter and year-to-date financial results, and we will open the call for some questions on these financial results. We will then spend the next 60 minutes to provide an in-depth update on the P&G Beauty Brands transaction, followed by questions and answers only on the P&G Beauty Brands transaction. Please reserve all questions on the merger transaction and the long-term financial outlook for the Q&A following the transaction update. To the extent we don't get through all the questions in the 90 minutes allotted, we would be happy to take additional questions following the call.

I would like to remind you that many of our comments may contain forward-looking statements. Please refer to our press release, our investor deck and reports filed with the SEC, where you will find factors that can cause actual results to differ materially from these forward looking statements. All discussions of net revenues are on a like-to-like basis. In addition, except where noted, the discussion of our financial results and our expectations do not reflect certain non-recurring and other one-time charges. 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 Bart.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Thank you, Kevin. This morning we will provide you with a brief overview of Q3 and year-to-date results, as well as a detailed update on the P&G Beauty Brands transaction. Our efforts to create a healthy platform for Coty to become a strong global leader and challenger in beauty remains on track. Q3 revenues, which declined minus 1% on a like-to-like basis, were consistent with our expectations for muted like-to-like trends through the end of the fiscal year, as we gradually rationalize non-strategic product lines and businesses. [Bio trends], on the other hand, continues to outperform the overall business, both for the quarter and year to date.

While Q3 adjusted operating profit was down due to one-off items, including the negative impact on the Brazilian Beauty Business as a result of a change in commercial terms to conform with Coty standards, our year-to-date adjusted operating profit was flat, with solid 7% growth in constant currency. For the full FY16, we continue to expect like-to-like revenue performance relatively consistent with the year-to-date trend. We anticipate high-single-digit growth in adjusted operating income at constant rates for the full year, offset by negative FX impact, with the adjusted operating income in line with the prior year at actual rates. These results and outlook are consistent with our strategy to build a healthier and better business, despite subdued revenue growth.

In summary, we believe we're well on track to build a healthy platform for Coty to become a global leader and challenger in the beauty industry, and provide the right basis to drive profitable growth and deliver shareholder value over time. I will now hand over the call to Patrice.

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

Thank you, Bart, and good morning, everyone. Total Q3 net revenues declined 1% like-for-like, with an improvement in the Fragment segment's revenue trends compared to the first half, and moderate Color Cosmetic segment growth, in spite of the decline in the US retained end markets. Fiscal year to date, the adjusted gross margin increased a very strong 110 basis points to 61.2%, reflecting our continuous efforts in driving supply chain efficiencies.

We keep on building a better business, even in the face of soft top-line trends, with stable adjusted operating income fiscal year to date, with a strong 7% increase at constant currency. The year-to-date adjusted operating margin grew 40 basis points. Our year-to-date adjusted diluted EPS was $1.08 compared to $0.91 in the prior year, in part reflecting the benefit from a favorable tax settlement of $113.3 million this year compared to a $30.5 million settlement in the prior period.

Turning to the capital structure, we took the opportunity to raise an incremental euro465 million in term loans and used the proceeds to partially repay borrowings under our revolving credit facility that were drawn to [sign] the acquisition of the Brazilian Beauty Business. Our strong balance sheet and cash flow generation allows us to continue to advance in our strategy [con fashion] objectives. Fiscal year to date, we generated $445.3 million in operating cash flow and $330 million in free cash flow, with free cash flow up over $100 million versus the prior. During the quarter, we did not repurchase any share, and expect to remain opportunistic with our existing 500-million share repurchase authorization.

This concludes our discussion of our Q3 and fiscal year-to-date results. Bart and I will now take a couple of questions on the results, after which we will provide you with a comprehensive update on the P&G Beauty Brands transaction.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Dara Mohsenian, Morgan Stanley.

Dara Mohsenian - *Morgan Stanley - Analyst*

Hey, guys, looking at the top line in the quarter, the Americas result was pretty weak, at down 8. But the international results generally looked pretty strong across the board. So I was just hoping you could give us some detail on if that international strength can continue going forward? And also any issues in America you think cause results to get better going forward?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Yes, I would say both the European as well as the emerging market business basically has done a bit better basically in the quarter, which is encouraging. Like you said, the US remains, for the time being, the soft spot. Clearly, in part, driven by the fact that last year, we had a very successful basically innovation, which was called Sally Hansen Miracle Gel, which we are now lapping, which clearly is part, basically, of the softness. So we're looking forward basically to correct that at some point in time. But you know, I would say, you put your finger on it -- is, the US basically is the area where we still have room for improvement.

Dara Mohsenian - *Morgan Stanley - Analyst*

Okay. And then in terms of A&P, can you give us an update on what you're spending levels were year over year in the quarter? And as you look going forward, obviously you're generating very significant cost savings. Are you assuming that more of that gets reinvested back behind the business to drive the top-line acceleration? And how should we think about spending back behind the business as you look out over the next couple of years on the heritage Coty business?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Yes, we have continued to focus on reducing our non-strategic spend within the advertising and consumer promotional budget. We've seen substantial increases in media delivery this year, which still needs to turn, basically into substantial increase in revenue growth. But we have seen, basically, shift.

So I would say there is not a need, basically, is to start spending back the increased profit, back into the business. Because -- let's call it the working media and the strategic spend behind the business -- has substantially increased already over the last nine months, and we will continue on this trend going forward. So we are seeing a re-allocation for non-strategic and strategic spend. Overall spend levels are more than competitive.

Operator

Steph Wissink, Piper Jaffray.

Steph Wissink - *Piper Jaffray & Company - Analyst*

Thank you. Good morning, everyone. Patrice, I just wanted to follow up on your comments that the US color business was down. I believe you said the color business overall was down. If you could just talk a little bit about the market for nail care, and more broadly, across color, that would be very helpful. Thank you.

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

The nail and care market is down at the moment. And clearly we're a market leader in the nail care category overall, globally, as well as in the US. So that clearly has impacted the business, no question about that. So it's not so much a share issue. It's much more lapsing of the key innovation which drove market growth last year. So we are getting ready basically for future innovations, clearly in order to drive the growth in the market. So that is probably the number one driver basically of the US for the time being.

Steph Wissink - *Piper Jaffray & Company - Analyst*

Thank you.

Operator

Bill Schmitz, Deutsche Bank.

Bill Schmitz - *Deutsche Bank - Analyst*

Hey, guys, good morning. I'm just trying to figure out how much of the stuff this quarter was kind of a kitchen sink cleanup. So can you just talk about the Hypermarcas sales number? Because it was like $30 million below our estimate. And then the true-up on incentive comp -- are you guys all caught up to the year? So that would be like an absence of the negative in the next quarter? And then I have an unrelated follow-up, if I can.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Sorry, can you repeat the last part?

Bill Schmitz - *Deutsche Bank - Analyst*

Just the true-up on the incentive comp? Is it trued up this quarter? So will it be an absence of a negative in the fourth quarter?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

All right, I will deal with the first question. So on Hypermarcas, there was a change in commercial policy following the acquisition. Just to give you some perspective, Hypermarcas has very long, basically, payment terms for its customers. In addition, provided substantial discounts at month-end and quarter-end in order to make the numbers. We have corrected for that and put -- the customer is much more on a Coty-type policy.

