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COTY - Q3 2018 Coty Inc Earnings Call

EVENT DATE/TIME: MAY 09, 2018 / 12:00PM GMT

OVERVIEW:

COTY reported 3Q18 reported net revenues of $2.2b, adjusted net income of $96m and adjusted EPS of $0.13.

CORPORATE PARTICIPANTS

Camillo Pane *Coty Inc. - CEO & Director*

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

Patrice de Talhouët *Coty Inc. - CFO*

CONFERENCE CALL PARTICIPANTS

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

Dara Warren Mohsenian *Morgan Stanley, Research Division - MD*

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

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

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

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

Linda Ann Bolton-Weiser *D.A. Davidson & Co., Research Division - Senior Research Analyst*

Mark Stiefel Astrachan *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

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

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

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

PRESENTATION

Operator

Good morning. My name is Jonathan and I will be your conference operator today. At this time, I would like to welcome everyone to Coty's Quarterly Earnings Call. (Operator Instructions)

I would now like to turn the conference call over at the Mr. Monaco. Mr. Monaco, you may begin your conference.

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.

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

Thank you, Kevin, and welcome, everyone to our fiscal 2018 third quarter earnings call.

Our results were generally in line with our expectations as we delivered steady performance with modest positive organic top line growth, supported by strong growth in a number of brands, emerging markets and new channels, partially offset by some challenges mainly in Consumer Beauty.

Q3 represented another great strong quarter for our Luxury division, while our Professional Beauty division once again demonstrated consistent solid sales growth. The Consumer Beauty division continues its uneven performance but with encouraging signs of stability and some bright spots that I will discuss in a moment.

The continued stabilization trend to our top line, coupled with ongoing improvements in our cost structure resulted in another quarter of healthy adjusted operating profit improvement. I'm pleased with this progress and with the improvements we have made so far. However, as I've said before, there is still much work to be done before we realize a consistent result that we seek as we deliver our synergies and continue the integration of the P&G Beauty Business.

Moving on to our divisional performance. Our Luxury division delivered outstanding 6.1% organic net revenue growth, marking the fifth consecutive quarter of healthy sales gain. Our strategy, which focuses on increased premiumization, including a stronger innovation pipeline and superior store execution, propelled growth across all regions and most brands.

We continue to gain share in travel retail, further building upon our leadership position in the fragrance category. Here, I will call out our performance in Asia where we saw strong consumption trends for our key innovation such as Gucci Bloom and Tiffany's, but also new levels in China, Korea and Thailand. Our European travel retail business also experienced excellent momentum in the quarter.

The continued strong growth in Luxury in EMEA was driven by both innovation as well as channel expansion in key geographies. China, for example, grew strong double digits driven by the recent rollout of Tiffany's in the country, the continued success of Philosophy, as well as recent changes made to our go-to-market strategy for Gucci. In fact, key Tiffany's launch in China was so successful that it propelled the brand to a top 2 position at Sephora in China.

As for innovation, during the quarter, we capitalized on the continued success of Gucci, which enjoys a strong top 10 position in most key markets by launching Gucci Bloom Acqua Di Fiori and Gucci Guilty Absolute Pour Femme with both showing very positive results.

Finally, in March, we launched Chloe Nomade, which has been showing promising results in its first weeks in the market.

Looking ahead to future growth, we have recently launched a new Burberry fragrance and we recently announced a new launch for our Marc Jacobs Daisy franchise for the first time in over 4 years called Daisy Love with an ad campaign featuring Kaia Gerber.

Moving on to our Professional Beauty division. Organic net revenues increased 1.9% marking the sixth consecutive quarter of positive growth. Our strategy to be the best partner to salon owners and professionals led to growth in all key hair brands and OPI. This solid performance was driven by the continuous strength of Wella Professionals, which continues to benefit from the success of our Wellaplex product line but also from other brands like Nioxin and Sebastian, which are performing well in most channels.

I'm also pleased that OPI continued to grow globally with particular strength in our North American region, which has shown growth -- which has grown for the past 4 quarters. In fact, both gel and lacquers had a solid growth in the quarters still benefiting from the restage of our gel product line, which includes new color coordinated bottles.

In Consumer Beauty, net revenues declined minus 4.4% on an organic basis with the backdrop of a challenged mass beauty market and competitive pressure, but with several pockets of strong results, including encouraging performance improvement from some of our key brand's relaunches.

As I've said before, it will still take time for the full recovery of the Consumer Beauty division, although we are seeing signs of stabilization improvement.

Europe was modestly better in the quarter compared with the performance of the first half of the fiscal year. In the U.K., we observed some encouraging results from the relaunch of Clairol Nice 'n Easy and our latest Root Touch Up innovation.

