



## COMPANY UPDATE / ESTIMATE CHANGE / CORRECTION TO PREVIOUSLY MISSTATED 3Q & 4Q FY18 EPS ESTIMATES

### Key Metrics

LANC - NASDAQ (as of 1/25/18)	\$124.59
Price Target	N/A
52-Week Range	\$113.33 - \$147.80
Shares Outstanding-Basic (mil.)	27.4
Market Cap. (\$ mil.)	\$3,413
3-Mo. Average Daily Volume	115,060
Institutional Ownership	53%
Total Debt/Total Capital (12/17)	0%
ROE (TTM ended 12/17)	22%
Book Value/Share (12/17)	\$22.67
Price/Book Value	5.5x
Annual Dividend & Yield	\$2.40 1.9%
EBITDA Margin (TTM ended 12/17, estim.)	16%

### EPS FY 6/30 (excludes nonrecurring items)

	FY17	Prev. FY18E	Curr. FY18E	Prev. FY19E	Curr. FY19E
1Q	\$1.22		\$1.07	A	
2Q	\$1.42		\$1.34	A	
3Q	\$0.95	\$1.08	\$0.92		
4Q	\$1.04	\$1.15	\$1.07		
Year	\$4.62	\$4.62	\$4.40		\$5.25
P/E	27.0x		28.3x		23.7x

Note: Quarterly figures may not add to annual figure due to rounding

**Note: 3Q and 4Q FY18 EPS estimates have been corrected from previously misstated figures of \$1.06 and \$1.20, respectively.**

### Revenue (\$ mil)

	FY17	Prev. FY18E	Curr. FY18E	Prev. FY19E	Curr. FY19E
1Q	\$291		\$299	A	
2Q	\$327		\$320	A	
3Q	\$294	\$300	\$294		
4Q	\$290	\$297	\$297		
Year	\$1,202	\$1,230	\$1,210		\$1,260

**Company Description:** *Lancaster Colony is a manufacturer and marketer of specialty food products for the retail and foodservice markets. Specialty food brands include Marzetti, Sister Schubert's, New York, Flatout, Chatham Village, Cardini's, Mamma Bella, Otria, and Girard's. The company acquired the Flatout line of premium flatbreads in March 2015 and the Angelic line of sprouted grain bakery products in November 2016.*

### Consumer Staples

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## Lancaster Colony Corporation

LANC — NASDAQ — Neutral-2

### Fiscal 2Q Results Had Some Noise

#### Investment Highlights

- **Sales for LANC's fiscal 2Q were surprisingly soft.** Net sales for the quarter ended 12/31/17 fell 2% to \$319.6 million, as opposed to our expectation of a 2% gain. Challenges included insufficient freight capacity and a disruption in the production and supply of a product line due to a facility issue. Also, lower volume in the Foodservice segment reflected ongoing sluggish restaurant industry conditions. Positive factors included growth in certain dressings, a full quarter of contribution from Angelic Bakehouse (a November 2016 acquisition), and reduced trade spending/lower coupon expense.
- **Gross margin fell 243 basis points—similar to the 1Q decline—due to increased commodity costs and higher freight costs.** SG&A expenses rose nearly 7%, reflecting greater investments in growth initiatives and increased amortization from Angelic. Reported EPS of \$1.67 reflected a one-time benefit of \$0.33 related to re-measurement of a tax liability. Excluding this, an adjusted EPS figure of \$1.34 was down 5.5% from a year ago. We have included an approximate \$0.20 benefit related to a lower effective tax rate. Our recent 2Q estimate of \$1.32 did not reflect any unusual tax circumstances.
- **Valuation remains above historical averages.** Despite several consecutive quarters of lower earnings, LANC is trading at a premium valuation relative to the stock's historical average and the Consumer Staples sector.
- **We maintain our Neutral rating.** We like the company's product lines and believe EPS growth can be significant when key factors such as commodity costs and operating costs are normalized. Assuming no change in company fundamentals, we would consider a rating upgrade at a lower valuation or clearer signs that earnings growth is imminent.

