Consumer Staples
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COMPANY UPDATE / ESTIMATE CHANGE / PRICE TARGET CHANGE

The Procter & Gamble Co.

PG — NYSE — Long-term Buy-1

Higher 2Q EPS Despite Margin Pressure

Key Metrics

PG - NYSE	(as of 1/23/18)		$89.05
Two-Year Price Target			$106.00
52-Week Range			$85.42 - $94.67
Shares Outstanding-Basic (mil.)			2,534
Market Cap. ($ mil.)			$225,653
3-Mo. Average Daily Volume			6,770,000
Institutional Ownership			61%
Total Debt/Total Capital (12/17)			41%
ROE (based on TTM core earnings ended 12/17)			19%
Book Value/Share (12/17)			$21.59
Price/Book Value			4.1x
Annual Dividend & Yield		$2.758	3.1%
EBITDA Margin (TTM ended 12/17)			27%

EPS FY 6/30 (excludes nonrecurring items)

	2017	Prior 2018E	Curr. 2018E		Prior 2019E	Curr. 2019E
1Q	$1.03		$1.09	A		
2Q	$1.08		$1.19	A		
3Q	$0.96	$1.02	$1.01			
4Q	$0.85	$0.91	$0.91			
Year	$3.92	$4.17	$4.20		$4.48	$4.50
P/E	22.7x		21.2x			19.8x

Quarterly figures may not add to annual figure due to rounding.
All EPS figures exclude nonrecurring charges and recently divested businesses.

Revenue ($ mil)

	2017	Prior 2018E	Curr. 2018E		Prior 2019E	Curr. 2019E
1Q	$16,518		$16,653	A		
2Q	$16,856		$17,395	A		
3Q	$15,605	$16,355	$16,300			
4Q	$16,079	$16,689	$16,652			
Year	$65,058	$67,025	$67,000		$68,950	$69,000

All revenue figures exclude recently divested businesses.

Company Description: *The Procter & Gamble Co. is the largest consumer products company in the world and features more than 20 brands that generate annual sales of over $1 billion each. Popular brands include Bounty, Charmin, Crest, Dawn, Downy, Febreze, Gain, Gillette, Head & Shoulders, Olay, Oral-B, Pampers, Pantene, Tide, and Vicks. The company conducts operations in about 70 countries worldwide.*

Investment Highlights

- **PG's fiscal 2Q results were generally in line with expectations.** Net sales rose 3% to $17.395 billion, essentially matching the street consensus figure and slightly surpassing our estimate. Organic sales rose 2% due mostly to higher volume, as overall pricing was slightly negative (mostly in the Grooming segment).
- **Core EPS rose faster than sales.** Core gross margin (excluding nonrecurring items) decreased 80 basis points due to higher commodity costs, mix, and pricing. Core operating margin dropped only 10 basis points, benefiting from cost reduction initiatives. Recently enacted tax legislation resulted in a $0.05 benefit to core EPS. Share repurchases also helped the EPS calculation. Core EPS of $1.19 exceeded the year ago figure of $1.08 and the street consensus of $1.14
- **Management's outlook for FY18 was little changed.** Guidance includes expected organic sales growth of 2-3% for the fiscal year and all-in sales growth of 3%. Margins are expected to improve in 2H. With continued share repurchases, this is expected to produce annual core EPS growth of 5-8%, slightly above the previous guided range of 5-7%. We have fine-tuned our annual EPS outlook, which includes a $0.03 increase to $4.20.
- **PG's Board composition is finally set.** In December 2017, following a lengthy and costly proxy battle for Board seats, PG announced the addition of activist shareholder Nelson Peltz as its 12th Director. In a bit of a surprise move, PG also added seasoned business executive Joseph Jimenez as its 13th Director.
- **We rate PG Long-term Buy.** We believe an earnings rebound is underway, slowed by macro and industry factors. We are raising our two-year price target by $1 to $106 per share to reflect slightly higher forward earnings given the progression of time. This suggests total return potential, including dividends, of about 12% on an annualized basis. Our Suitability rating is 1.