In emerging markets, Consumer Beauty continues to gain share in Brazil, Turkey and Mexico. Speaking about Brazil, I'm pleased to see a continued increase in share across most brands, although the trade has been aggressively managing inventory levels in response to price readjustments, creating some near-term headwinds for Coty Brazil but ultimately, creating a healthy business in the future.

In China, since creating our [finished] structure, our focus has been on delivering a new fast beauty model, opening more retail distribution in Tier 2 and 3 cities and in shaping our business partnership with Alibaba.

Regarding brand performance. Max Factor global relaunch, including the You x Max Factor campaign, led to double-digit growth versus the year-ago period fueled the best success in China and in the Middle East as well as the return to growth in the U.K. Bourjois maintained its #1 position in the Middle East, and we just launched the brand in China this quarter.

In the U.S., most retailers have now received the new COVERGIRL wall graphics and imagery, while the phasing of new projects is ongoing with a complete nationwide conversion expected by calendar year-end.

Overall the beginning of our relaunch is showing encouraging improvements of our sellout in the last couple of months, and we expect sales to continue showing gradual improvements over time. Although we continue to emphasize that COVERGIRL recovery will take time, it should be evaluated over several quarters.

For Clairol, our recently launched new ad campaign in the new Nice 'n Easy technology, translated to improved sellout trends for the Nice 'n Easy and Root Touch Up figures. However, reduction in distribution of some of our other hair color brands such as Vidal Sassoon has left the performance of our hair color portfolio under pressure. We continue to focus on driving improvements in sales through our brand-building activities.

Younique generated strong, but smaller growth compared to the last quarter. In Q3, the recruitment of presenters continued at a strong pace. Active presenters of 250,000 grew modestly versus a year ago given the high base comparison.

Other KPIs such as frequency of purchases and value per presenter continued to show very positive progress. We expect these trends to continue through Q4 as Younique prepares a new set of launches for fiscal '19. On that note, Younique has just launched its first fragrance and its the first joint project with Coty, which opens an exciting new category for presenters. Looking ahead, we continue to be very pleased with the performance of Younique as we develop this platform for the future.

I would now like to pivot to a key growth pillar, which is the acceleration of our end-to-end digital transformation, including e-commerce. We've continued to focus on transforming our digital capabilities across the organization, and the launch of our digital accelerator this quarter is a key milestone in this transformation. This new program allows technology start-ups to share their latest innovations at Coty's Quarterly Digital Accelerator Summit and earn the opportunity to work with our vendors' brand portfolio. This is truly an exciting new program and I cannot wait to share more with you in the future.

I'm also pleased to report that we again, realized strong growth in e-commerce revenues on our base business in all 3 divisions ahead of the market.

Let me just comment on our previously announced brand portfolio rationalization program, which is now concluded, resulting in the reduction of 14 brands, including GUESS, Cerruti and Playboy. The streamlining of our portfolio allow us to focus on those brands where we are, particularly suited to drive long-term revenue growth. We are confident that we are creating the right portfolio brands across categories to continue fueling our growth. Patrice will provide further details in a few minutes.

I'm very encouraged by what we have achieved so far in fiscal '18, including the continued stabilization of our performance, the continued integration of the P&G Beauty Business, and the relaunch of many of our brands. There is certainly still much to do, and I'm confident that our commitment to our growth strategy is working, and has put us on the right path to a full recovery for Coty and I believe that these results show that.

As I told you last quarter, revenue recovery will be not a straight line, but we'll continue to aim to deliver modest organic net revenue growth for the second half of the year.

For adjusted operating margin, we've continued 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 and synergies.

I will now turn the call over to Patrice.

Patrice de Talhouët - *Coty Inc. - CFO*

Thank you, Camillo, and good morning, everyone. The third quarter saw further progress across several areas, including the P&G Beauty Business integration, the rationalization of our brand portfolio, and the delivery of results consistent with the framework we have provided.

Reported net revenues reached $2.2 billion in the quarter, a 9.4% increase versus last year at actual rates. Excluding the impact of exchange rates and the contribution from Burberry and 1 month of Younique, organic net revenues were up slightly at 0.2% versus prior year at constant currency.

I am particularly pleased with the quality of earnings delivered this quarter. First, our adjusted gross margin was 64.3%, an increase of 100 basis points year-over-year mainly due to the realization of benefits from our synergy program. This realization has been seen in all 3 divisions, and will continue to be a focus area in the future to allow us to achieve sustainable operating margin improvement. This increase has also allowed us to dial up some marketing spend in the period to support our multiple brand relaunch efforts as planned.