So what does that mean? That clearly means that the payment days, or the receivable days for customers, are coming down substantially. And also basically, the month- and quarter-end discounts have been largely eliminated. The result of that is a substantial reduction of trade inventories in Brazil. They were well-over 100 days in the trade, and they have been practically cut in half. So clearly that has an impact on the revenues.

Just to reassure you, the consumption growth in Brazil remains very good. It remains ahead of the market; it remains basically in the double-digit range. So it is not an issue, basically, of sell-out. It is a temporary issue of sell-in, because of the adjustment of commercial terms. I think you should expect that as, basically, we go forward, this gradually basically goes back to a normal level.

We have said this business was roughly $250 million in size, with a margin-accretive performance, and we are sticking with that. There's really nothing basically on an underlying basis which creates any concerns. I will now basically hand over to Patrice, who can answer the comp question.

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

So Bill, on the stock comp question, this is really due to prior for futures for certain executives that have left the business. So that's really what it is. So it has nothing to do with the true-up of this quarter.

Bill Schmitz - *Deutsche Bank - Analyst*

Okay, great. And then I'd just like a follow-up. You don't really talk about your digital and e-commerce strategies. And I know you bought that small media company in New York, digital media company. So how much reinvestment do you have to do in that business? And how far behind -- if you guys think you are behind? Do you think you are, and how long will it take to kind of bridge that gap?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

So there is a substantial increase in digital media happening as we speak. And I would say we're going to see another step-change basically next year. I don't think we are that far behind, to be honest with you, with the general consumer goods industry. I think everybody around the industry is basically getting adjusted to the fact that consumers increasingly consume digital, rather than media -- rather than television or print media.

It clearly differs very much by market. For instance, clearly, if you take the established markets like US, UK and some other European countries, you see very high consumption clearly to go to emerging markets, because you see much less consumption. So there is it a sequential increase in digital happening as we speak. So I would say the gap is going to be closed in the next 12 to 18 months.

Operator

Olivia Tong, Bank of America Merrill Lynch.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Great, thanks. I was wondering if you could talk a little bit about operating margin by product segment? Clearly a very big divergence in terms of the trend line across Fragrance, Cosmetics and Skin Care. But particularly on Fragrance, can you talk about the run rate that you expect going forward, given the big increase in A&P this quarter?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

So I really would encourage you not to look at quarterly results basically on categories, for a very simple reason, is, you're going to see substantial swings, simply because of the initiatives which are launched in the market. So you are going to see certain A&P phasing happening, but you need to really look at category profitability on an annual basis, not on a quarterly basis. Otherwise, every quarter we will have the discussion, because a certain initiative gets launched that the operating margin comes down.

And clearly in this quarter, there was a substantial investment behind CK2 happening on Calvin Klein, which clearly is depressing the operating margin. So I really think you need to take a look at it on an annual basis. The fragrance business, as you've seen historically, has been a very profitable business for Coty, and it will remain a profitable business going forward.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. And then maybe if I could follow up on Color, is there a big difference in terms of margins between Color Cosmetics versus -- like, face cosmetics versus nail care?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

No, not really. No.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Okay, thank you.

Operator

Jason Gere, KeyBanc.

Jason Gere - *KeyBanc Capital Markets - Analyst*

Okay, thanks. Just two quick questions. One, just wanted to go back to the nail category. I was wondering if you can talk maybe a little bit about the different channels out there? Because I know the specialty channel is kind of making some higher investments in this category. So I was just wondering if you could talk maybe divergence of sales by this versus other retail or salon? That's the first question.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

So we have -- clearly we have two very different nail businesses, and they overlap in one channel, which is called Ulta, where you will see both brands. So clearly OPI is predominantly a salon business, but you do see it show up in Ulta, which definitely is declined, which is developing very fast. Sally Hansen clearly is the mass-market brand, but also shows up in Ulta. So there are basically certain channels where there is overlap. I'm not sure I answered your question, but that channel is clearly is developing relatively fast.

Jason Gere - *KeyBanc Capital Markets - Analyst*

I guess what I was trying to figure out is that if you saw more of a slowdown in maybe some more of the mass channels versus specialty, versus maybe the last quarter or the last two quarters? I'm just trying to see within -- I know the whole category obviously is lapping against Miracle Gel. But I was just kind of -- just in general, I just wanted to see if you're seeing continued faster growth in specialty, where there's a lot more investment behind the category, as opposed to mass, where it doesn't feel as much? So I was just wondering if you could just maybe expound a little bit more on just the differentiation. That's what I meant. Sorry for the confusion.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

No, I would not -- no, I would say the development of the nail category is pretty much basically across the board. Now, having said that, within that, certain channels basically perform better than others. So I highlighted one, clearly, which is Ulta. But other than that, there is -- we are simply lapsing a very successful period for the category and for Sally Hansen behind Miracle Gel.

Operator

John Faucher, JPMorgan.

John Faucher - *JPMorgan - Analyst*

Thanks, good morning. You guys have been pretty adamant in terms of talking about really improving structurally the long-term margins in the industry. And when you talk about the stuff that is going on in hypermarkets, et cetera, that you're looking to fix, you can see how there is opportunity there. But I guess it also highlights that the industry has a lot of bad margin practices that are going on there.

How do you guys get your margins up? I mean, do you worry about what the industry does in response, in terms of sort of potentially going to the lowest common denominator? Do you need the industry to move with you, or can you move independently here? Thanks.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

So no, I really don't believe that the industry needs to move with us. And the reason why I am saying that is because I believe that our investment levels are very much competitive with the industry. So that means that the margin improvement that we are realizing is independent from the investment level that we have in the business. And therefore, there is a possibility to structurally improve Coty's margins ahead of the industry.

John Faucher - *JPMorgan - Analyst*

Great thanks.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

We'll take one more question, and then we shift over to the next presentation.

Operator

Joe Lackey, Wells Fargo.

Joe Lackey - *Wells Fargo Securities - Analyst*

Hi, thanks. One quick one, and then a larger one. On stock repurchase, a little bit surprised that there wasn't any this quarter, given the announcement last quarter. And can you talk about the Board's willingness to repurchase stock here before the Procter transaction?

And then the second question, just going back to the advertising and promotion boost that you guys have made, I'm just a little bit surprised that we haven't seen a better response on the top line, I guess. Is it more consumers not responding to the increased media spending, or does it just take some time to flow through? Thanks.

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

So on your first question, so what we said is that we wanted to remain opportunistic. So the Board gave us an authorization to repurchase up to $500 million that we will remain very opportunistic. So I have no other comment to make at this stage.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

So in investment in A&P, we have seen very good response in some pockets, on some brands and in some geographies, and not so good in others. And so you're absolutely right. So for instance, Rimmel has done very well, Marc Jacobs has done very well, Sally Hansen outside of the US has done very well, [the news] responded very well. At the same time, we've also seen on some other brands like Calvin Klein, where the response has been much more muted.

