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COTY - Q2 Fiscal 2014 Coty Inc. Earnings Release Conference Call

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PRESENTATION

Operator

Good morning. My name is Tracy and I will be your conference operator today. At this time I would like to welcome everybody to Coty's second-quarter FY14 results conference call.

(Operator Instructions)

As a reminder this conference call is being recorded today, Friday, February 14. Thank you. I would like now to 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. Thank you for joining us. On today's call are Michele Scannavini, Chief Executive Officer, and Sergio Pedreiro, former Chief Financial Officer.

Before we begin 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 you will find factors that could cause actual results to differ materially from these forward-looking statements. Except where noted, the discussion of our financial results and our expectations do not reflect certain non-recurring and other charges and the discussion of our revenue growth is on a like-for-like basis, therefore constitutes non-GAAP measures. You will find a reconciliation between GAAP and non-GAAP figures in our press release. I will now turn the call over to Michele.

Michele Scannavini - *Coty Inc - CEO*

Thank you, Kevin and good morning, everybody. Before I begin commenting on the business results, I want to take a minute to introduce the two new members of our Executive Committee. Let's start with Patrice de Talhouet who joined the Coty team last month as Chief Financial Officer. Patrice brings with him more than 25 years of finance experience, having served inside Senior Finance roles for a number of global corporations. He most recently served as Chief Financial Officer Europe for Mars Chocolate and Corporate Financial Officer, Americas for Mars. In these roles, he oversaw governance and compliance in the Americas and successfully led a multi-year program to transform the global finance structure.

Specifically, Patrice has a strong track record of driving efficiencies in each organization he has led. We are very excited to have Patrice on board and I believe we will benefit from his expertise and drive to bring Coty to the next level of growth and profitability. Patrice couldn't be with us today but will be with me from the next call on.

We are also excited to welcome to our Executive Committee Catia Cesari. Catia joins us as the Senior Vice President, Business Development, Mergers and Acquisition. She brings to Coty 20 years of successful experience in M&A, at global companies such as General Electric, Gucci Group, and Labelux. I believe that Catia's deep expertise and successful track record in scouting and executing highly strategic deals will be a strong asset in supporting Coty's long-term strategy.

And I also want to take a moment to thank Sergio Pedreiro, as this is his last earnings call with Coty. Sergio joined Coty in 2009, in the midst of the robust financial crisis and quick implemented a strategy that supported our growth, reduced cost, and increased Management focus on earnings and margin expansion, resulting in significant improvement. Sergio also strengthened governance and compliance and was instrumental in guiding Coty through its successful public offering last June. On behalf of the Executive Committee and the Organization, we are grateful for his great contribution over the last five years and we wish him well in his next venture.

Now let's talk about our quarterly results. The key market trends and business dynamics that impacted our first-quarter results continued into the second quarter. This was largely anticipated and the quarter results came generally in line with our expectations. In the last few months we have seen a progressive [financial slowdown] in the Fragrance market, and further deceleration in the mass Color Cosmetic market, particularly in the makeup category.

The Fragrance market in the US reported negative growth in the quarter with a low-single digit decline in prestige, and high-single digit decline in the mass channel. The holiday season has been generally softer than anticipated. [Slow fit trends] enhanced the need to increase incentive and promotional activities to stimulate consumer purchases and this had an impact on margins. In Europe, the Fragrance market was generally flat versus last year, though more promotional.

The mass Color Cosmetic market decelerated further in quarter two, particularly in the makeup category. The US makeup category in the mass channel declined 6% in the quarter following a 4% decline in Q1. As a reaction to this consumption slowdown, retailers have randomly adjusted their inventory levels. This reduction continues in quarter two; however, to a lower extent than in quarter one. Now we believe that a big part of the inventory reduction should be over and we expect more marginal adjustment in the future, in line with [flip tuition] in consumption.

Against this backdrop, our second-quarter revenues declined 4% on a like-for-like basis. This performance was a combination of positive 2% volume growth, more than offset by a negative 6% price mix impact, reflecting aggressive discounting and promotional activity we are facing in certain markets. On a year-to-date basis, our revenues declined 3%.

Our business in the prestige channel grew with positive contribution from both the Fragrance and Skin Care segments, while our mass business decreased, triggered by market consumption decline, particularly in the Fragrance and mid-market and unfavorable launch phasing.

Let's now examine more closely the quarterly trends in each of our segments. In Fragrances, our revenues declined 2% on a like-for-like basis. We maintained strong momentum in several of our power brands, such as Marc Jacobs, Chloe, and Davidoff, on the wings of successful launches in the first quarter. Also we received strong contribution from our recently launched franchises such as Cavalli, which grew at a fast pace in Europe and the Middle East, and Katy Perry.