All this, combined with a tight cost discipline, which is and remains a priority, has resulted in a 9.4% increase in our adjusted operating income to $228 million or an equivalent 10.2% of net revenues. Adjusted net income of $96 million was largely due to higher net interest expense and a slightly higher tax rate, resulting in adjusted earnings per share of $0.13.

In a seasonally low quarter in terms of cash flows, the progress in the integration of the P&G Beauty Business translated into partially high operating and capital expenditure cash costs. Looking ahead, our focus on cash and working capital management remained absolutely unchanged, and we expect cash generation to improve over time as the top line and shape of the P&L continue to improve. We also continue to return cash to shareholders, utilizing more than $90 million to pay dividends during the quarter.

Let us now focus on our progress in building a [peer] changer in the beauty industry. The overall integration is progressing in line with our timetable. As we advance towards the end of the integration, we have fine-tuned our original estimate made 2 years ago and have broadened the scope, including further go-to-market changes, systems enhancements and more complete one order, one shipment, one invoice. As a result, we now expect to incur a slight increase in one-off costs from $1.2 billion to approximately $1.3 billion. The CapEx will remain in line with the original estimate of approximately $500 million.

As far as the synergies are concerned, we are confirming that we are in line with our progress to achieve 50% of the $750 million synergies by the end of this fiscal year and expect to achieve a realization of the balance by the end of fiscal 2020.

Last but not least, as mentioned in my opening remarks, I am pleased to say that we have just finalized our previously communicated brand portfolio rationalization program. This is an important milestone to our objective of simplifying the business and optimizing the allocation of resource, and as result we have 14 fewer brands in our portfolio. We achieved this rationalization by being very financially disciplined with around mid-single-digit annual EPS impact. As already discussed, the proceeds have been used to pay down debt.

I would now like to take a moment to highlight the strength of our balance sheet and the recent successful refinancing of our capital structure.

Despite volatile market conditions in April, we executed the full refinancing of our debt capital structure, including the issuance of our first bond offerings. There were a number of benefits realized in this refinancing, including simplifying the dual capital structure created as a result of the acquisition of the P&G Beauty Business; decreasing the weighted average cost of debt, while extending the debt maturity profile; increasing the fixed rate portion of net debt outstanding to 50% of our portfolio; and further diversifying our funding base across different markets, while properly matching euro debt and cash flows. This refinancing has created a solid foundation upon which we can continue to be a global challenger in beauty.

In summary, we are pleased with the progress made during the quarter with the quality of Q3 earnings and with the strengthening of our balance sheet, which are all important steps in building the right foundation to achieve our long-term strategic objectives.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Faiza Alwy from Deutsche Bank.

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

So a couple of questions. First of all, could you maybe just aggregate the growth in ALMEA between Brazil or Latin America and what the negative impact from that was versus the growth in China?

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

I think Faiza, thanks for the question. Our performance by region is actually very positive for Luxury and Professional Beauty where we've experienced growth across all regions with higher levels in ALMEA. When we look at Consumer Beauty, it's fair to say that we've continued to really have more pressure in North America and Europe but in ALMEA, we are growing. And because of the destocking that we had in Brazil, we had slowed down our growth in Q3. Really not taking consideration of the Brazil growth, we're actually experiencing a good level or a strong level of growth in the rest of ALMEA in Consumer Beauty and we're quite pleased with that. That includes China.

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

Okay, great. And then, Camillo, I just wanted to ask you, you've been a company in transition for several years and as you look ahead to fiscal '19, it seems you're generally on track to stabilize the business. So I'd love to hear, what your strategic priorities are going to be and what areas you will be spending most of your time on? And related to that, can you discuss how you're viewing M&A as you look ahead to next year?

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

Yes. As I said, I think we are seeing a good sign of stabilizations and also actually we had the 2 divisions out of 3 that continue to perform very well. And now this has been happening for a number of consecutive quarters. When I look at my strategic priorities, I think they are in line -- and where we spend a lot of time, they are in line of where I discussed previously, in one of the previous quarters in terms of strategy. So I will spend a lot of time on innovation because we need to continue strengthening our innovation process to be faster and that will result in a stronger innovation pipeline, although we're making good progress in this area. The second area is definitely the digital transformation, and one thing that I can say is that I'm pleased with the progress because we are experiencing a strong level of growth in our e-commerce sales, growth which is ahead of the market in all the 3 divisions. And the third part where I will clearly spend time is the continued relaunch of some of our key brands. I think a lot of focus has been put on the COVERGIRL and Clairol relaunch in the past couple of quarters. But it's fair to say that across the different portfolio, Consumer Beauty, we still have to continue with the COVERGIRL and Clairol work but also to work on some of the other brands, which require a strong consumer connection. On M&A, I will not comment specifically so that's probably the last part of your question but Patrice has said several times that this is part of our future strategy, although at the moment we are clearly focusing on completing the integration and returning closely to the results that we're seeing that we want to have.