Note Important Disclosures on Pages 7-8.
Note Analyst Certification on Page 7.

Exhibit 1
Consolidated Statement of Earnings (figures in millions except percentages and per share data)

	Fiscal 2Q Ended			Six Months Ended		
	12/31/17	12/31/16	% chg.	12/31/17	12/31/16	% chg.
Net Sales	$17,395	$16,856	3.2%	$34,048	$33,374	2.0%
Cost of Products Sold	8,667	8,298	4.4%	16,896	16,400	3.0%
Gross Profit	8,728	8,558	2.0%	17,152	16,974	1.0%
Selling, Gen., & Admin. Exp.	4,725	4,683	0.9%	9,414	9,328	0.9%
Operating Income	4,003	3,875	3.3%	7,738	7,646	1.2%
Interest Expense, net	56	80	(30.0%)	122	176	(30.7%)
Other Expense (Income)	(86)	539	N/A	(168)	476	N/A
Earnings Before Taxes	4,033	3,256	23.9%	7,784	6,994	11.3%
Taxes	1,472	695	111.8%	2,353	1,558	51.0%
Net Earnings from Contin. Oper.	2,561	2,561	0.0%	5,431	5,436	(0.1%)
Less: Earnings Attributable to Noncontrolling Interests	66	21	214.3%	83	64	29.7%
Net Earnings Attrib. to PG	$2,495	$2,540	(1.8%)	$5,348	$5,372	(0.4%)
Diluted Earnings Per Share:						
As Reported, from Contin. Oper.	$0.93	$0.93	0.0%	$2.00	$1.93	3.6%
Incremental Restructuring	$0.02	$0.03		$0.05	$0.05	
Other Nonrecurring Items, net	$0.24	$0.12		$0.23	$0.13	
Core EPS	**$1.19**	**$1.08**	**10.2%**	**$2.28**	**$2.11**	**8.1%**
Avg. Diluted Shares Outst.	2,670	2,738	(2.5%)	2,680	2,780	(3.6%)
As a % of Net Sales:			bp. chg.			bp. chg.
Gross Profit	50.18%	50.77%	(60)	50.38%	50.86%	(48)
Selling, Gen., & Admin. Exp.	27.16%	27.78%	(62)	27.65%	27.95%	(30)
Operating Income	23.01%	22.99%	2	22.73%	22.91%	(18)
Earnings Before Taxes	23.18%	19.32%	387	22.86%	20.96%	191
Net Earnings from Contin. Oper.	14.72%	15.19%	(47)	15.95%	16.29%	(34)
Tax Rate	36.50%	21.35%	1,515	30.23%	22.28%	795

Source: Company reports Note: June fiscal year

2Q segment highlights. PG's 2Q of FY18 delivered a 2% increase in organic sales compared to a 1% gain in the previous quarter; this reflected 2% volume growth, a slight benefit from foreign exchange, and an overall negative impact from pricing. All-in sales rose just over 3% to $17.395 billion, in line with street expectations. This represented the best quarter in several years due to the substantial transformation of the product portfolio—including divestitures—over the past few years.

The company's largest segment—Fabric & Home Care—posted a 3% gain in organic sales as volume benefited from recent product innovations and marketing support. We were particularly pleased with 10% sales gain from the Beauty segment, which had been scrutinized for its lackluster performance over the past year or so. Here, product innovation and success of a premium line were contributing factors. Health Care also posted strong results, with total sales up 7% due in part to product innovation and a notable cough/cold season.

The main disappointment to us was the Grooming segment, which continued to face headwinds such as societal preferences toward shaving (more casual looks), increased competition (shave clubs/mail order), and the impact of PG's recent price cuts with the *Gillette* brand (anniversary coming in fiscal 4Q). Total 2Q sales for the Grooming segment declined 1%, but pre-tax profits fell a notable 14%.