**Note Important Disclosures on Pages 6-7.**

**Note Analyst Certification on Page 6.**

**Exhibit 1****Lancaster Colony Corp. - Consolidated Statements of Income**

(figures in thousands except per share data and percentages)

	Quarter Ended			Six Months Ended		
	<u>12/31/17</u>	<u>12/31/16</u>	<u>% chg.</u>	<u>12/31/17</u>	<u>12/31/16</u>	<u>% chg.</u>
Net Sales	\$319,665	\$326,773	(2.2%)	\$618,581	\$618,134	0.1%
Cost of Sales	<u>235,724</u>	<u>233,034</u>	1.2%	<u>459,163</u>	<u>443,761</u>	3.5%
Gross Profit	83,941	93,739	(10.5%)	159,418	174,373	(8.6%)
SG&A Expenses	<u>36,676</u>	<u>34,381</u>	6.7%	<u>67,827</u>	<u>64,261</u>	5.5%
Operating Income	47,265	59,358	(20.4%)	91,591	110,112	(16.8%)
Interest Inc. & Other (Exp.)	<u>412</u>	<u>206</u>	N/A	<u>770</u>	<u>293</u>	N/A
Income Before Taxes	47,677	59,564	(20.0%)	92,361	110,405	(16.3%)
Taxes Based on Income	<u>1,757</u>	<u>20,608</u>	(91.5%)	<u>17,055</u>	<u>38,049</u>	(55.2%)
Net Income	<u>\$45,920</u>	<u>\$38,956</u>	17.9%	<u>\$75,306</u>	<u>\$72,356</u>	4.1%
Diluted E.P.S., as reported	\$1.67	\$1.42	17.8%	\$2.74	\$2.63	4.3%
Less: one-time tax benefit	<u>\$0.33</u>	<u>\$0.00</u>		<u>\$0.33</u>	<u>\$0.00</u>	
<b>Diluted EPS, adjusted</b>	<b><u>\$1.34</u></b>	<b><u>\$1.42</u></b>	<b>(5.5%)</b>	<b><u>\$2.41</u></b>	<b><u>\$2.63</u></b>	<b>(8.3%)</b>
Dividends Per Share ~	\$0.60	\$0.55	9.1%	\$1.15	\$1.05	9.5%
Avg. Shares Outst., diluted	27,460	27,441	0.1%	27,456	27,435	0.1%
<b>As a % of Net Sales:</b>			<b><u>b.p. chg.</u></b>			<b><u>b.p. chg.</u></b>
Gross Profit	26.26%	28.69%	(243)	25.77%	28.21%	(244)
SG&A Expenses	11.47%	10.52%	95	10.96%	10.40%	57
Operating Income	14.79%	18.16%	(338)	14.81%	17.81%	(301)
Net Income	14.37%	11.92%	244	12.17%	11.71%	47
Tax Rate	3.69%	34.60%	(3,091)	18.47%	34.46%	(1,600)

Source: Company reports

Note: June fiscal year.

Excludes nonrecurring items

**Additional comments on 2Q results.** As in recent quarters, the Retail segment (sales down 2%) fared slightly better than the Foodservice segment (down 2.5%). At the Retail segment, *Olive Garden* dressings fared well but an independent facility servicing the *New York Bakery* frozen garlic bread line had a fire-related disruption during the quarter, leading to lower sales and inefficient operations. Also, a shortage of trucks and drivers stemming from recent weather anomalies and other unique factors hindered sales. Challenges related to these situations could linger in 2H but mainly in 3Q, in our view.

As in recent quarters, the Foodservice segment's sales decline reflected a sluggish restaurant industry environment that included lower same-store sales and overall traffic. Volumes to national chain restaurant accounts were down, while modest inflationary pricing helped a bit.

Cost of sales rose at a faster rate than sales due to increased commodity costs and higher freight costs. SG&A expenses rose despite the overall lower business level, leading to a 338 basis point drop in operating margin.

The tax situation was a bit unique in 2Q, as the Tax Cuts and Jobs Act of 2017 led to a lower federal income tax rate (a \$0.20 per share benefit to EPS in 2Q) and a one-time benefit resulting from the re-measurement of a net deferred tax liability (a \$0.33 per share benefit). We have excluded the one-time benefit from our presentation of adjusted earnings but have included the impact of a lower tax rate, which is likely to benefit future quarters as well.

**Financial condition.** The balance sheet remained in good shape, in our view. Cash and equivalents as of 12/31/17 were \$178.7 million. Inventories and accounts receivable were at reasonable levels, in our view. The current ratio was 4.0-to-1. As in recent quarters, there was no long-term debt. Shareholders' equity was \$621.0 million. The company has access to roughly \$150 million under a credit facility, if needed. Management remains comfortable with the company's financial position and its flexibility in terms of investing in current operations, seeking acquisitions, and paying dividends.

**Dividends.** In November 2017, the company's Board of Directors raised the regular quarterly cash dividend by 9% to \$0.60 per share. This marked 55 consecutive years of dividend increases for LANC. Management believes LANC is one of only 14 U.S. companies to have increased regular cash dividends each year for 55 consecutive years.