Operator

And our next question comes from the line of Dara Mohsenian from Morgan Stanley.

Dara Warren Mohsenian - *Morgan Stanley, Research Division - MD*

So it sounds like China Travel Retail and e-commerce were all key drivers behind the revenue growth in the quarter. We've been spoiled by most other beauty companies breaking out, how much of those businesses are worth the sales mix. You guys haven't been as generous with us, but I was hoping, given their importance to your revenue growth recently, you'd be willing to provide us with some more detail on how large each of those areas are now as a percent of your sales mix? And then just conceptually, as you look out the next year, how should we think about the momentum there? And if it's sustainable, as we look out to fiscal 2019?

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

Thanks, Dara, for the question. We will not really go into the details of the specific size of the 3 areas, but what I can tell you is that we are very pleased with the performance in China. In one of the previous call, I did mention that one of the earliest step that we took, which was [quite bold] at that time, because it was the beginning of the merger, was to go straight into an affiliate model, so in-house operations in China across the 3 divisions. So to move straight right away from distributor set up to in-house and affiliates. And I have to say that both in Luxury and Consumer Beauty but also Professional, our structure is paying off because we're experiencing a strong level of growth. In Luxury, for example, we are, I think, the fastest-growing fragrance company in China. But also, it's not only that, it's the fact that it's the quality of the work that I'm seeing with digital innovation, with the partnership with Alibaba, with the work that we're doing with Tmall, at the moment, we already have 6 brand stores on Tmall, and we plan to have more in the next 12 months, this brand store that we have are in Consumer Beauty, in Luxury but also in Professional. So overall, strong work in China. And one more thing that I would like to say is that really we're also focusing on delivering an innovation pipeline that is more suited and focused on the Chinese consumers. When I look at Travel Retail, I think what is important to say that this is -- has been quite a strong channel for us for quite a long period of time, we are the fragrance leader in Travel Retail, and it's interesting that we are achieving growth in all the different regions. And this is not only driven by the Gucci and the Tiffany that I mentioned but also by the Philosophy, for example, which is going very well in Travel Retail. And another interesting fact is that actually Tiffany in Travel Retail in Asia is performing at the same level in Gucci Bloom, which, again, shows how important it has been the launch of Tiffany for us. And the last thing is, we are, as many companies are doing, focusing on the Chinese consumers also for Travel Retail and therefore we are developing more Chinese-friendly products; we're engaging more digitally; we're focusing on gifting, which is quite an important element in the Chinese culture and it's also an important part that fits very well with the fragrance business that we have. I think e-commerce, I have already mentioned, we are growing strongly ahead of the market across the 2 divisions. This is a big focus for us. And since I have announced a new e-commerce structure, the renewed focus on this channel, I have to say that we have seen a step up in the performance of these channels across the 3 divisions.

Operator

Our next question comes from the line of Wendy Nicholson from Citi.

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

Could you talk a little a bit more about the impact of the divestiture program. I think you initially said it was 8% of sales that you were targeting, but the impact is only mid-single digit on EPS. Is that all in next year because I know you've already been selling of some of these brands. So can you just clarify specifically as we model our fiscal '19 results, what impact we should see on both the top and bottom line?

Patrice de Talhouët - *Coty Inc. - CFO*

Thanks, Wendy. Great questions. So on the portfolio rationalization, first, so when we talk about 6% to 8%, when we talked about that 2 years ago and the work that we have done in the course of these 2 years is to have a thorough review of the portfolio and to see with the performance to date the brand positioning, the brand potential and the strategic fit with our portfolio, which one would stay within our revenue. So we have decided to either discontinue or sell 14 brands. What I said is that the EPS impact was on an annual basis, mid-single digits, that you are going to see as from now, so 2 months in the coming quarter, in Q4, and then the rest in the quarters to go. And we didn't specifically mention what was going to be the impact on the top line. What I can share with you is that it will be very modestly growth accretive on the overall portfolio of Coty. And the other data point that I can give you is that actually this roughly represents 6% of -- it's mainly in Consumer Beauty and it represents 6% of the Consumer Beauty portfolio, excluding Younique.

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

And are all of those brands going to be...

Patrice de Talhouët - *Coty Inc. - CFO*

And the proceeds, As I've always shared, have been used to pay down the debt.

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

Okay, got it. And all of those transactions are done. It's not like you're waiting to get proceeds in the door or commitments to be signed?

Patrice de Talhouët - *Coty Inc. - CFO*

Correct.