As we had previously discussed, promotional activity in Fragrances have been high over the holiday season, particularly in the mass channel, and 2% volume growth has been more than offset by adverse price mix impact. Also, Q2 was impacted by unfavorable launch phasing, as last year, Q2 benefited from the very strong Lady Gaga launch, which did not repeat this year.

Cosmetics declined 9% on a like-for-like basis. This was driven by the decrease in nails as a result of negative category trends, high competitive activity, and very difficult comps for Sally Hansen, against last year massive launch of the premium-priced gel nail kits. Net of our nail product, our core cosmetic business had solid growth in the first half. While it is difficult to gauge whether the nail care category will stand a decline, we are working to reestablish full competitiveness on our leading brand Sally Hansen.

As we have previously discussed, much of the growth in the nail care category in the last couple of years was driven by the special effect subcategory, a new fashionable trend that pushed the whole category consumption up strong double digits month after month. Sally Hansen led this trend with a string of surprising innovation, getting more than 50% market share in this particular segment of the US market.

Now, the wow effect of this trend is progressively fading and the segment is declining at a fast rate, with Sally Hansen paying a heavy price given its leading position in the subcategory. Going forward, we're focusing most of our future innovation on enhancing the performance of our core main products. The strength of Sally Hansen in this field has been proven again in 2013 by the outstanding success of the new Salon Manicure line, which was the most successful launch in the US in the whole Color Cosmetic segment in mass; we achieved sales more than double those of the second best innovation of the year.

Rimmel continues to be a star performer with revenue growth meaningfully outpacing the mass Color Cosmetic market trend in US and Europe. The brand continues to gain share in the UK, in France, in Spain, and US, where Rimmel is the fastest growing color brand among the Top 10 in the color mass market.

In Skin and Body Care revenues declined 2% like-for-like. The highlight of the Skin and Body Care segment was Philosophy, which had solid growth for a third quarter in a row. The brand grew across all three channels including brick and mortar, QVC, and philosophy.com. We are seeing this momentum not only in the newly launched products such as Hope in a Jar Night, and the Time in a Bottle Serum, but also within the core franchises, including Grace and Purity, suggesting that the efforts of our team to reenergize the brand are beginning to bear fruit. Our expansion of the brands international market such as UK and Asia Pacific is also showing promising initial results.

Adidas was in line with the previous year as growth in the US and emerging markets such as Brazil, China, and South Africa was offset by continued softness in the European markets. We expect that the pipeline of innovation slated for the second half of the year will materially accelerate the growth of the brand.

As for TJoy, in the last year we went through a reorganization of the Management team of the salesforce and of the distribution organization. Recently we've also launched a new Skin Care line, and together with this new Management team, we are closely monitoring the impact of all this force. In the meantime, we keep delivering strong results in China with prestige fragrances, and with Adidas, which delivered another quarter of double-digit growth. As we speak we are launching a new Adidas shampoo in China as the third leg of the Adidas middle line, after shower gel and Skin Care.

Let's turn to our business by region. In EMEA, sales declined by 1% in the quarter, they were positive 1% in the first half. While market conditions remain difficult in Southern Europe we saw improved consumption trends in the UK and Germany over the holiday season, picked up by high promotion and discounting. We recorded solid growth in emerging markets of the region such as Eastern Europe, South Africa, and [travel excite].

In the Americas, our business was down 10% on a like-for-like basis. As discussed earlier, this was fueled primarily by the US mass retail channel, which lowered demand in Color Cosmetic, in particular in nail. On a positive note, our emerging markets in the Americas delivered double-digit growth, particularly thanks to our new joint venture and commercial partnership in Brazil. In Asia Pacific, revenues grew 2% in the quarter and 4% year to date, primarily driven by a strong pick up in Southeast Asia where we leveraged our new structures.

We continue to stay focused on our growth strategy and keep investing to progressively achieve our long-term target to grow in line or better than the markets where we compete. One of the key pillars of our growth strategy is the acceleration of our development in the emerging markets.

Our effort to build or strengthen our structure in new markets has begun to pay dividends. In the first semester we grew 7% in emerging markets, and significant contribution to the growth came from Brazil, Southeast Asia, and South Africa, where we build new capabilities in the last few months. We expect to see a progressively greater impact from these markets as well as from the recently announced new joint venture in the Emirates.