The annualized dividend rate of \$2.40 per share equates to a current yield of 1.9%. As a matter of comparison, the current yield on the S&P Consumer Staples index is currently 2.6%. We believe LANC's dividend rate is likely to be raised annually, around November of each year.

**Outlook.** For the remainder of the FY18 period, the Retail segment should benefit from its core brands and some new products. The plant disruption event in 2Q could have a lingering impact in 3Q. The Foodservice segment will implement several initiatives aimed at generating sales from existing and new customers. Price increases in both the Retail and Foodservice segments could help in 3Q, but perhaps more so in 4Q. Overall commodity and freight costs are expected to remain above average for the balance of the fiscal year.

We have fine-tuned our FY18 estimates to reflect 2Q results and our views on the second half of the fiscal year, with the net impact being lower sales and EPS figures for the year compared to our previous view. We have initiated FY19 estimates, with a degree of conservatism attempted. We have updated our tax rate assumptions in both years based on management's recent commentary on recent tax reform.

We continue to believe this is a relatively stable, slow growth top line story, with strong product quality and market share positions. Short-term factors such as commodity price fluctuations, investments in growth initiatives, and operating costs issues can impact EPS on a quarter-to-quarter basis. Over the longer term, reflecting current product lines and businesses, we believe EPS can grow at a mid- to upper single-digit rate on a compounded annual basis. LANC management does not provide financial guidance.

We do not assume significant share repurchases or further acquisitions in our outlook, although we would not be surprised to see either considering the company's strong balance sheet, untapped credit facility, and the goal to boost EPS.

**Valuation.** We believe a price/earnings valuation is most appropriate in analyzing LANC shares. This is due to a relatively clean and straightforward income statement with few or no nonrecurring charges and a balance sheet with no debt. LANC shares are currently trading at just over 28x our fiscal 2018 EPS estimate and 26x our projection of twelve-month forward earnings. Over the past ten years, LANC has traded in a range of approximately 11x to 30x estimated forward earnings with a median of about 18x.

Over the past five years, perhaps a more insightful time period given a generally favorable market view of the Consumer Staples sector (including some recent acquisition/consolidation activity), the median forward P/E multiple on LANC is a loftier 23x. Over the past two years, the median multiple is 26x.

Also, LANC shares are currently trading at 1.2x the forward multiple for the S&P Consumer Staples sector, in line with the median figure over the past five years.

We believe factors that may have had a favorable influence on LANC's valuation include its high quality product lines, market leadership positions, a cash-rich and debt-free balance sheet, considerable free cash flow, and a long record of paying and raising dividends (including some special dividends). In addition, in recent years we believe some investors may have considered LANC a logical acquisition candidate for a larger food company.

**Opinion.** Though not as large as some peers, LANC has one of the highest quality product portfolios in the packaged food industry, in our view. We consider the core Retail product lines—including *Marzetti* and *Sister Schubert's*—to possess competitive advantages related to quality and brand equity. Line extensions have had some success and represent a prudent strategy, in our opinion. New products add an element of risk but are necessary for growth. Meanwhile, the Foodservice business is impacted by restaurant industry challenges but features some growing and well-respected chains.

Overall, we feel greater geographic distribution, new products, and margin expansion resulting from operating efficiencies and price increases represent potential sources of earnings growth. Also, future acquisitions are likely, in our view, although we have not factored any in our outlook.

Current sluggish earnings and stock valuation are the primary reasons for our Neutral rating. Assuming no change in company fundamentals, we could consider a more favorable rating at a lower valuation or with clearer signs of earnings growth. For now, we will remain on the investment sidelines, monitor company developments and stock price movements, and seek a better potential entry point.

**Suitability.** Our Suitability rating on LANC is 2 on a 1-to-4 scale (1=most conservative, 4=most aggressive). This reflects the company's earnings and dividend history, financial condition, and market capitalization.

**Risks.** Factors that we believe could affect the company's operations, and therefore stock price, include:

- competitive conditions in the company's markets, which may impact sales and operating margin
- loss of or a significant reduction in business from top customers (McLane Co. and Wal-mart Stores, Inc. were recently LANC's largest customers at roughly 18% and 17% of annual sales, respectively).
- the impact of potential food safety concerns; potential product recalls
- an inability to renegotiate union contracts; just over 20% of the company's employees were recently represented under collective bargaining agreements
- an unplanned loss of one or more members of the management team
- the approximate 30% stake in the company held by CEO John Gerlach and family, which could result in significant influence over matters submitted to shareholder vote
- changes in consumer demand for the company's products
- consumer sentiment toward competing private-label products
- volatility of commodity markets (soybean oil, eggs, flour, etc.)
- crude oil price trends and the resulting impact on transportation, energy, and packaging costs
- the ability to implement price changes in response to rising input costs
- the success and costs of introducing new products
- the purchase and integration of potential acquisitions