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

Got it, and then actually I have just a second follow-up question actually, on OPI. The fact that, that business came in -- I know it's not a huge brand, but it still caught my eye because I know the nail category has been so tough, so is -- would you be willing to say this is sort of the beginning of maybe some growth in nail or was this just something specific you were doing in OPI that boosted market shares temporarily? Just because I know it's been such a tough spot for a long time now, category-wise.

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

Wendy, thanks for the question. I think on OPI, I can tell you a couple of things. First of all, the nail category, it's true that it is under pressure in the mass retail, where it continues to decline, although the declining has been softening in the last couple of months. But we are talking about a brand that is mostly sold through the Professional channel and through the Luxury prestige channel. It's mostly really a professional brand. And in the Professional channel, we are not seeing a big decline in the category, or I cannot tell you the category is growing a lot, but definitely it is not as soft as it's been in mass retail. Because the service, the consumers are getting continues to be very, very appealing and OPI is absolutely a great brand, the biggest brand in professional nail care in the world. And the reason why we are achieving good results in OPI is twofold. First it is because it's now being managed by the Professional Beauty division, which is the division that has the highest level of expertise in B2B, so in dealing with a service channel and therefore having the right attention, skills and capabilities on how to educate and service and provide to the professional nail channel. Because, of course, this is the reason we are dealing with the hairdressers and in the hair category for decades. So that's truly part of the DNA. And the second one is that we have a couple of very good innovation OPI, which are also helping to propel growth. And one is still the gel we launched, which I have mentioned a while ago, and the second one is a couple of very strong collections. OPI is truly part of the pop culture, especially in the U.S., therefore getting the right collections in the hand of retailers, consumers and the professionals, is absolutely key. So I can tell you the last Lisbon collection is performing quite well. And I think the combination of the 3 factors, capability and innovation, are driving OPI growth at the moment.

Operator

Our next question comes from the line of Mark Astrachan from Stifel.

Mark Stiefel Astrachan - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Wanted to ask about free cash flow. So just in general, I guess it's been a little bit weaker maybe than expected. So how should we think about it, sort of broadly relative I guess to what you'd outlined a couple of years ago on the road show. And just in terms of the puts and takes, you've commented on some of the costs today, but just on the actual cash from operations generation? And then how do you think about that as the ability to repay debt? What's a reasonable level to think about from debt reductions going forward? And if you could give whatever the impact was on the proceeds from the divestitures, that will be helpful too.

Patrice de Talhouët - *Coty Inc. - CFO*

Yes, great question, thank you, Mark. So cash is, and remains a top priority for the corporation. And currently, it's very clear to all of us that we have the firm intent to deleverage the business. So that's really just to set the scene. This quarter is a low seasonal quarter from a cash generation standpoint. That's point one. Point two, for this quarter, we have built up, intentionally, we have built up some inventory to prepare for the distribution center consolidation. So that has an impact on the working capital. Third, we have accrued some one-off costs for the integration in the previous quarter that had a significant cash impact into this quarter. So I would say that this quarter had been abnormally low from a cash flow generation and as a result, the leverage now is closer to 4.5 while normally, it was before at 4. But, clearly, in the course of Q4, we are aiming at coming back to a normal level and working capital is and remains a priority. I remind all of you that I've already mentioned that we were at 0 working capital, which is best-in-class performance in this industry. And that -- this continues as is, and so we have the firm intention to deleverage the business. I'm not going to give you a target but, clearly, as from next year, we want to deleverage the business and that's a key focus, and we are gearing up the organization to be able to do that. On top of that, as you know, we have already incurred most of the one-off costs, which means that this will weigh significantly lower in fiscal '19 and we'll increase our ability to regrowth and to pay down debt. I am not going to give you, I'm sorry, but I will not disclose the exact number of proceeds but as I have said -- and so as I've said in the credit road show, we have already used these to pay down debt.

Operator

Our next question comes from the line of Joe Lachky from Wells Fargo Securities.

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

Just a clarification on the last one on the divestitures and the proceeds. I guess, I'm not seeing anything in the cash flow statement. Is that a Q4 impact? And was that debt paid down in Q4?

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

Correct.

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

Okay. All right, and, I guess, if we could go back to the restages. I guess, how would you view the success of the restages to date? Or, I guess, is it simply too early to tell, I guess, given you really didn't see the benefit in Q2 -- or in Q3, excuse me. Are all the new products on shelf, are all the fixtures in place? Was there any impact this quarter from discounting older merchandise during the restages? And then finally, can you walk through the degree of acceleration and sell-through that you've seen, if there has been any?