So it is not a simple picture, as it doesn't work at all or it works completely. It is very much in pockets. [You'll see] that Europe and the American markets are doing better than North America. So also by geography, it has differed quite a bit. But you're absolutely right that we are focusing harder and harder on returning investment in A&P, to make sure that we're getting a better top-line reaction.

So I suggest we stop it there and that we move to the presentation on the impact of the P&G merger. Because I'm sure you'll have quite a few questions on the subject, and I want to make sure that we answer your questions. And any further questions on the quarter, we would be more than happy to take those after the call is over. So in terms of the update on the transaction, we are really going to cover three subjects. First, we're going to confirm the strategic rationale of the transaction. We're going to provide an update on the transaction and the progress we have made around this on a year-to-date basis. And finally, we're going to provide an update on the financial benefits of the merger with the P&G specialty business. So next page, please.

So first, before I give the strategic rationale one more time, let me first highlight what Coty's vision is in beauty -- is to really to transform Coty over time into a new global leader and challenger in the beauty industry clearly with -- or for the ultimate benefit of shareholders. Now, in that respect, the P&G merger clearly is a very good step in that direction. We are creating, with the merger, a $9 billion leader and challenger in beauty, becoming the number three, after L'Oreal and Estee Lauder, in the industry. Not only do we create a much more of a skilled player in beauty, we also are creating the worldwide number one in fragrance. Can we have the next slide please?

As you can see basically from the slide which is now on the screen, so you can see that we are becoming well-ahead basically of L'Oreal in terms of market position. In terms of Color Cosmetics, we are becoming the number three overall, most likely the number two basically in [mass] Color Cosmetics, with a number of very good brands, as we will show you in a minute. Finally, we're adding the worldwide number two in hair salon. Clearly this is a new category for Coty.

In terms of the portfolio, we are getting a very nicely balanced portfolio, in terms of [working] between categories, as well as distribution channels. So just to take you very quickly through that: Coty Consumer Beauty will be 41% of the total business of roughly $3.8 billion, very much focused on the mass channel and on three categories. Which are Color Cosmetics -- hair retailing, which is hair coloring and styling, as well as body care. Coty Luxury -- very much focused on the prestige channel, and focused on fragrance and skin. And Coty Professional, very much focused on the salon channel, focused on hair, as well as nail care.

So a very balanced portfolio, both in terms of categories and distribution channels. And most importantly, with the very strong portfolio brands. You can see Coty Luxury, there you will have -- the top three brands will be Calvin Klein, Gucci, and Hugo Boss. And Consumer Beauty -- the size of the brands is more evenly balanced. You see some very strong brands like COVERGIRL, Rimmel, Max Faxtor, Sally Hansen, et cetera. And then ultimately, in Coty Professional Beauty, you see two main brands which are anchoring the business, which are Wella and OPI.

Not only do we get a very strong portfolio, we are also increasing the critical mass across basically our top markets. And importantly, we are increasing critical mass in several of the emerging markets. So Brazil, clearly that's a very big increase [in euro], but that was off a very small base in Brazil. So clearly this number doesn't even include Hypermarcas, and Brazil will become a very big market for Coty.

Russia was a decent-sized market, becomes a much bigger business for us. China also becomes a much bigger business for us. So not only are we getting a substantial increase in scale in the established markets, but we also increase the scale in a number of the emerging markets. So overall, that gives us a very nice basically portfolio with strong brands and scale benefits in our geographies. And -- can we please see the previous slide, please? Thank you.

So it also provides a very good opportunity to accelerate growth and improve profits and cash flow. So from a growth point of view, we will have, going forward, a divisional structure. Why is that important? Because a divisional structure is a much more focused structure than what we have today. So as I already showed you, it will focus very much on a single distribution channel, and only two to three categories per division.

And with that, we hope that we're going to get, not just increased focus, we get increased competence, and we get a much more competitive basically capability in place, in order to compete in the market. We also are going to substantially further increase our focus on sell-outs by increased digital consumer engagement, improving the in-store excellence, and to drive high levels of product innovation.

Another topic which we still have to come to and which we'll further detail in the next couple of months is the rationalization of the portfolio and the wholesale business. Why is that important, is because we still need to tighten down the focus on fewer brands and fewer doors, in order to drive a higher-growth and a better-quality business.

And finally, clearly from a growth point of view, we will be looking in due time to further acquisitions. Patrice will highlight this a little bit later. But clearly, perform our financial profile will very much allow us to participate in further acquisition opportunities.

In a minute, we'll come to profit and cash flow. But clearly we are anticipating material earnings-per-share accretion due to synergies. And we also expect substantial incremental cash flow, due to both higher profits, as well as network and capital benefits. Finally, we will very much, from an incentive system, make sure that the management is very much driving a combination of top-line growth, margin expansion and cash flow generation. And we will do that both through the combination of short-term bonus structure, as well as long-term incentives, in order to make sure that we are getting a balanced basically focus behind those three basically key levers.

So that gives you a quick snapshot of the strategic rationale basically for the business. As you can see from the slides I just presented, this is very similar to what we discussed in July. And so we're very much confirming the strategic rationale of the merger with the P&G business. I am now going to hand over to Patrice, who is going to take you through the transaction update, the progress we have made, as well as the financial benefits of the transaction.

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

Thank you, Bart. So a couple of points on the slide 13, the transaction summary. So first on the structure, very much of the same. So the transaction proposal was valued at $12.5 billion, comprised of $9.6 billion of equity and $2.9 billion of debt.

We have a collar mechanism of plus or minus $1 billion, based on the trading price of Coty stock, with a range of $22.06 to $27.06, with a minimum of $24.56, based on the latest share price. And we've assumed here the price on April 13, which was for the S-4 filing of $29.81. Coty estimates that the issuance of 412 million shares and $2 billion of assumed debt. The spread between the P&G and the Coty shareholders will be 54%/46%.

So now a few words on the mechanics of the transaction. The preferred option from the P&G side, is to do a split-off. In a split-off, P&G offers its shareholders the option to exchange their shares of P&G common stock for shares of the new Coty. For the offer to be fully subscribed, 6% of the P&G shares need to be tendered -- only 6% of them. In terms of timing, it is fair to say that the transaction is expected to close in the course of the month of October 2016.

Now next slide, 14, the updates on the progress that we have made. So as you have seen, all of you -- so we have five of the on S-4 on April 22. We have the unconditional anti-trust clearance for the EU and the US. And we have confirmed the transfer of 10 fragrance licenses.

Operationally, as Bart said, we have now an organizational structure, we have design [organizational] structure. We've obviously [seen] the headcount, and the decision regarding the location has been mainly made. In terms of staffing, the Executive Committee and the Management team of the division has been appointed, and we are now going to the next layer. In terms of [deals that we make], that we come back to that on a few slides, but we have done most of the work.

In terms of full [value] and wholesale rationalization, it's fair to say that the work is still very much in progress. But what we can say at this stage, is that on the [profit] rationalization, in terms of discontinuation and divestments, we would have some discontinuation in divesting in the range of 6% to 8% of the combined new portfolio. So I am sure you're going to have a lot of question on the impact on the [deal a could a meeks], [we did UPS you troy yes] on [those], et cetera. We are not ready to answer any of these question yet. We just want to signal to the market what we have in mind for the time being. There's still work in progress.