Financial condition. The balance sheet remained in decent shape, in our view. At December 31, 2017, cash and equivalents totaled $7.432 billion. Short-term investments available for sale totaled another $11.326 billion. Total debt (short-term plus long-term) was $37.733 billion, or 41% of total capitalization. Shareholders' equity was $54.721 billion.

For the quarter, operating cash flow was $3.684 billion. After $768 million in capital spending, free cash flow was $2.916 billion. During the quarter, the company paid $1.813 billion in dividends and spent $1.751 billion on share repurchases.

Exhibit 2
Fiscal 2Q - Segment Sales and Margin Summary (figures in millions except percentages)

2Q FY18	Sales	% chg.	Pre-tax Earnings	% chg.	Pre-tax Margin	Net Earnings	% chg.	Net Margin
Beauty	$3,233	10%	$853	19%	26.38%	$655	21%	20.26%
Grooming	1,776	(1%)	531	(14%)	29.90%	423	(10%)	23.82%
Health Care	2,212	7%	668	10%	30.20%	455	8%	20.57%
Fabric & Home Care	5,434	3%	1,101	(2%)	20.26%	714	(2%)	13.14%
Baby, Femin., Family Care	4,613	(1%)	933	(10%)	20.23%	597	12%	12.94%
Corporate	127	(8%)	(53)	N/A	N/A	(283)	N/A	N/A
Total	$17,395	3%	$4,033	24%	23.18%	$2,561	0%	14.72%

	Vol. with acquis. & divest.	For. exch. impact	Pricing	Mix	Other	Net sales gr.
Beauty	2%	2%	1%	7%	0%	10%
Grooming	1%	1%	2%	0%	0%	(1%)
Health Care	4%	4%	3%	1%	0%	7%
Fabric & Home Care	3%	4%	1%	0%	0%	3%
Baby, Femin., Family Care	(1%)	(1%)	1%	0%	0%	(1%)
Total	2%	2%	1%	1%	0%	3%

Note: Figures are as reported, including restructuring expenses

Source: Company reports Note: June fiscal year

Recent shareholder vote on director slate. In mid-December 2017, PG officially added activist investor Nelson Peltz as the 12th member of the Board of Directors following a very close, and often recalculated, shareholder vote. His stint will begin on March 1, 2018. In addition, and in a bit of a surprise to us, a 13th Director was added as PG appointed Joseph Jimenez, the soon-to-be-retired CEO of Novartis AG, also effective March 1, 2018.

Peltz and his investment firm, Trian Fund Management, recently held a 1.5% stake in PG. He has a demonstrated history of Board experience with numerous public companies. We believe Peltz and PG's existing Board/management team have the capability to work together, including consideration of some of Peltz's ideas on making PG more efficient and enhancing shareholder value. Peltz has some history of doing such while being a Board member and investor of other public companies. With Peltz now on the Board, we believe increasing shareholder value could become a stronger focus.

Although seemingly not capturing as many media headlines, we consider the addition of Jimenez a significant development as well. We have respect for his business career, including his eight-year run as CEO of Novartis, which is set to end with his retirement on 1/31/18. We believe this addition of a 13th Director strengthens the overall quality of PG's Board and its independence.

Dividend update. In April 2017, PG raised its dividend by 3% to a quarterly rate of $0.6896 per share. This marked 61 consecutive years of dividend increases. With the recent strategy of exiting non-core businesses (over 100 brands), PG now has a lower revenue base compared to several years ago. We expect a continuation of annual dividend increases going forward, announced about the same time each year. We consider PG's dividend yield, currently 3.1%, a positive investment factor. The recent yield for the S&P Consumer Staples sector was 2.8%, while the yield for the S&P 500 was 2.3%.

Earnings outlook. In addition to reporting 2Q FY18 results, management updated its financial guidance for the fiscal year ending June 30, 2018. Highlights of this outlook include:

- Organic sales are expected to rise by 2%-3% (no change from previous view)
- All-in sales are expected to be up 3% (no change)
- Core EPS (including currency impacts but excluding nonrecurring items) are expected to rise 5-8% from $3.92 in FY17. This would represent a range of $4.12-$4.23 in FY18. This is moderately higher than the previously issued guidance range of 5-7%.