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

Thanks, Joe. Look, the restages are -- I'll focus on the top ones. So clearly COVERGIRL in the U.S., Clairol in the U.S., U.K. and Canada. We also actually restaged also Max Factor in the rest of world, which I can mention a couple of words. Starting with COVERGIRL, we are encouraged by the performance of COVERGIRL so far, and we have seen early signs of stabilization. The brand has gone from primarily double-digit declines prior to relaunch to a low single-digit decline in March and April. And not only are we seeing improvement in sell-outs but also we have started to stem the losses in share and actually, we had a couple of weeks in which we had share growth versus prior year. And prior to the relaunch, I have to say that the brand had not really positive share gains for quite a long time. So when we look at the sell-out results, we're encouraged by seeing these improvements, as I mentioned. And there a few other things that are encouraging like, for example, the organic online conversations that we keep seeing on COVERGIRL, they are growing double-digit. And normally this is a positive indicator of future consumer connection, and that's how we're forming our encouragement and opinion. I think you asked about how much product or new products has been -- has reached the shelf for COVERGIRL. What I can tell you is, and that -- I did mention this, this is a big undertaking with over 1,000 SKUs changes in over 60,000 doors. So by now, for an execution point of view, 95 -- so basically almost all retailers have now received the full -- the new wall graphic, the new imagery. But from a new product point of view, therefore also new packaging, only 30%, 40% of the new product is on shelf today. And we do expect 100% of the new product to be on shelf by the end of the calendar year. So it's phasing in, the wall has been changed, the imagery as well. [Reform of] packaging we are in the middle of this. Despite that, as I said, there are some encouraging results. Looking at Clairol, which was the second, I would say, major relaunch. What we've done in our original phase of the relaunch in Clairol, we focused our investment 2%, Nice n' Easy which has also a new technology and Root Touch Up, which has a new innovation with a temporary root touch up problem. And we are starting to see the positive momentum in both Nice 'n Easy and Root Touch Up with an improvement of, week over week, of our sell-out performance in both U.S. and U.K. although we are still declining, but we're not declining as much as we were declining before the relaunch. In Canada, where the transition has been faster, we're actually experiencing some share growth. So this really gives us some optimism in the future. Now it's also fair to say that the overall Clairol brand is still under pressure because there are other parts of the brand like Age Defy and Vidal Sassoon, which is part of our hair color portfolio, which are under a lot of pressure and therefore they are being offset in the improvements we're seeing on Nice 'n Easy and Root Touch UP. And the last piece -- and on Clairol, in terms of implementation of the new packaging, we're also in the middle. This is a bit slower than COVERGIRL because it takes a bit longer. This is a category, a product category that consumers buy with less frequency than Color Cosmetics and therefore it's going to take a bit of a longer time so we're in the middle as well. The last one I want to mention is Max Factor where we have not changed the packaging but we have changed the imagery of the wall and the positioning with the new creator. We have a new creator, new positioning and this is driving actually a stronger double-digit growth in several markets, including Middle East and China. And this is, of course, encouraging for us as well.

Operator

Our next question comes from the line of Olivia Tong from Bank of America Merrill Lynch.

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

First on COVERGIRL. Where do you think you are in terms of sell-through of old inventory? And then when it gets to a steady state, how do the margins of the revamped line compare to that of legacy COVERGIRL? And last quarter you said that Consumer Beauty should have sequential improvement in second half. Do you still think that's the case?

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

Thanks, Olivia. In terms of sell-through inventory, as I said, we are in the middle. So that's what I mentioned before. New products, which includes innovation but also new packaging for the [class of] standard products. We are 34 -- around 40% of the new products in shelf and the rest still to come. So we have until -- we expect this to really be fully completed at the end of calendar 2018. In terms of innovation margin, what I can tell you is that all the innovation that we're bringing are actually performing better than the previous innovation that we launched a few quarters ago. So that's also very encouraging because this is really the first innovation bundle, let's call it, that is being developed by the new team -- by the new Coty. And we can say that from a margin point of view, there is no theme happening, the new innovation is in line or accretive versus the previous innovation. In terms of an estimate for our second half of '18, as I said we're not really changing our view versus Q2. So we really aim to deliver modest organic net revenue growth for the second half of the year. And in terms of operating margin, we continue to aim for a healthy improvement in the second half of the year versus the previous -- prior year with most of the impact in Q4 because of the delivery of our synergies.

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

Got it. And then a second question on synergies, you talked about being on track for the achievement of synergies. Your advertising spend should be around 25%, 26% of sales. You talked about some of the digital investments that you've made already. So how do you think about the flow through of savings as we go into next year? Are there other investment plans? Or should we start to see more of that synergy flow through?