The Middle East is a priority item for our growth strategy, considering the robust market growth and the strong culture for Fragrance. The new joint venture will enable us to strengthen our go-to-market capabilities in the United Arab Emirates, allowing us to fully leverage the potential of Coty's brand, particularly the prestige Fragrances. We are also targeting the expansion of our Musk brand in the market, including Rimmel and Adidas.

Looking now at the near-term outlook, heading into the crowded quarter, market conditions remain challenging in several markets around the globe, particularly in the mass channel. Despite these uncertainties, we keep targeting to return to top line growth in the second half, thanks to a competitive innovation plan, the increasing impact of our new structure in the emerging markets, and continuous marketing investment to support our power brands.

Looking at our innovation plan, the focus will be on restoring growth in our Color Cosmetics segment, stemming the decline in our [line integrity] and fully leveraging the strength of Rimmel. Speaking of nail, in Sally Hansen we are implementing a 360-degree program to increase competitiveness and come back to market share gains. This program includes a modernization of the brand image through a new advertising campaign and in-store fixturing, an increase in marketing spending to announce the visibility of the program, and the robust innovation plan, culminating in the launch of (inaudible) product by the summertime. We are expecting the brand decline to slow in the next quarter with growth returning in quarter four.

On OPI, we are targeting robust growth in the second half due to both product initiatives and distribution enhancement. On the product side, we will have a string of very creative collection, including a special collection developed in partnership with Coca Cola supported by a strong digital plan. OPI should also benefit from the full impact on this distribution with Sally Beauty in the US, and distribution and visibility gains in Europe and travel retail. In this context the recently announced acquisition of Lena White, the previous OPI distributer in the UK, plays an important role. This acquisition will allow us to merge Lena White's strength and expertise in the professional channel with Coty capabilities in retail, significantly enhancing the reach and power of OPI in the UK, which is the second largest OPI market in the world.

Speaking now of prestige Fragrances, in the second half we have an important initiative on Calvin Klein, including Endless Euphoria, CK One Red, and the collective edition of Eternity, which are expected to re-boost our Calvin Klein business particularly in the US. Also, we will rollout Rose [decloir] in the US, after successfully launching it in Europe in the fall.

In mass Fragrance we are currently launching the new perfume from Beyonce called Beyonce Rise. It's worth also reminding that we have recently signed a new license agreement with the Spanish singer and entertainer Enrique Iglesias. This will help to expand our Fragrance business particularly in Brazil and to the Latin population, which is getting an increasing share of total Fragrance consumption in the US.

In Skin and Body Care we are targeting growth in the second half, as we expect Adidas to progressively gain momentum with the launch of the workout inspired Get Ready line, as well as progressive expansion in the emerging markets. Philosophy should also continue on its growth path aided by the broad rollout of Time in a Bottle, new initiatives under the Miracle Worker franchise, and further international expansion.

Importantly, to progress toward our long-term growth target, we are not and we will not compromise on our strategic and long-term investment, including marketing support of our power brand and building our structure in emerging markets, even at the expense of short-term profit gains. In the first half we increase our SG&A as a percentage of our net sales mostly due to higher marketing investment and of course to build new subsidiaries in emerging markets.

At the same time, we are working aggressively to gain efficiencies in our cost structure in consolidated markets. As a result, we now expect to exceed our productivity program goal of $45 million savings by FY16 and accelerate the delivery of the majority of the efficiencies already in FY15.

In a fast changing environment it is extremely important to have effective management of working capital. I am pleased to report another strong quarter of efficiency gains in all the key areas of working capital management. This is the main contributor to our best-in-class performance and cash flow.

In the first six months of our fiscal year, we generated a $331 million of free cash flow, which represents 44% growth versus prior year. Our strong free cash flow and solid financial position have led us to announce a $200 million share repurchase program this morning. This program speaks to the Board's confidence in our business strategy and fundamental and are like our commitment to generating shareholder value.

In summary, Q2 was challenging and our results were in line with our expectation. We saw considerable strength in many of our power brands and across our businesses in emerging markets where we compete. We remain focused on executing our long-term strategy, including continuing to invest behind our power brands, driving innovation, accelerating our emerging market business, and generating strong cash flow, and we keep looking for ways to improve efficiencies in our cost structure.

We believe that our focus and consistency on these priorities will allow us to come back to top line growth in the second half and to progress versus our long-term target to grow in line with or better than the markets where we compete. I will now hand the call over to Sergio, who will bring you through the key financials for the quarter.