In terms of go-to-market change, we are assessing some of these, especially in emerging markets. And of course, there is an extensive preparation in terms of processes, in terms of systems, in terms of infrastructure. There is 200 people full time within Coty working on that, with a lot of help from experts that has done this type of transaction in the past. So we very much in motion.

In terms of financing, so as you all know, Coty entered into a secured financing commitment of $4.5 billion. We have used the opportunity to up-size this to $5 billion in last month, actually, in April 2016. Galleria, who is fully owned by P&G, entered into secured financial commitments of the same amount, $4.5 billion, expected to be ultimately assumed by Coty from the close. Now back to Bart on the management team.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

I think you have seen that we have put in place a very strong management team, not just at the Executive Committee level, which we see basically on the screen, at the moment. The Executive Committee team has very extensive experience in consumer goods across the board. And in addition to that, where relevant, they also have basically very extensive beauty experience. It is an increasingly diverse group.

Also, below this team, we have made many appointments already. So we have made practically all the appointments at the level below this group, and we are well advanced in terms of making appointments at the levels below that.

And you will see that this is -- that across the board, we have made very good appointments, some of them which have been announced externally, as you have seen basically with Shannon Kirkman basically last week in the United States. So we have made a raft of new appointments. They are not all basically from P&G and Coty. Some of them are from external. So the mix has changed, and is changing as we speak. But overall, a very good team. Back to you, Patrice.

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

Thank you Bart. Now on the financial update, so on slide 17, so certain statements in this presentation are forward-looking statements. So I am not going to go through -- Kevin already alluded to that at the start of the call. The only point I would like to emphasize is the bottom of the page, where this acquisition of the P&G Beauty Brands is a complex carve-out transaction. And as a result of that, the integration efforts might, for a certain period of time, detract us from improving the performance of the underlying business.

So this being said, the next four slides are, I am sure, slides that most of you were expecting. So we're going to spend a bit of time on that, going through these slides. So on the slide number 18, on the synergies. All these four slides are really a refresh of the July presentation. So you can see that in the format, we did roughly the same to make sure that you had a comparable basis.

So first on the synergies. So we start from the FY15 adjusted carve-out EBITDA coming from P&G, which includes already $380 million of synergy that will materialize day-one. Then we have the impact of two of the licenses that are not coming with the transaction, so Dolce Gabbana and Christina Aguilera.

So we take $130 million, which is the brand contribution. So what is the brand contribution? The brand contribution is the gross margin, deducted from all the investment in advertising and consumer promotions to support and to nurture the brand. Then you have the synergies of $400 million, which is in a [base] versus the July presentation.

So let me spend a little bit of time on this $400 million. So first point, our ongoing position has been to build an organization by division, focusing on each of the segments. Two, how did we do that? We did that with a bottom-up approach by function and by country. So a very in-depth work. And that we have crossed the [anstead] organization in each of these [countries and each of the counties] challenge against benchmark-based targets.

So this is where we landed now, with this targeted organization that has been [costed]. And when you compare the Coty organization plus the P&G organization, minus the targeted organization, you connect with the $780 million synergies. So these $780 million synergies represent 16% of the acquired revenues. And they are very much going to be phased, with 40% materializing in year-one, 70% after year-two, and 80% after year-three, and then the full synergies after year-four.

In order to be able to realize these synergies, we're going to incur $1.2 billion of costs. So let me spend a little bit of time on these costs. So first, 90% of them are cash costs. And out of this $1.2 billion, you have 25% that is really related to the specifics of this transaction, which is a combination of the carve-out under an empty umbrella. So this is roughly $320 million that is related to that.

So let me give you a couple of example on this call. So first, you have the [THC] costs. Second, P&G is a high-integrated business with a big GBS share set [we center]. And so we have to disentangle the P&G Beauty with the rest of the P&G business, which is increasing complexity, and as a result of that, associated cost.

Third point, the A&P requires the business of P&G to be carved out and then integrated. What does that mean? This means that we need to set up interim P&G entities and processes that then, after the exit of the GSA, need to be [unwinded] and integrated into the Coty processes. And of course, we need to train people to be able to do so. Fourth, most of the carve-out came as either increasing the scope, like adding new categories, for instance, or increasing the scale. Actually, we are doing both, which -- increasing the complexity and then the costs associated to that. So that's roughly what is leading to 25% of the cost, which is the $320 million, which for us, due to this very unusual transaction.

Second part of this $1.2 billion, you have roughly one of $135 million that is due to go-to-market [gariot] changes that will happen later on. This is very much a work in progress, but we're going to reset up some of our go-to-market from [Gabriel]. The last part, $745 million, is directly related to the synergies. So we are generating $780 million synergies, with a one-off directly [assumed] synergy with $745 million. And I think this is really the way you should look at it.

So we are building, on a bottom-up basis, an organization which is extremely focused, divisionalized, focusing on that expertise in the respective segments, with a very lean organization. So now what does that mean in terms of operating margin? So first, all these slides do not include Hypermarcas. Same start as what you have seen in July, but of course updated.

So what you can see is that you start in slide 19 from the standard old Coty, which is 12%-plus operating margin. We added the carve-out business from P&G, which adds at 200 basis point. So we would result in 14% operating margin, without touching the business. Then you deduct, which is an impact of 40 basis points impact of P&G and Christina Aguilera.

And then with all the synergies, we have 430 basis points. So this means that we are going to add 600 basis points with Coty standalone business in operating profit margin over a four-year period, making Coty clearly an industry leader, at 18% operating margin. Our top peers are in the range of 15% to 17% operating margin percentage. So really, with this transaction, we are immediately positioning ourselves to an 18% pro forma operating margin. And this doesn't include Hypermarcas, as I said.

So now, next slide -- what that means from an EPS standpoint. So first, this slide excludes the purchase price accounting related to the amortization. And we are currently revisiting the metrics with which we should measure the underlying performance of the business. And in doing so, what we pay attention to is that it needs to be similar to the way we measure the business on a historical basis. And it also needs to be comparable to our [fields]. And that's the reason why we are currently assessing and evaluating the option to exclude the purchase price accounting-related amortization.

So when you go through this slide, you start with the Coty FY15 adjusted EPS, which is $0.99. That you have the dilution based on distribution of sales, which is the same number as what we've quoted, in July. Then you have the contribution of the P&G carve-out business, which is $0.83. That leads to $1.20 to $1.25. Then you deduct the D&G and the Christina Aguilera brand contribution, which is $0.11. And then you add all the synergies that we'll generate, which is $0.39.

What does this mean? This means that we will increase by 50% the EPS versus the current standalone Coty business. And I really think this is the way you should look at it. We have a current standalone Coty business which is in the range of $1 of EPS. And now, we'll be more in the range of $150 after these transactions, on a pro forma basis. And this is, of course, after we implement all the synergies -- so after year-four.

So now in terms of cash, cash is king, so slide 21. In terms of working capital, immediately at closing, we will generate -- we will more than double the cash generation of Coty standalone, to generate, on a free cash flow basis, between $800 million and $900 million, without further reduction of the working capital. Then you add some amenities that we have made on the working capital. And so we're refreshing these synergies by increasing the working capital synergies from $200 million to $500 million -- so $0.5 billion -- over four years. The bulk of that will be realized by the end of FY18.