**Exhibit 2****Consolidated Statements of Income** (figures in thousands except per share data and percentages)

	<b>FY15</b>	<b>FY16</b>	<b>FY17</b>	<b>FY18E</b>	<b>FY19E</b>
Net Sales	\$1,104,514	\$1,191,109	\$1,201,842	\$1,210,000	\$1,260,000
Cost of Sales	846,822	891,480	883,078	908,000	933,000
Gross Profit	257,692	299,629	318,764	302,000	327,000
SG&A Expense	102,831	115,059	126,381	134,000	137,750
Operating Income	154,861	184,570	192,383	168,000	189,250
Interest Inc. & Other (Exp.)	(309)	63	768	700	750
Income Before Taxes	154,552	184,633	193,151	168,700	190,000
Taxes Based on Income	52,866	62,869	66,323	47,742	45,600
Net Income	\$101,686	\$121,764	\$126,828	\$120,958	\$144,400
<b>Diluted EP.S., adjusted *</b>	<b>\$3.72</b>	<b>\$4.44</b>	<b>\$4.62</b>	<b>\$4.40</b>	<b>\$5.25</b>
Dividends Per Share ~	\$1.82	\$1.96	\$2.15	\$2.35	\$2.55
Dividend Payout Ratio	49%	44%	47%	53%	49%
Avg. Shares Outst., diluted	27,327	27,373	27,440	27,475	27,500
<b>% Year Over Year Chg.:</b>					
Net Sales	6.09%	7.84%	0.90%	0.68%	4.13%
Gross Profit	3.67%	16.27%	6.39%	(5.26%)	8.28%
SG&A Expense	8.47%	11.89%	9.84%	6.03%	2.80%
Operating Income	0.71%	19.18%	4.23%	(12.67%)	12.65%
Net Income	0.69%	19.75%	4.16%	(4.63%)	19.38%
<b>As a % of Net Sales:</b>					
Gross Profit	23.33%	25.16%	26.52%	24.96%	25.95%
SG&A Expense	9.31%	9.66%	10.52%	11.07%	10.93%
Operating Income	14.02%	15.50%	16.01%	13.88%	15.02%
Net Income	9.21%	10.22%	10.55%	10.00%	11.46%
<b>Tax Rate</b>	34.21%	34.05%	34.34%	28.30%	24.00%

\* Adjusted EPS excludes nonrecurring items such as one-time tax benefits

~ Excludes \$5.00 per share special dividend paid in FY16.

Source: Lancaster Colony Corporation and Hilliard Lyons estimates

Note: June fiscal year

*Additional information is available upon request.*

Prices of other stocks mentioned: Wal-Mart Stores, Inc. - WMT - \$106.60  
 Berkshire Hathaway (parent of McLane Co.) - BRK'B - \$215.10  
 Darden Restaurants, Inc. (parent of Olive Garden) - DRI - \$97.86

**Analyst Certification**

I, Jeffrey S. Thomison, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

**Important Disclosures**

Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

**Investment Ratings**

**Buy** - We believe the stock has significant total return potential in the coming 12 months.

**Long-term Buy** - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.

**Neutral** - We believe the stock is an average holding in its sector, is currently fully valued, and may be used as a source of funds if better opportunities arise.

**Underperform** - We believe the stock is vulnerable to a price set back in the next 12 months.

**Suitability Ratings**

**1** - A large cap, core holding with a solid history

**2** - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks

**3** - An above average risk/reward ratio could be due to small size, lack of product diversity, sporadic earnings or high leverage

**4** - Speculative, due to small size, inconsistent profitability, erratic revenue, volatility, low trading volume or a narrow customer or product base

<b>Rating</b>	<b>Hilliard Lyons Recommended Issues</b>		<b>Investment Banking Provided in Past 12 Mo.</b>	
	<b># of Stocks Covered</b>	<b>% of Stocks Covered</b>	<b>Banking</b>	<b>No Banking</b>
<b>Buy</b>	31	28%	10%	90%
<b>Hold/Neutral</b>	75	67%	9%	91%
<b>Sell</b>	6	5%	0%	100%

*As of 8 January 2018*



Note: Price targets accompanying Buy ratings reflect a one year time period while price targets accompanying Long-term Buy ratings reflect a two to three year time period.

### Other Disclosures

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