Sergio Pedreiro - *Coty Inc - CFO*

Thank you, Michele, and good morning, everyone. First, I'd like to remind all of you that my comments today on our results and outlook includes a discussion of adjusted results, which excludes the impact of non-recurring items including private Company share-based compensation and restructuring costs. When applicable I will also discuss our adjusted results in constant currency. This presentation is consistent with how we plan to report results and provides our outlook in future quarters. You can find the bridge from reported to adjusted results, including foreign exchange translation impact in the reconciliation tables in the earnings release.

As anticipated during our November first-quarter earnings release call, we expected a challenging second quarter, and overall, results came in inline with our expectations. Our revenues declined 4% on a like-for-like basis. As Michele explained this is a reflection of continued weakness in the mass channels and the US nail category, unfavorable phasing and going through the innovation, and a high level of promotion and discounts in several markets in face of the slow consumption during the holiday season.

As a result of the market promotional activity the 2% increase in volume was more than offset by a 6% negative price mix. The revenue decline was partially offset by strength in several of our power brands and continued momentum in emerging markets, which grew 6% in the second quarter and 7% in the first half. Our adjusted gross margin for the quarter decreased 50 basis points to 58.7%. We continue to see consistent productivity gains in our supply chain, which resulted in improved efficiency in cost of goods.

In the quarter we also had the benefit of favorable mix towards the higher margin prestige business. These effects were more than offset by higher discounts and allowances as well as higher trade marketing expense in support of our brands, and by foreign exchange. Our reported operating income declined to $143.5 million from $222.3 million in the prior year, driven by lower gross profits, higher SG&A, and a prior year one-time gain on the sale of assets. The increase in SG&A was primarily driven by one-time costs associated with our new subsidiary in South Africa. Reported net income decreased to $82.5 million from $123.2 million in the prior year as a result of lower operating income, partially offset by lower tax expenses.

On an adjusted basis, operating income declined 17% to $183.3 million. As a percentage of net revenues adjusted operating margin decreased 210 basis points to 13.9% from 16%. This margin decline reflected lower gross margin and increased SG&A expenses as a percentage of net revenues, which was primarily driven by an increase in emerging market investments following our recent acquisition.

And while our overall initiative costs increased, outside of our investment in emerging markets our initiative costs in developed markets actually declined. We continued to increase the support behind brands, and in the second quarter, advertising and promotion, taken together with marketing trade expense, which is accounted for as a reduction to net revenues, increased by 60 basis points, reflecting continued investment and commitment to protect our brands in the mass challenging market environment.

Our productivity program is progressing well. We expect to be more than halfway towards our savings goal of $45 million by the end of this fiscal year, and we are now targeting to exceed this goal by the end of FY16 by approximately $15 million.

Looking at our performance by segments, our Skin and Body Care operating income margin expanded, while our margins in Fragrance and Color Cosmetics contracted. Adjusted operating income for the Skin and Body Care segment returned to positive territory, and totaled $6.1 million, with the operating margin expanding 150 basis points to 3.1%. This reflects higher gross margin driven by continued efforts to streamline operations as well as by favorable price mix as philosophy continues to show good momentum with positive and consistent growth for the third consecutive quarter.

In Fragrances adjusted operating income declined 11% to $143.5 million while operating margin decreased by 170 basis points to 18.1%. This decline reflected higher gross margin that was more than offset by an increase in the [MPPU] spending, and by higher order SG&A as a percentage of net revenues.

In Color Cosmetics operating income declined to $33.7 million while the operating margin went down 540 basis points to 10.1%. This decline in operating margin was primarily driven by lower gross margin resulting from revenue declines and a strong promotional pressure in certain markets, as well as higher SG&A as a percentage of net revenues.

Our adjusted effective tax rate was 26.8% compared to 32.2% in the prior year. The decrease was a result of a higher effective rate in the prior year incorporating the expected expiration in December of 2012, offsetting the US tax spreads on foreign sourced income, which were reinstated in January of 2013. For the full year, we continue to expect an adjusted effective tax rate of 28% plus or minus 3%.

For the first half of FY14, cash paid on income taxes was 14.8% of adjusted income before income taxes, reflecting the benefits of accumulated NOLs as well as the tax deductibility of goodwill monetization for OPI and philosophy. For the full year we continue to expect a cash tax rate of 18% plus or minus 3%.

On an adjusted basis our net income decreased by 12% to $111.3 million, primarily reflecting lower adjusted operating income partially offset by lower income taxes and lower interest expense, reflecting consistent strong cash flow generation. This strong cash flow was achieved in spite of the continued pressure we saw in some of our markets, and was driven by our continued focus on net working capital.

As we discussed with you before, we have historically been able to achieve improvement in net working capital, first through better management of account receivables, and more recently by working partnership with our vendors to improve accounts payables. Going forward, we believe we will continue to achieve efficiencies in working capital.

