COTY

COTY – A WORLD LEADER IN BEAUTY
Coty (COTY:US, Market Capitalisation US$ 13.3B) is a significant player in global beauty. The Company manufactures, markets and sells branded beauty products in the fragrance, colour cosmetics (including nail care) and skin & body care categories. Products are sold in more than 130 countries worldwide using a multichannel distribution strategy with products positioned across a variety of price points, including prestige and mass market channels.

GROWTH THROUGH M&A
Coty's strong market position is the result of its aggressive M&A strategy. In October 2016, Coty doubled in size through the merger (acquisition) with (of) P&G's beauty business. The merger (acquisition), initially valued at US$ 12.5B, was by way of a Reverse Morris Trust and saw Coty take control over some 41 brands previously owned by P&G. The transformational deal bolstered sales and expanded Coty's product suite to include the addition of 'salon professional' and hair colouring brands. Coty is now ranked as the third largest beauty manufacturer in the world, holding dominant positions across key beauty categories including #1 in fragrances, #2 in salon hair, and #3 in colour cosmetics. However, the deal has not been without its challenges.

STOCK PRICE WEAKNESS PRESENTS A LONG-TERM OPPORTUNITY
Coty has experienced negative investor sentiment following trading disruption around the close of the P&G beauty deal and concerns toward slowing revenue growth and capital expenditure. Coty has posted weak quarterly results while inventory levels (for acquired brands) have been significantly higher than anticipated. There appears an increased likelihood of integration complications with inherent uncertainty towards the timing of synergy extraction. As a result, Coty's stock has fallen 41% from its recent high of US$29.75 in August 2016 to US$17.60 in April 2017.

The Elevation Capital Value Fund began to establish a position in Coty in January 2017, at an average cost of US$18.72 per share (as at 12 April 2017).

M&A INTEGRATION
The most important value creation from the merger (acquisition) of P&G's beauty brands is Management's estimated improvement of Coty's operating profit margins from 14.3% *(Standalone Coty FY16 adj. operating profit margin)* to ~19.6% in FY2020 *(Pro forma Coty adj. operating margin).* This will make Coty an industry leader in profit margins. There exists scepticism toward whether this is achievable by 2020. However, it is our view that even if Management missed their target by say 1%. i.e., only achieved an 18.6% operating margin by 2020, the significant improvement would still require the market to rerate the stock. We also note that the margin improvement forecast does not include the anticipated portfolio rationalisation and any underlying growth in the newly combined business.

ECONOMIES OF SCALE
The completion of the P&G deal marked the largest beauty portfolio acquisition in history, significantly increasing Coty's scale. It saw the Company become the third largest beauty company globally, from seventh before the merger (acquisition). The move places Coty in an even stronger position when negotiating with suppliers, retailers, advertising agencies, and the likes. The Company has already established a name for itself as a tough negotiator including the insistence of 120-day payment terms for marketing contracts. *(Advertising agency Grey, recently resigned its Coty account citing financial differences – we hypothesise this represents a push by Coty to reduce its cost base).* We further assert that Coty's scale will enable the Company to accelerate revenue growth through the acquisition of smaller products/brands, utilising their distribution and sales networks to enhance their value.

DIVERSIFIED PORTFOLIO OF ICONIC BRANDS
Coty has a broad, well-diversified portfolio of more than 70 iconic brands including Calvin Klein, Chloé, Clairol, CoverGirl, Marc Jacobs, Max Factor and Wella to name a few. We see additional upside through further optimisation of Coty's brand portfolio. We suggest that the acquired P&G brands have not received the necessary attention required to run them optimally as they were being prepared for sale. We further highlight the 16-month window that the Coty/P&G deal took to close during which time P&G would have had little incentive to invest in the growth of these brands. We look to Coty to continue to strengthen its global brands by directing resources to higher growth potential brands while stabilising remaining brands. Coty has openly stated its intent to explore alternatives for non-core brands including the potential for divestment. We believe that this is one short-term catalyst that can improve margins, revenue/profit growth and at the same time deleverage the balance sheet.