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

So as we have already said, most of the -- we have -- we will have, by the end of this fiscal year, realized 50% of the synergy. What we have done is that because we have inherited from a smaller business and from a more distressed Consumer Beauty business, we have used the synergies to mitigate some of the negative financial impact. So now this being said, going forward, you should see the bulk of the synergies, of the remaining 50% that we will generate in fiscal '19 and fiscal '20, to fall bottom line. This being said, between quarters, I've always said, we might dial up the investment to further fuel the top line, so that might vary one quarter versus the other quarter. But generally speaking, the bulk of the synergies going forward should pull bottom line. And that's one of the way in order to achieve our ambition, to achieve higher teens operating margin.

Operator

Our next question comes from the line of Jonathan Feeney from Consumer Edge Research.

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

Just to follow-up on the last -- on the synergy delivery. I think it was on the last quarter's call, you talked about 50% and then 80% of synergy capture by the end of '19, and then all of it by '20. I think earlier in your comments you said just 50% over the next 2 years. I realize you're talking about 30%, 20% versus 25%, 25%, but would you still think you'd get 80% synergy capture by the end of '19 in addition to all of it by being on track for '20? Forgive me if I heard that wrong. And secondarily, if you could talk about the expansion in operating profit in Professional, impressive. Is that synergy capture, is that a mix margin issue and any comments he could make there?

Patrice de Talhouët - *Coty Inc. - CFO*

Yes, great, great question. So let me clarify. So the synergies, the saving of synergies are the following and remains the following: 50% by the end of this fiscal year, 80% by the end of fiscal '19, and 100% by the end of fiscal '20. So this is the phasing of the synergies. And what we have also said is that the synergies is escalating, so this fiscal year, will be a back-end loaded and you should see some benefit of that in Q4. Now regarding your question on the Professional division, you are absolutely correct. The profitability of the Professional division has increased by 650 basis points to 6.7% operating margin. While I must admit, the starting point was low because it was breakeven last year. But this being said, it has been on the back of 2 main elements. The first one is the premiumization of the gross margins. So, as I have said in my script, gross margin is a priority of the corporation, it's really the pulse of the corporation and what allows us to further invest in our brand. So there have been some interesting development in Professional Beauty on the gross margin. And we have also attacked our cost structure in order to be able to boost the profitability, and they have done that quite successfully. So that's the 2 elements that are driving the 650 basis point improvement.

Operator

Our next question comes from the line of Andrea Teixeira from JPMorgan.

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

So I know Nielsen doesn't cover all your businesses but just as on a sequential basis, the data in the U.S. looks like you continue to lose some distribution points for Consumer Beauty. So I was wondering if you can call on -- in the last call, I was wondering if you can comment, of course, on the reposition of COVERGIRL? And on the last call I recall you said that you were guiding for flat distribution for this year and in the U.S. So can you just talk about how you're seeing it now, relative to your plans? And if you're starting to see it flat and in the back half of the year? And the second question is a clarification on Wendy's question. And you said in the portfolio rationalization, you're looking at a mid-single digit impact on EPS starting in the fourth quarter fiscal. So does that mean like a cent EPS, like a $0.04 to $0.05 EPS impact over the next 4 quarters? Or you're looking at a percentage impact? So I just want to clarify. And on that, what is the type of margins you're getting in this business? I'm assuming those margins were higher. So there will also be a margin impact I'm assuming as we -- as you pointed out in the past.

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

Thanks, Andrea, for the question. Yes, looking at distribution, what I can tell you is that looking at what I've said in the last few months, COVERGIRL distribution has stayed relatively flat. And so from that point of view, based on the improvement and the performance that we have seen on COVERGIRL, we would expect to retain the vast majority of our shelf space in the U.S. However, as you know, shelf space decisions are at the discretion of our retailers -- retail partners. Now when you look at Clairol, it's a similar situation because at total level, Clairol distribution has actually stayed flat over the spring, so the January, March shelf reset. And -- but what happened, within the Clairol brand there has been a bit of a rightsizing between the different subbrands because we had some declines in nonproductive subbrands like Age Defy or Vidal Sassoon but at the same time we also had gains in ancillaries and root touch up segments. So overall -- the overall Clairol distribution is -- has stayed more or less flat, but with a bit of a shift within the segments. And in terms of expectation, we are working really with the retail partners. We're seeing improvements in our performance, but of course, these are ongoing discussions for the future. Do you want to talk...

Patrice de Talhouët - *Coty Inc. - CFO*

Yes, so regarding the clarification question on the portfolio rationalization. So your analysis is correct in the sense that the mid-single-digit EPS impact is on a full year basis and because we have done -- we have realized and completed the portfolio rationalization early May, you should have a 2-month impact of this mid-single digit -- that's on an annual basis. You should have a corresponding impact in Q4 and also in 3 quarters of next year. So now in terms of operating margin, normally we don't go to that level of detail. But it is fair to say that what we said also before, that these brands were usually profitable, more profitable than the average of Consumer Beauty, so you should have the corresponding impact on the shape of the P&L. And for EPS, it's a mid-single impact on an EPS, not on a percentage, on cents.