Net cash provided by operating activities totaled $346 million for the quarter and $447 million in the last six months. And after capital expenditures our free cash flow was $295 million for the quarter and $331 million in the last six months.

Let me mention that SAP has been one of the contributing factors behind increased efficiencies, not only in cash but also in our ability to better manage costs in our business. As an update, I should say that our SAP rollout program is advancing as planned with successful implementations completed in FY14. Namely we launched SAP in Europe in January, and earlier in the fiscal year, we enabled our entire third-party manufacturing management platform with SAP. We are on schedule to launch SAP in our largest manufacturing plant in Sanford, North Carolina in the fourth quarter of FY14.

By the end of the fiscal as we continue to rollout the program, SAP coverage we will be above 70%, both in commercial and manufacturing. As we continue to increase our cash balance and evaluate alternative use of capital, we have as you'll recall significantly increased our dividend in FY13, and I am pleased that the Board of Directors have just approved a $200 million share repurchase program as an additional avenue to return capital to our shareholders. The program is open ended and we will monitor market conditions, should drive a swift and efficient execution.

Before I open the call for questions, I want to take a moment to thank you for the opportunity we had to work together and to welcome Patrice in his new role. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question comes from the line of Olivia Tong from Bank of America Merrill Lynch.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Thank you, good morning. First question, just we know you're expecting growth to resume in the second half and that's great, but can you talk about the cadence between Q3 and Q4 given the timing of when innovation hits as well as some of the logistics issues that you've had in the comp period? And do you expect organic growth in both Q3 and Q4?

And then secondly, can you talk about the delta between volume and price mix going forward? Do you continue to expect that to be fairly wide in the second half? Thank you.

Michele Scannavini - *Coty Inc - CEO*

Okay, well good morning, Olivia.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Hi, Michele.

Michele Scannavini - *Coty Inc - CEO*

So in terms of growth, we are not commenting and we're not as you know giving guidance in our growth by quarter. What I can say is that obviously, in quarter three, we expect to see prestige particularly performing well also because all the issues that we encountered the last year with [arvodo] why we expect mass progressively getting better in the last quarter of the year, given that as I grow this [castle] the visibility that we have on improvement on the mass channel is still very limited, and our innovation phasing in our mass business is more skewed to quarter four.

In terms of volume and price, it's difficult for us to anticipate, but clearly, as of today, we still see in certain markets high promotionality and trade pressure, so it's fair to assume that pressure on price is going to go on for the next few months at least.

Olivia Tong - *BofA Merrill Lynch - Analyst*

Got it. Appreciate that. And then just following up on emerging markets, can you tell us specifically what Latin America grew at because it's obviously great that emerging markets grew, but it was a bit of a deceleration from the growth you put up last quarter, and I would have thought that growth would have been accelerated given the timing of the Brazil start up.

Michele Scannavini - *Coty Inc - CEO*

Yes, let me say obviously, when you make those kind of investments, it's very difficult and risky to see growth quarter by quarter and we need to focus on what is the growth trend on the longer period of time. What I can tell you is that the growth in the quarter that's been particularly driven by our new initiative in Brazil has been one of this one, why recently in the quarter in emerging markets we have seen a deceleration of certain area of the Middle East due to let me say an environmental situation that was not tolerable to develop a strong business. So it's always when you look at the overall emerging markets it's a lot of markets. There are markets growing at a certain pace, a market growing less, but what's important for us is that the three areas where we focus our effort, Southeast Asia, Brazil, and very recently South Africa are growing in line or better than our expectation.

Operator

Thank you for your question. Your next question comes from Bill Schmitz from Deutsche Bank. Please proceed.

Bill Schmitz - *Deutsche Bank - Analyst*

Hi, good morning. Can you talk about some of the market share trends both in the open and [MPD], specifically in the US, because I know you said it's pretty promotional, but it looks like some of the market share in both prestige and mass for you guys is actually suffering quite a bit, and then I have a follow-up if you don't mind.

Michele Scannavini - *Coty Inc - CEO*

Yes, so let's say it is a very mixed situation, I would say in all the segment areas we compete, so if we take Color for resale, as I was discussing before. On one side we have a brand that is performing extremely well, like Rimmel gaining market share in Europe and the US, and particularly US being over the total calendar year '13 and even the last quarter the fastest growing brand among the Top 10.

On the other side we are suffering on Sally Hansen, and the reason is due as I was explaining, number-one for the sharp decline of these special effects that even though they represent around 15% to 20% of the total category, but Sally Hansen has more than 50% of the share there so the decline impact in the overall Sally Hansen share, and also because of the competition in this space has increased significantly over the last period.