So actually, you have two effects on that. The first one is that you have a one-off $0.5 billion cash generation. And the second one is that by doing that, we will be very close to the working capital, which means that your cash conversion ratio is optimal. So your earnings are converting into cash immediately.

Now in terms of CapEx, so we are increasing by $100 million the CapEx versus our July assumption, which is mainly -- you know, you have three main legs into this CapEx of $500 million. You have real estate, because we need to stand up some organization and co-locate the division in most of the markets. So that's point one.

Point two, evidently, like in all the transaction, you have a lot of [viking] transaction that we need to [be in step with]. And it's fair to say that all the work that we've done in the last two years is now producing some really good results, and is allowing us to avoid some CapEx that we will have to add, providing we didn't do anything in the last two years. And of course, you have the end of supply chain CapEx to be able to send in a couple of factors. So 90% of this one-time CapEx will be incurred through FY18, and then we will come back to a much more normal ratio of CapEx, which could estimate being 4% of top line.

Now on the capital structure, we are slightly increasing the pro forma leverage to 3.2 times net debt-to-adjusted EBITDA. Why is that? Because we are expecting the Hypermarcas acquisition, and the share buyback program that we have [existed] between the month of July and the month of December FY15. We are going, as we said, to increase the dividend per share to $0.50 post-closing.

And so it's clear to me and is clear to all of us that we're going to have a combined business with a lot of strategic and financial flexibility, with a very lean cost structure, and with a very moderate pro forma leverage of three times two. Which, once again, as Bart said, gives us ample ammunition to further participate in the consideration of this industry.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Excellent.

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

So now I give the floor to Bart for the wrap-up.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

So yes, in summary, the merger creates a very good pure play new global leader and challenger in beauty. With $9.2 billion in net revenues, you've seen basically the substantial increase in pro forma EPS of roughly $0.50, off more or less $1 where it sits today. So a very substantial increase. It is targeted to generate substantial pro forma free cash flow of about $800 million to $900 million, providing ample flexibility for the future.

Post-rationalization of Coty 2's portfolio in the wholesale business, which we are working on, the merger creates a clear opportunity to accelerate growth, both organically and via future M&A. And that is very much because we are going to create a different structure for the Company, a much more focused structure, with a more focused portfolio, with better staffing behind that. And with ample basically support level behind that. We have appointed already a very strong new management team, which is being well-aligned to drive shareholder value.

So overall, I think I can confirm today that the strategic rationale for the transaction remains. We have made excellent progress basically from an integration point of view, year to date. We should be well-positioned to absorb this business. And you have seen Patrice take you through the financials, which are substantially better than where they were when we announced the transaction. So with that said, I suggest we take the first question.

QUESTIONS AND ANSWERS

Operator

Wendy Nicholson, Citi.

Wendy Nicholson - *Citigroup - Analyst*

Hi, good morning. Thank you. Two questions. First is with regard to sort of your updated look at the business. Can you comment on the trends that we've been watching in the Procter business? The brands you are acquiring, have those basically been as expected? Or worse than you would have expected a year ago when you announced the transaction?

And then second thing, just looking back at the quarter, you just printed your comment that the core business may suffer a little bit of disruption. Just broadly speaking, it feels as if kind of the cost to compete in the makeup, cosmetics industry has gone up. We're just seeing slower growth in the industry, slower growth from you, slower growth from Estee -- and yet, a continued high level of investment.

And my question is, does that concern you? Do you think differently? I mean the cost savings outlook for the Procter acquisition looks fantastic. But you think today that you might have to invest more to achieve the same level of growth that you had hoped to achieve, just given the competitive dynamics in the industry? Thanks.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

So in terms of the trends, the trends have not changed dramatically since we bought the business. So clearly within the business, you have seen the S-4 filing. So you have the numbers. The business is declining 2%. So clearly if you ask me, am I excited about this quarter, the answer is no.

Within that business though, there are certain parts which are doing very well. For instance, the salon business is performing very nicely. The fragrance business is doing better than it has done historically. On the other side, basically we do have some concerns about Color Cosmetics, and substantial concerns about the hair coloring and styling at the retail level. So it is not a uniform picture on the P&G business. If you ask me, am I excited about that business trend, the answer is no, there is still a lot of work that needs to be done in order to address that.

In terms of the investment levels, basically which are required in this business, it is definitely a challenging business, in particular because the whole industry to some extent is fragmenting, in terms -- in pockets, both from a channel and a brand point of view. And clearly, that requires basically stronger activity in order to maintain a growth momentum.

Will that eventually mean that we need to invest more? I am not sure, because we have quite substantial investment levels on the business already. I think what is more required is that we have a tighter, more focused business in order to compete. And we will be coming back to this when we talk about a rationalization of both basically the portfolio and the number of doors in which we compete.

Wendy Nicholson - *Citigroup - Analyst*

And just following up on that, when you were talking about the Coty quarter -- but this applies to the broader business -- you said at the very end, I think, in the Q&A, that some of your reinvestment was in having the payback that you had expected it to when you were working to improve sort of the return on your investment spending. But given the vastly more complex organization, how do you go about improving that? Is that a systems process? Is that a peoples process? How do you make sure that the money that you are reinvesting actually pays off?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

I would say, very good points. From a return on investment point of view, there's more work that needs to be done within Coty. We need to become much more of a sell-out-focused organization. Parts of the Company doing a good job, other parts of the Company are not. It is something which we are actively working on and addressing, but we're not there.

Like I said before, we have certain brands, brand-country combinations, which are doing extremely well. So if you look at Rimmel, overall, is doing very well. Sally Hansen, outside of the US, is doing very well. Marc Jacobs is doing very well. Miu Miu has done very well. But we also have other pockets where we are not getting the return on our investment. So there is certainly room for improvement. And it's not just a question of systems; it's a question of training of people.

Operator

Lauren Rae Lieberman, Barclays.

Lauren Lieberman - *Barclays Capital - Analyst*

Thanks, good morning. You made a point of mentioning throughout that Hypermarcas was not included in these numbers. So if you could talk a little bit about the degree to which incremental CapEx on that business, or any kind of incremental spending, how that would impact this forward-look? Thanks.

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

Yes, Lauren, so thanks for the question. So in terms of incremental CapEx for Hypermarcas, this is going to be extremely marginal. So in the big scheme of things, given the picture we are looking at, I don't think that's going to be very much at all. So that's what we see. We intentionally decided in this presentation to exclude Hypermarcas, to make things more comprehensive and more readable, rather than mixing different acquisition, et cetera. So we will come back there. But honestly, in the big scheme of things, Hypermarcas is not very much at all.

Lauren Lieberman - *Barclays Capital - Analyst*

Okay. And the same goes too, Patrice, just in terms of incremental spending, to hire people in Brazil, and so on? Because my understanding is, you are getting almost no infrastructure with Procter in Brazil.