Operator

Our next question comes from the line of Lauren Lieberman from Barclays.

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

I just wanted to go a little bit more into detail on Brazil, because as I recall last quarter, you guys talked about competitive pressure on pricing in Brazil, so meaning you had competitors that were being pretty aggressive on pricing but you were still gaining share. And then this quarter in the release it talks about or suggests that you've taken pricing up in Brazil. And then on the call you talked about inventory destocking. So I just love a little bit of -- I guess connecting those 3 threads. And if you could give us a little bit more of a discussion of Q2 versus Q3, I know Clairol was a big benefit last -- was a big success last quarter of Brazil, but then also the local brands. I'm just having trouble putting all the pieces together.

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

Thanks, Lauren. I'll try to connect those results. So what happened is, first of all, I think the most important thing is to say that in Brazil, we continue to experience very a strong sellout and market share growth across most of the brands. And we've been growing more than twice the speed of the categories in which we play. So that is really a very strong result that we continue to have, similar to what we had in the previous quarter, which I had mentioned before. And it's clearly, a very strong indication that our portfolio is really reaching out to consumers in the right way. What happened in this quarter is that really we wanted to have a healthier business, and so we went through a series of actions, including the increased pricing. And what happened is, given the current tough economic conditions we have experienced during this quarter, quite a large destocking effort by the retailers and, which is something that has can happen when you increase pricing, you need to manage inventory at the beginning and immediately after the price increase. But overall, it's going to create a much healthier base for our business going forward. And that, to me, is a positive clearly effect of these type of actions that we have taken. Connecting the dots, I think the most important point between Q2 and Q3 is that our Brazil business continues to be healthy from a consumer point of view, from a sellout point of view, from a -- connections with the retailers and the markets and the consumers. And from a P&L point of view, we are taking steps to have a better margin so that we can continue to invest in this business. If these steps are creating some short-term headwinds from a trade reduction point of view, that's something that we need to manage and we're managing at the moment.

Operator

Our next question comes from the line of Steph Wissink from Jefferies.

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

Id like to dig into the marketing step up. I think you called that out the last couple of quarters. If you could just talk a little bit about where you're focusing some of your marketing spend? If we should think about this as a temporary step up to support the relaunches or if you're seeing this as an elevated level that we should model over the next couple of fiscal years just to support the overall brand portfolio?

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

Thanks, Steph, for the question. In terms of marketing spend, what I can tell you clearly is that when you relaunch brands like COVERGIRL and Clairol, which had not been performing for a while, you do require a bit more fuel, especially in the beginning to kickstart the engine and that's what's happening, especially in the month of March, so towards the last part of the quarter that we are -- that we're releasing today. In terms of this being a temporary step up, what I can tell you is that you always have different phasings within your marketing investment when you relaunch several brands. This is normal to put -- to have this -- you need to have this set up. On a long-term basis, we remain confident in our 25% --

approximately 25% of the marketing, as a percentage of net revenues, is the right level that we need in the overall company to bring Coty to the success that we want, and we deserve.

Operator

Our next question comes from the line of Linda Bolton-Weiser from D. A. Davidson.

Linda Ann Bolton-Weiser - *D.A. Davidson & Co., Research Division - Senior Research Analyst*

I was wondering if you could venture a guess and speculate on why the mass color market is declining at least in the U.S.? And Estée Lauder on their earnings call mentioned that they think that consumers could be trading up. So do you think there's trade up going on from mass to prestige? And can you just comment on what you think about the trends in the market?

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

Yes, thanks, Linda for the questions. Yes, I think it's true that the mass market, in general, is in the U.S. But also in some key European markets like U.K. and Germany, are experiencing some protractive softness. And I do agree that this is driven by continued trade up to prestige, but also there is the element of high-growth rate of e-commerce. And, in general, I think, the consumers are looking for a better experience. From our point of view, we continue to work with all of our retail partners -- mass retailer partners, to improve this in-store experience. We're doing a lot of digital innovation as well, in partnership with some of the big mass retailer partners. But also, as I mentioned, in one of my previous answers is we are increasing significantly the effort on e-commerce, which is one of the growing channels. And also Younique, of course, which is a new channel for us that provides more personalized experience to our consumers, given it's a direct selling platform with thousands and thousands of presenters.

Operator

This does conclude the question-and-answer session. I'd like to hand the program back to Camillo Pane for any further remarks.

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

I would like to thank all of you for having attended the call, and we'll speak soon. Thank you very much.

Operator

This does conclude today's conference call. You may now disconnect.