I was looking with interest to the report coming out a few days ago from IRI specifically on the nail category, and in two years in the biggest retail mass customer in the US. The number of SKUs in mass Color in the store has increased anywhere from 60% to 120%. So just to give a sense of how the competition has increased over the last few years, and obviously Sally Hansen having such a dominant share of the market, suffered.

Where we look at Fragrance, also here, we have brands that are performing very well. Chloe is clearly an example, with market share growing everywhere in the world, but also we see solid performance in other brands like Marc Jacobs [floristas]. On the mass channel on the other side we are suffering in market share, particularly for two reasons, one for the innovation phasing that was unfavorable to let me say this half of the year for our mass Fragrance brand, and also for the decline of some of our celebrity brand. So it is a mixed bag with lights and shadows.

Bill Schmitz - *Deutsche Bank - Analyst*

Got you, great. And then just the follow-up question, do you have any sense for I think you said that most of the destocking is done, but can you just tell us like in a US and Europe how many weeks of inventory you have? And where that was before the destocks, and maybe where you think it needs to go, just so we can get a sense for how much is left in the destocking especially in mass? And then along with that, maybe is there going to be any impact from the SAP implementation in June in the numbers either a pull forward or push forward? And then I'll stop.

Michele Scannavini - *Coty Inc - CEO*

Okay, so as far as the inventory situation, obviously it's very difficult for us to judge and tell when retailers think that this inventory is at the right levels, so we are obviously on our way to checking is what is the level versus our position in the year before vis-a-vis consumption trend. They bring us to think that today the inventory is in a much better situation compared to a prior year than we have seen in the previous quarter.

Again, looking forward because it is so much tied to the trend of consumption is almost impossible to have a clear statement if the inventory is a direct level or not. But what we can say, we see today's inventory level to a much more normalized level, let's call it that and that's why we believe that the big resizing is behind the back, and what we can see in the future is more limited adjustment related to fluctuation that we could have in consumption.

As far as the SAP implementation. Now we come from several experiences of very successful SAP implementation, and also very recently as Sergio was saying we had two successful SAP implementation with no disruption in the business and no material change in our shipment flow.

So we are organizing our sales the same way for the next SAP implementation, so we do not anticipate at this stage anything that is material, so we are not at this stage coming from a specific scenario or significantly different flow statements, so this is what should be the normal situation.

Operator

Thank you for your question. The next question comes from the line of John Faucher from JPMorgan. Please proceed.

John Faucher - *JPMorgan Chase & Co. - Analyst*

Good morning. Wanted to sort of follow-up on the nail category and I understand the share comments that you just made in response to Bill's question. Is this a category that needs dramatic innovation to grow longer term, or is this something where we're just seeing a normalization of the effects trends? And then secondly, I guess I'll leave it at that for right now. Thinking more in the long term, not necessarily the short-term in terms of responding to the recent weakness.

Michele Scannavini - *Coty Inc - CEO*

Okay, the underlying nail trend on the long run is a growing trend. The category is sensitive to innovation as many other categories. What happened in the last two or three years has been a particular boost because of the innovation has been brought to the market was particularly disruptive for the -- disrupting in a good sense I mean, so brought several consumers to change their habits and their views of a new product, and it brought consumer to a kind of collection aboard the different special effects in a sense maxing out a bit the household inventory of product.

So what I believe is that there is a room and (inaudible) in the category to keep on growing on the long run at least in line with the Color Cosmetic trend because there is still room to increase penetration, still room to increase distribution, still room in order of new markets where this is not yet maybe comparable to mature markets. So I believe that it's more (inaudible) than we are seeing in this moment following the big boom of the latest two years related to this special effect. But I have a strong confidence that we will see nail back to a solid growth on the long run going forward as has been in the past.

John Faucher - *JPMorgan Chase & Co. - Analyst*

Got it. And then looking at the recent rebound in philosophy, there's still a lot of skepticism out in the market in terms of your ability to compete effectively in Skin Care. Can you talk maybe about the lessons learned as you've dealt with this and gotten it back to growth, and does that give you a little bit more confidence about your right to compete in that category?

Michele Scannavini - *Coty Inc - CEO*

Okay. I'll tell you a bit of how we (inaudible) philosophy, and then I will answer to the more general question on our ability to compete in Skin. So as far as sales is concerned, I should say that this is exactly what we discussed before and what we anticipated, so the brand has developments lower than we were expecting basically for two reasons. One, because the innovation pipeline was not bringing the contribution that you should expect from innovation in this category, so we had to work to rebuild innovation pipeline, and as you know, this takes in Skin Care between 18 to 24 months.