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

Yes, but that's really -- this is one of the benefits of the transaction with Hypermarcas, is that it's going to smooth -- it's going to be an enabler for [those] transactions. Because actually what we are acquiring there is the go-to-market, state-of-the-art factory and warehouse. So we are getting that via the Hypermarcas acquisition. So I expect some limited impact, from that standpoint.

Lauren Lieberman - *Barclays Capital - Analyst*

Okay. And then the phasing of synergies that you shared on slide 18, just to be clear, does that refer to $400 million incremental, or the total basket?

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

No, that refers to the total. So the $780 million synergies are going to be phased, with 40% in year-one, which is all the $380 million that I was talking about, rising immediately at closing, 70% year-two, 80% year-three and 100% at year-four. But that refers to the total of the $780 million.

Operator

Mark Astrachan, Stifel.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Thanks, and good morning, everybody. I wanted to go back to the operating margin expectations, the 18% that you talked about. How much implied reinvestment is in that? Is there any step-up relative to current levels? I know you were talking about, Bart, not anticipating any sort of meaningful reinvestment. But maybe you can give us a little bit of color in terms of what is actually baked into the numbers as a percent of sales? Or just broadly, if you don't feel comfortable giving a specific target?

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

Yes, so thanks for the question. So actually in this exercise, the way we did it, is really to take the pro forma of Coty, to take the pro forma of P&G, and then to deduct the two brands in terms of brand contribution, and to add the synergies. We didn't change anything in terms of underlying business, in terms of assumption, in terms of [18 other]. So it's really just by adding the synergies and adding the P&G business, mechanically, the operating margin is at 18%.

And that's the reason why I mention, it doesn't include Hypermarcas, it doesn't include any changes in the way we're going to invest, et cetera. This is just pro forma, without touching the business, and just materializing the synergies.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Got it. So --

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Yes, and to clarify, there is no basically reinvestment assumed basically in these numbers back into A&P. And as we discussed earlier, in my mind, there is not really a need for substantial reinvestment behind the business. There is a need for improvement of return on investment. Investment levels in this business are quite high, as they are on both sides. The number-one improvement which is to be had, is to improve the ROI on the investment.

Now, part of the exercise also needs to be -- is a narrowing of the focus of the business. Because -- and just to give an example, in fragrances the number of brands, which we will be managing in a post-transition, is very large. And so, in order to improve return on investment, we also need to narrow the focus. Because simply from a go-to-market organization is -- the number of brands which will be sitting in the portfolio is too large basically to do an outstanding job. So it's really -- it's about focus in ROI.

Mark Astrachan - *Stifel Nicolaus - Analyst*

Got it. And sort of related to that last point, you talked about 68% of combined new portfolio being rationalized. Without giving specifics, is it fair to think that the focus on that would be in some of the underperforming areas and categories? And I just wanted to relate that to a comment or question on the quarter, if you could just talk about the impact of rationalization or discontinuation of certain brands on the business, as reported today?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Yes, so the 6% to 8% of rationalization which needs to take place refers pure and simple to discontinued and divested brands. It does not refer to any reduction in the number of doors in the wholesale business. So the bulk of that will have to be done. The vast majority will have to be done on the fragrance category, because there we have the largest number of brands, between the two portfolios. So it is premature basically to sit here and to have a final discussion about that, because the ongoing basically discussions are still taking place with the business, in terms of how exactly we're going to structure this.

In terms of impacts on the quarter, we are rationalizing doors basically in the quarter and year to date, and we're also rationalizing lines within the business. Because historically, Coty has basically over the last decades, expanded into too many lines, into too many doors, in order to have a healthy and a strong business, with a very strong focus.

And so I could give you speculation on the number, but it is clearly not helpful from a growth point of view when you do that. So rationalization and increase in focus is, in my mind, is a key requirement for this business to be healthy in the long run. And that means some short-term pain that we're going to have to go through.

Operator

Javier Escalante, CER.

Javier Escalante - *Consumer Edge Research - Analyst*

Hi, good morning, everyone. I have actually two questions. One just has to do with year-one. You mentioned that savings are going to be $400 million. But in the filing, it seems like there is a temporary agreement with Procter, in which -- it may last six months -- in which you are going to be highly in-services from Procter for the human resources, the IT. So how that $400 million -- you are realizing the savings, but at the same time you will need to be spending money against those savings, because you don't have the [quarter] structure yet? That's my first question.

THOMSON REUTERS

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

So the answer to this question is that this is going to be done through TSAs. The TSAs are only on a couple of areas, which are mainly finance, IT and supply chain. And these TSAs allow us to gradually step up, and are going to last one year. And so you have these actually in the one-off, so that's part of the $320 million of one of specific transaction that [tablet] did, which is the 25% of the overall $1.2 billion. This is included there. So the costs of the TSA are included in the $320 million.

Javier Escalante - *Consumer Edge Research - Analyst*

And you are including that cost as a one-time cost, as opposed to an ongoing cost? Because these services are going to be [ran] there for six months?

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

Yes, you are correct. So these costs that are going to be there for one year, are considered as one-off costs.

Javier Escalante - *Consumer Edge Research - Analyst*

Okay. So my second question has to do with coming back to the 6% to 8% rationalization, and potentially reducing the number of doors. And the assumption that was made in the valuation of the Procter business that the secular growth rates were due to be 1.5% and 2.7% positive -- so this is 2025. So basically the assumptions value in this business is that the entirety of the business will be growing, even so 10 years down the road. And yet, what we're hearing is that you are going to reduce the size of the business.

So I do not understand the relationship between what you said about -- what is your expectations, again, for the top-line growth, on an organic basis, of this combined business? Because in the valuation, it seems like you are implying that it's going to be up to 2.5% per year, 10 years down the road. But at the same time, everything that you had suggested implies little growth.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

We have never made any basically forward looking statements regarding the growth of the business, either for P&G or for Coty. Right now, the P&G business is declining minus 2%. You have the Coty numbers. Clearly what we are working on is to change basically the growth outlook. But we have not made any basically statements, forward-looking statements, regarding the growth rate of the combined entity.

Operator

Linda Bolton Weiser, B. Riley.

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

Yes, hi. I guess the previous slides you had provided were kind of on an EBITDA basis. Is there any reconciliation anywhere you will be providing, or any comments that kind of go through these numbers on an EBITDA basis? And the tax rate has been sort of different in different time periods for Coty. What tax rates are you assuming in these EPS calculations? Thanks.

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

So I am sure that on the reconciliation between the EBIT and the EBITDA, you can take that clearer online with the IR team. I think they have all the detail, and will be able to provide that to you. In terms of blended tax rate that we've assumed in the EPS calculation, we have assumed a 26% blended tax rate.

Operator

Dara Mohsenian, Morgan Stanley.

Dara Mohsenian - *Morgan Stanley - Analyst*

So synergies at 16% of sales in this acquisition is far above what we've generally seen from other peers, which are more in the high-single-digit range over time. So can you run through what's giving you confidence in that number, given it's so much higher than we've seen versus peers in the industry? And then can you give us more of a sense of kind of magnitude for some of the key areas or key buckets of savings with that synergy number?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Yes, so we certainly can. So we've gone through a very exhaustive bottom-up exercise to take a look at all basically pockets of synergies. So I would say that probably is the one good thing that we are having between this lengthy time between announcement and closure, is that we have had plenty of time to study everything in excruciating detail, which we have done.