CORNERSTONE SHAREHOLDER OF POSITIVE INFLUENCE
JAB Holding Company ("JAB") is Coty's largest shareholder, with a shareholding of 36.84% *(~US$ 5B as February 2017).* JAB is the investment arm and holding company of the billionaire Reimann family. JAB focuses on long-term investments in companies with premium brands, attractive growth and strong margin dynamics *(Assets as at 31 December 2016 totalled € 21.3B including a ~9% stake in Reckitt Benckiser).* JAB stands out, mainly due to the immense experience of the people who run it, particularly within the consumer

products industry. Current management consists of Peter Harf (ex-Chairman of Anheuser-Busch InBev), Bart Becht (ex-CEO of Reckitt Benckiser) and Olivier Goudet (Chairman of Anheuser-Busch InBev). JAB has direct ties to renowned investment firm 3G Capital - Olivier Goudet currently serves as chairman of 3G-controlled Anheuser-Busch InBev. Both JAB and 3G have a history of investing in consumer brands with a focus toward cost reduction. We believe JAB's cornerstone shareholding is extremely positive for long-term minded minority shareholders.

THE COLLAPSE OF DUAL-CLASS SHARE STRUCTURE

Following Coty's merger (acquisition) with (of) P&G's beauty brands, JAB converted all its super-voting Class B shares to ordinary Class A shares for nil compensation. With this conversion, JAB's voting rights declined from 97.5% to 36.8%. While JAB continues to have considerable influence over the Company, the collapse of the dual-class share structure allows the Company to improve transparency and governance. It also opens the door for other shareholders to have an influence over the Company.

MANAGEMENT INCENTIVES

Management is incentivised to be shareholder-oriented toward long-term value creation. Current incentive plans are structured through Employee Bonuses and Long-Term Incentive Compensation. Bonuses are conditional on increased profitability and improvements in cash generation where key performance metrics include; revenue growth, profit growth and cash conversion. Coty also encourages Management to acquire & hold their personal wealth in shares - Executive Committee members are expected to hold US$1.8M-US$5M of Coty shares while the 'top-80' leaders are expected to hold up to US$1M of Coty shares.

INSIDER TRADES

'Insiders' (including Management, Directors and JAB) have been actively buying Coty shares since the completion of the merger (acquisition) with (of) P&G's beauty brands. This includes an additional ~€ 72M of Coty shares acquired by JAB in February 2017. Such acquisitions highlight JAB's confidence in Coty's to execute on its integration strategy. We view such stock purchases as affirmation of the apparent value gap between Coty's current share price and its intrinsic value.

RETURNING CAPITAL TO SHAREHOLDERS

Management continues to show confidence in Coty's cash flow generation capability – the Company recently transitioned to quarterly dividends and increased its dividend payment by 82% to $0.125 per quarter (*this amounted to US$93.4M, vs Coty's Free Cash Flow of US$567M in Q2/17*). This implies a dividend yield of 2.8% *(based on Coty's share price of US$17.60 as at 12 April 2017)*, which is currently 87% higher than the industry peer group average of 1.5%. Furthermore, Coty bought back 1.4M shares for the six-month period ending 31 December 2016, with a price range of $25.35 - $27.40.

INVESTMENT THESIS - SUMMARY

Following the completion of Coty's complicated multi-year integration process, we expect the Company to emerge as a formidable challenger to leading peers of L'Oréal and Estee Lauder. A focus on increased scale and business segment expansion are projected to deliver economies of scale and further diversify revenue streams. We see this as a catalyst for Coty to improve its margins and stabilise its earnings profile.

Due to the extent of integration and reorganisation required, we expect Coty to experience a period of short-term uncertainty and volatility. However, we continue to have confidence in both the Board and Management to execute on its plan. Furthermore, we believe the investments into P&G's orphaned beauty brands (e.g., the relaunch and repositioning of COVERGIRL and Max Factor) could yield surprising upside in the medium term that is not currently being considered by the market. In the meantime, we are paid to be patient, as Coty currently pays what we believe to be a sustainable dividend which yields above its peers at 2.8%. Assuming sustainable cash flow generation, the attractive yield should reduce downside risk in a market sell-off.

Coty currently trades at US$ 17.60 per share *(as at 12 April 2017)*, at an implied P/E multiple of 16.76x *(based on an adjusted FY16 EPS of US$ 1.05)*. We estimate Coty's Intrinsic Value to be between US$ 16.68 - US$ 42.02 assuming normalised trading conditions. Our valuation/s represent downside/upside potential of between -5.2% to +138.8%.

For an in-depth appraisal of our investment in Coty, please refer to our full presentation which can be viewed at http://www.elevationcapital.co.nz/coty/

This summary report was written in April 2017.