Number two, it took longer than we were expecting to reformulate product, to make it suitable, to be registered and sold in international markets. So as these things are in the process to be fixed, we see the business improving.

And as I was saying before, the growth is mostly due to new launches and inventory expansion, but we feel also that more traditional franchise existing in advances many years like Purity or Hope in a Jar starts having a positive trend. So I think the overall activity of reenergizing the brand, bringing more innovation, bringing more advertising, we are in the book supporting the launch of Hope in a Jar in January, February in the United States in a visible way.

We are making important retail activity, so I believe that the combination of these start supporting philosophy on a different trend. Philosophy is a big significant brand in United States. It's not a niche brand.

As far as our ability to compete in Skin. As I said a few times, we could have had the same question a few years ago about our ability to compete in Color, so if you go back six, seven years ago, more than 70% of our business was in Fragrance. And then progressively, through a string of successful acquisition and progressively building capability in the Company, we have become progressively a very solid strong player in Color.

So as far as Skin and Body Care is concerned, we have started a similar journey. We are acquiring brand. We are strengthening our internal capability. We are bringing people that have specific expertise in Skin Care, particularly in R&D and in marketing. We are working on our existing business like Adidas or La Costa to have organic growth on this business, and we keep looking for potential opportunity on the market. So we the talent brand portfolio, can we deliver growth? We can. Can we be a top competitor in the Skin arena? We cannot yet, so to do this, we need more brands and more critical mass.

Operator

Thank you for your question. Your next question comes from the line of Chris Ferrara from Wells Fargo. Please proceed.

Chris Ferrara - *Wells Fargo Securities, LLC - Analyst*

Hi, thanks. Guys, I guess coming out of holiday, sort of a bigger picture on mass Fragrance. I guess it's sort of understandable what's going on in nail, but can you just give an updated view on what you think is causing the trends in mass Fragrance, whether it's macro, different underlying consumer trends. But I'd appreciate it if you could just give an update on what you think is going on there from a market perspective.

Michele Scannavini - *Coty Inc - CEO*

Yes, when you look that there is a difference between the trend that we discussed in mass Fragrance, why nail was a sudden change of trend and we discussed about what is happening. A trend of consumption decline in mass Fragrances, I should say particularly in the US is a little bit longer trend.

And what is happening there? I believe that it is a combination of let me say an overall situation for the mass channel but also now that category is not healthy in terms of consumption trend, but also the fact that let me say there is a shift of focus on brands that belong more to the prestige environment than to the mass environment. Actually when you see the composition of the business, the vast majority of the business in the US is in prestige Fragrances than in mass that is the same things for us. So the big business in Fragrance is and always has been prestige.

So what we are doing here? We are testing new routes to ensure that we address what can meet the need of people that shop into the mass channel for a Fragrance that is substantially good price, good value for money. And as we shared in a couple of earnings call ago, we have just now launched a line in exclusivity with a big retailer in the United States that is full of love, is a Fragrance and toiletry line with a very nice appearance and aesthetics, very, very accessible price. And this is for us a very interesting test to see if providing the consumer with great advances in terms of value for money in the mass channel can drive increased consumption.

It's obviously very, very, very early to assess because we just started; the initial signs are encouraging, but this is something that we need to monitor for the next three to six months at least to see if these are the right route to reenergize the business in the mass channel.

Chris Ferrara - *Wells Fargo Securities, LLC - Analyst*

Thanks and I guess just a follow-up on Fragrance margin. I think you said gross margin was up in Fragrance. I guess the follow-up is why is gross up -- how is gross margin doing that well given the weight of the promotions? Maybe I'm not thinking about where those promotions are accounted for correctly, but if you've spent a lot I guess it's more in advertising to support brand than it is discounting, but the pricing wouldn't necessarily justify that, so how are gross margins up? And then SG&A dollars are down in the first half of the year. Can SG&A dollars be down in the back half of '14 as well?

Sergio Pedreiro - *Coty Inc - CFO*

So in terms of gross margin, it's correct. For the Fragrance we saw an increase when we look at the quarter vis-a-vis the previous year, and this was primarily driven by a positive mix. We just discussed trends in terms of mass and in terms of prestige, and there is a difference of profit still. And as Michele said, our business in Fragrance in the US is primarily prestige and therefore we have the positive mix impact.

And in terms of SG&A, you should consider that there is a component of A&P that is a phase and so when you look at quarter by quarter, you may have some differences from one quarter to the other. And we also have as you know throughout the organization and with an impact in all categories including Fragrance, the development of the emerging markets, which in the second half will be fully developed in terms of the structure that we're building, and therefore, we should continue to see that contributing to the SG&A.