So in the supply area, we have really gone through everything, in terms of buy, make and deliver the product. And have looked at every single aspect in terms of what we can assume from an optimization point of view, in terms of procurement, in terms of manufacturing, in terms of logistics. We also have costed out the entire organization, down to the last head practically, in every single division, as well as in the corporate headquarters and any other functional support staff. We have used that basically in order to cost-out our entire SG&A footprint for the combined entity.

So there is a very detailed basically calculation between all of this. So in terms of the split, it is very much balanced between, I would say, broad -- what you can expect in cost of goods, and in SG&A. There is a relatively even split between the two. The synergy number of 16% is definitely at the high end of the range. But it is not basically -- these types of numbers have been achieved before in other types of transactions. So it's not like a number which is out of the range.

Dara Mohsenian - *Morgan Stanley - Analyst*

Okay. And then Bart, you mentioned a couple times about wanting to further participate in the consolidation of the beauty industry. From a timing standpoint, when should we think about acquisitions becoming a focus again? I would guess there is a pause here as you integrate P&G and Hypermarcas with the heritage Coty reorganization, et cetera, which might limit acquisitions in the next couple of years.

Is that fair? How do you look at that from a timing standpoint? And then also can you just share some of the financial hurdles you look for in acquisitions, particularly in terms of return criteria? Thanks.

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

Yes, thanks for the question. So we usually do not comment about M&A. It's the best way to be really effective. And so we're not going to provide all the detail. However, the only thing we can say is that, for the time being, we have to integrate this business, and to make sure that the combination of P&G and Coty works, and that we have a very successful integration. So that's going to be the focus of the organization in the coming 18 months.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

So in terms of hurdles, we run a standard approach in terms of P&L and cash flow forecast -- look at not just the discounted cash flows, but mostly in terms of how much basically over the cost to capital basically we return. And at what point we breakeven against the cost to capital. So I would say, EPS accretion is also being looked at. But as you well-know, most transactions are EPS-accretive in the consumer goods space. So that generally is not the main hurdle, because that's almost a given. It's much more basically in terms of return relative to the cost of capital, that we look at.

Operator

Bill Schmitz, Deutsche Bank.

Bill Schmitz - *Deutsche Bank - Analyst*

Hey, guys. Can you just clarify one thing on slide 18? You had that sort of phase-in of synergies. Is that the incremental synergies, or is that the aggregate synergy number? So does that exclude like the $380 million from P&G, or is that just the incremental beyond that?

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

So I am not sure I understand the question, but I'll give you an answer, and you can (laughter) the right of your question. But the total level of synergies is $380 million, plus $400 million, which is the $780 million that we have quoted.

Bill Schmitz - *Deutsche Bank - Analyst*

Yes, that's clear. But there is that bullet on page 18 that has like the percentage of synergies realized by year -- it's 40, 70, (multiple speakers)

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

Yes, so this is based on the total view. So this is the split, the phasing per year, based on the $780 million.

Bill Schmitz - *Deutsche Bank - Analyst*

Okay, it doesn't make a lot of sense, though, because it seems like that whole $380 million is just allocated overhead. So shouldn't that all be gone once you lap it after the deal closes?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Yes, and that's why -- that is the 40%-plus.

Bill Schmitz - *Deutsche Bank - Analyst*

So there is no other -- okay. But there's no other synergies then, except for just lapping the overhead allocations.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

No, because in the early days, you actually need to staff up before you staff down. So you do not -- this is a carve-out. And people generally don't get this, but if I combined two companies, I could realize synergies in year-one. But we're not getting basically a complete Company. We're getting a partial Company. And so in a partial Company, I'm actually going to have to staff up to absorb it, in order to -- before I can staff it down.

So you have basically -- yes, the full $380 million goes away. But then I need to have certain resources basically in that organization in order to -- which I can then basically take down once we are integrated.

You have to realize, there are three basically steps in the transaction. There is the carve-out and stand-up, and stand-up is required from a reverse Morris Trust point of view. So P&G actually has to stand up its own organization independently. Then there is a transition phase, which is -- and the transitional services phase. And then there is basically the final integration. It's a much more complex process than a normal basically merger of two companies.

Bill Schmitz - *Deutsche Bank - Analyst*

Yes, that makes sense. Are these synergy numbers net synergy numbers then? Are they net of the cost associated with -- do you know what I'm saying? Because that's what it sort of implies, if you're staying you have to staff up to hit those synergies. Do you know what I mean?

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

Yes, so actually, the 40% in year-one is a net between the synergies that we're realizing and the staff-up that we need to do in order to be able to build the combined business.

Bill Schmitz - *Deutsche Bank - Analyst*

Okay, that make sense. And then just one last one. On the salon color business, how long do you think it's going to take you guys to really learn that business? And then do you think you can be successful in the US without owning your distribution? Because I think that's probably the critical inhibitor, is that L'Oreal owns their distribution, so they have much better reach into the salons. Tell me if you disagree with that, and then maybe some thoughts on that end?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

So first of all, on salon, we need to understand that the entire organization comes with the transaction. So in terms of the entire commercial basically infrastructure, comes with the transaction, with all the associated staffing. And I would say, the good thing about the salon business -- it took P&G a while, but they actually have figured out how to run this business. And you can see in the S-4, the business is actually doing just fine.

And so from a trend point of view, it's doing very well. The management team and the entire commercial infrastructure is coming with the business, and they have basically good results behind that. So, do other people in Coty have to learn certain things about the salon business? Absolutely. But I think there is a lot of work between the two organizations taking place at the moment, to make sure that we have a smooth transition of this business.

In terms of owning the distribution, while clearly, I do not agree that we need to own the distribution. Because we have proven that, while not owning the business, from a distribution point of view, we can grow the business. And certainly on the salon business in the United States, on the P&G side, has a very good performance. So I think that in itself proves that the business can succeed without owning the distribution.

Bill Schmitz - *Deutsche Bank - Analyst*

Okay, great. Thanks so much.

Operator

Olivia Tong, Bank of America Merrill Lynch.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Great, thank you. I know these aren't your businesses yet, but what's your assessment of why the mass hair and cosmetics businesses that you are acquiring has been unperforming, particularly since the deal was announced? We have a FY15 in the first-half numbers. And what you think needs to happen to get these businesses back to health?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Yes, so I would say there are several factors. First, it's been hit very hard by FX, because part of the business is in places like Brazil. So that's not helpful, clearly.

Having said that, I don't think that's the bigger issue. The bigger issue is that this is being managed by the corporate sales force within Procter & Gamble, within their hair category. And so when you have a corporate sales force like you have in the United States, which is managing a orphan asset, which is being divested, as you can imagine, the focus is not going to stay on it. And this is exactly what's happening.

And clearly, at Coty, we are quite concerned about the business trend within this business. And so I think increasing the focus, which we will have immediately after close, hopefully, is going to help basically nurture this business back to a better performance. But right now, it's an orphan asset being handled by a corporate sales force, which has at least another 20 priorities. So that clearly is not very helpful.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. And just to revisit the accretion -- the synergy targets, particularly in year-one. So $0.50 by year-four. But do you have a sense of what pro forma would look like when adding in these businesses in year-one? Is it just as simple as 40% of that $0.50 target?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

There is a phasing of the benefits that you can see. So you could make a certain modeling behind that if you wanted to. We have not provided any guidance on this point.

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

Yes, we're not providing any assumption in terms of the phasing, and so on, on the cost [we gave you], et cetera. So I think you can make that assumption. But that's the only thing we can say at this stage.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. Thank you.

Operator

Joe Lackey, Wells Fargo.

Joe Lackey - *Wells Fargo Securities - Analyst*

Hi. My first question is on kind of the status of the innovation for the Procter business. I remember you guys had some issues when you bought philosophy, as far as the pipeline not being as strong as you had expected, and it took multiple years to kind of turn that business around. So I am just wondering, what's your view of the innovation pipeline at Proctor?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

So we do not have a complete view on that at this stage. We should not forget that the two businesses are competing businesses. And we have not been allowed access, from a legal point of view, in terms of the innovation pipeline. So that's still to come.

Joe Lackey - *Wells Fargo Securities - Analyst*

Okay. And my second question, on slide 24, part of the adjusted EBITDA is a depreciation accounting reclass. And I was wondering if you could just shed some light on what that is, and why you guys are handling it as a depreciation versus SG&A at Proctor? Is it just carve-out accounting, or some sort of acquisition-related accounting difference? Is that the reason for the reclass? Thanks.

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

Its [count-out] accounting actually. So it's really now, we translate the chart of account of P&G to our chart of account, and that's the result of this. So that's really fixed [extra] that we are [rotated by marketing furniture].

Joe Lackey - *Wells Fargo Securities - Analyst*

Okay, thanks.

Operator

John Faucher, JPMorgan.

John Faucher - *JPMorgan - Analyst*

Thanks. A couple of questions here. First off, you're talking about the 6% to 8% in potential divestitures, and I was wondering -- is that included in your run rates that you have given us in terms of earnings per share and EBITDA and margins? And then one sort of clarification on the cash costs. Did the cash costs include or exclude the CapEx associated, sort of the one-time CapEx? It sounds like those cash costs actually exclude the CapEx. Thanks.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

So no, the rationalization is not included in the run rate EPS or EBITDA numbers at this stage in the game. Right now basically, the first thing we have to determine, what exactly we are going to rationalize, and what the ramification of that is. So it is not specifically not included. On the CapEx?

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

On the CapEx, I would say, John, your understanding is correct. So the one-off costs exclude the CapEx impact.

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John Faucher - *JPMorgan - Analyst*

Got it. And then one final housekeeping question here, because I've been getting some questions on this. Obviously deals closing in FY17, probably late Q1, early Q2. So when you look at year-one, year-two, year-three, year-four, it's FY17 through FY20, right? That's how we should be looking at this?

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

No, the closing is scheduled for October of this year, right? So yes. So closing will be in 2017, yes.

John Faucher - *JPMorgan - Analyst*

Excellent.

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

You're looking the right way.

John Faucher - *JPMorgan - Analyst*

Thank you.

Operator

Javier Escalante, CER.

Javier Escalante - *Consumer Edge Research - Analyst*

Hi, thank you. I would like to go to slide number 20, where you show the pro forma Coty 2015 being $1.20 to $1.25, and then four years from now, being $1.48 and $1.53. Does it mean that you expect the combined Company to grow EPS of 5%? Organically, this is the way to reach it? Thank you.

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

No, actually, that's not what we're saying in this slide. In this slide, what we're saying is that we've -- on a pro forma basis, if you have the Coty business, the P&G carve-out business, plus the synergies, minus D&G and the Christina Aguilera, you increase EPS by 50% after year-four.

We are not speaking about growth rates, underlying improvement of the business. We are not adding [ida machas]. We're not doing any of this. We are only doing a mathematical exercise where we're saying we are Coty standalone. Day-one the carve-out business from P&G will come, plus we will generate some synergies with the impact of the three factors into our current EPS. That's all what we're saying. Which is already, by the way, a pretty substantial increase in EPS.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

But just to be clear, so organically, on the underlying business, I would not make any aggressive assumptions. Because you have to realize that the same people which are doing the integration also have to manage the business, just to be crystal clear. So this is a very complex transaction which has to be integrated over the next couple of years. So it's the same people which are doing both.

Operator

Dara Mohsenian, Morgan Stanley.

Dara Mohsenian - *Morgan Stanley - Analyst*

Hey, Patrice I just wanted a couple of clarifications. And maybe I'm looking at this wrong -- there's a lot of info here, But it looks like your pro forma free cash flow expectation is moving down to $800 million to $900 million, from $900 million previously. Is that correct, and why is that, given the higher synergy and pro forma EBITDA assumptions?

And then also the brands that aren't transforming over, Dolce and Aguilera, it looks like you're paying $3 million less in the deal, despite losing $130 million in EBITDA. Is that correct, or am I missing something on that front? Thanks.

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

So first on the $800 million, $900 million. This is at closing. So this is without the synergies, this is without the working capital synergies. This is not -- when we receive the business, the pro forma free cash flow generation will more than double, day-one. That's the way you should look at it. And then you add the working capital synergies, and all the rest.

So now on Christina Aguilera and Dolce & Gabanna -- first, we have put in the S-4 a conservative assumption. But at the end of the day, for the time being, we are not in the driving seat of that, so we need to wait until we see what happens on D&G and Christina Aguilera before we can draw any conclusion. First point.

Second point, the $130 million -- this is not the ABGA. The $130 million is the gross margin minus the brand investment, which is the NCP. The cost structure attached to that is part of the synergies level that we have indicated.

Dara Mohsenian - *Morgan Stanley - Analyst*

Okay, that's helpful. Thanks.

Operator

Linda Bolton Weiser, B. Riley.

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

Hi. Of the $400 million of synergies, excluding the $380 million that are initially recognized, how much of that $400 million falls in year-one?

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

So we have not provided this level of detail. What we have said is that we will generate $780 million, and that this $780 million has a phase-in of 40%, 70%, 85% and 100%. What you can assume is that the totality of the $380 million are going to materialize day-one. Okay? And the first year, as Bart has indicated and as I've indicated, we'll have to staff up the organization and stand up the organization.

You need to understand that, as Bart said, it is a carve-out. So what does that mean? This means that P&G is organized with a big shared service center called GBS. We do not get any of this. So from a back-up expansion, for instance, we don't get any person to close the books. So we need to staff up and to set up our organization, in order to be able to close the books after month-one. So that's one example amongst many others.

So I think the way you should look at it is that the $380 million are going to materialize year-one. And then you're going to have a couple of investments that we need to do in order to be able to staff up the organization. But the true way to look at it is that we are going to generate $780 million of synergies with 16% of the acquired revenues. And 70% of that is going to materialize after year-two.

Bart Becht - *Coty Inc. - Chairman & Interim CEO*

Right. I think that concludes basically today's session (technical difficulty).