Operator

Thank you for your question. Your next question comes from the line of Lauren Lieberman from Barclays.

Lauren Lieberman - *Barclays Capital - Analyst*

Thanks, good morning. Just was curious you guys shared the advertising and promotion number inclusive of the promotion dollars and gross margin. Could you say how much A&P alone with the SG&A portion was up in either the quarter or the first half? And then I'm assuming we should be seeing that go up in the second half given the comments on supporting Sally Hansen, and then particularly through bigger efforts around philosophy, and I wanted to check if that was correct, thanks.

Sergio Pedreiro - *Coty Inc - CFO*

Lauren when you look at the A&P for the alone, it's essentially flat year over year. When you include also the trade spend as we mentioned it is increasing in terms of the percentage of net revenue, up 60 basis points. And this is really the right way to look at it. We talked about what is in the trade spend, which is essentially marketing dollars as we mesh together with the trade. So this is the dynamic, to be more precise the A&P as a percentage of net revenue is also up 5 to 10 basis points, and as I said together with the trade spend it's 60 basis points.

Michele Scannavini - *Coty Inc - CEO*

I want to add because we said already several times but is important. When we talk of trade spend, there's no discount, there's no pricing, it is a trade marketing. And just to give an example, if we launch exclusively with a retailer, all the expenses for the launch, advertising, fixturing, windows, activity installed displays on the floor goes from an accounting standpoint into trade spend. Even though they are clearly expensive, there are direct-to-consumers to increase the sales of the brand.

So and this is something that we see growing as we grow exclusivity agreement with our retailer that in many countries of the world become one important way to differentiate your offer. And there is more and more a request and more opportunity there, so this is important to remind -- we already discussed these a few times in the past, but is always good to remind everybody.

Operator

Thank you for your question. Your text question comes from the line of Neely Tamminga from Piper Jaffray. Please proceed.

Neely Tamminga - *Piper Jaffray & Co. - Analyst*

Great, good morning. Just want to wish all my best to Sergio for sure. It's been good working with you. And I wanted to just ask a little question here about OPI. So we heard a lot about Sally Hansen. Could you get a little bit more color behind OPI?

I think we had had a discussion from you guys about you distributing through new doors of distribution here in the United States, where are you in that process? And how did OPI perform obviously relative to Sally Hansen?

And just one little clarification point on philosophy. Could you comment on how Fragrance within philosophy performed relative to your rest of portfolio, whether it be prestige or mass? That would be helpful, thank you.

Michele Scannavini - *Coty Inc - CEO*

Okay, so let's start with OPI. So for Sephora you're talking about distribution expansion, you are mentioning specifically US, I assume the rest of the world to our agreement with Sally Beauty, this is off to a very strong start. We are just at the beginning, but just to give you a color on this, in the first month we reached 40% sale through on the first orders of Sally Beauty, and this is very strong performance. So we are very happy with the start, I know they are very happy with the start, so we look to this partnership with a lot of optimism going forward.

On the other side, outside the US, starting the beginning of this calendar year, we have started managing directly a solid retailer operation on important countries such as Germany, UK, Italy, and Australia. And we expect to see a strong acceleration of the retail business, I'll remind you that OPI is sold for the vast majority in professional, but we are start expanding in prestige retailer, and we see the result of this where we did so far are very strong, so we expect to see a material acceleration going forward in the next quarters.

So just to give you an example, we started selling OPI in travel retail basically 12 months ago, and in one year, OPI has already a very, very strong position, is number two name brand in travel retail worldwide.

As far as philosophy is concerned, the question was -- the Fragrance. So let's say that our focus so far on philosophy has been mostly Skin Care because this is the core business of philosophy. This is the most important part of the philosophy business for us, so the growth as of today is mostly driven by Skin Care.

Now we are addressing also Fragrance, actually we have very, very recently launched a new fragrance with an initial very interesting result, particularly in some retailers in this moment are supporting philosophy very strongly, such as Ulta for example. And we count on the Fragrance contribution to drive growth of philosophy going forward. But as of today, our focus has been on Skin Care and it is where today we see the growth for the brand.

Operator

Thank you for your question. Thank you. This concludes the question and answer portion of today's call. I would now like to turn the call back over to Mr. Monaco. Please proceed.

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

So thank you again for joining us here today. We do appreciate all of your questions, so please feel free to reach out to us in the Investor Relations department if we can answer any further questions or assist you in anyway, thank you.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. And have a great day.