We have fine-tuned our financial model. As noted in Exhibit 3, our FY18 outlook includes net sales of $67.0 billion, a slight reduction from our previous estimate due to our views on the competitive environment (primarily in the Grooming segment). We project core EPS at $4.20, which is $0.03 above our previous estimate and up 7% from the FY17 figure. We assume a 2.7% reduction in the weighted average share count due to the dual impact of share retirement resulting from the recent transaction with Coty, Inc. (beauty brand divestitures) and ongoing share repurchases as part of PG's existing buyback authorization.

For FY19, we expect a year similar to the current year: 3% revenue growth and 7% core EPS growth. We expect efficiencies from recent portfolio transformation, yet further spending to produce an innovative product line and to capture market share. We have made minor adjustments to our financial model (see Exhibit 3).

We believe much of the appeal of PG shares and the company outlook relates to the longer term, beginning with FY20. The company's product portfolio transformation seems to be essentially complete, with an acquisition strategy possibly back in the picture. More aggressive spending on product innovation and advertising could move organic sales growth above recent levels. Also, the overall cost structure should continue to tighten and the share count could continue to decline due to ongoing repurchases dictated by free cash flow generation. With some beneficial impact from share repurchases, we believe long-term EPS growth could be at upper single-digit levels on a fairly consistent basis and occasionally reach low double-digits.

Valuation. We note current valuations on PG have an upward bias due to current sluggish earnings. PG shares are now trading at about 21x our estimate of forward earnings. The median forward multiple for PG over the past fifteen years is 19x. This reflects a generally rising valuation over the past nine years, similar to the S&P Consumer Staples sector valuation and, to a lesser extent, the S&P 500.

Additionally, PG shares are currently trading at 1.11x the forward multiple on the S&P 500 compared to a historical premium of 1.16x over the past fifteen years. PG's forward multiple currently represents 1.02x that of the S&P Consumer Staples forward multiple, slightly below the mean premium of 1.10x over the past fifteen years.

Opinion. We consider the "heavy lifting" phase of PG's product portfolio transformation to be essentially complete. Over the past few years, changes at the company have related to the product portfolio (divestitures), operating execution (efficiency improvements), management (CEO), and now the Board (size and composition). Over the past two years, the company has divested, discontinued, or consolidated over 100 brands. Combined, these brands represented only 14% of PG's recent annual sales and 6% of annual profits.

We believe there is upside potential with PG's financial and operating performance, including measures such as market share positions, product innovation, product quality, profit margins, and earnings. Ongoing cost savings programs and continued investments in the business in order to maintain and grow market share are priorities at the company, and ones that may serve as catalysts for future stock price appreciation.

As with most stocks, we believe PG shares are primarily influenced by earnings growth, which we expect at modest levels in the near term. In the longer term, we believe pricing can be a potentially more meaningful tool, market share positions could be boosted by product innovation, the product portfolio could sport higher margins, and the recent detrimental foreign exchange impact could reverse. We also believe acquisitions could be a potential source of growth.

Our rating on PG is Long-term Buy. We are raising our two year price target by $1 to $106 per share in a fine tuning measure based on a slightly higher forward earnings assumption related to the progression of time. We assume a price/earnings multiple of 21x on expected forward earnings two years from now. This is similar to the multiple on our estimate of forward earnings today (21x) and above the fifteen-year median forward multiple (19x). Our two-year target reflects potential total return, including dividends, of about 12% on an annualized basis. This meets the threshold of our typical "low double-digit" required total return for a purchase recommendation on PG.

We like PG's traditionally defensive characteristics and its attractive dividend policy, with fundamental improvements serving as catalysts for improved earnings in the coming years. Because of these positive attributes, along with its sizable portfolio of billion-dollar consumer product brands and a strong balance sheet, we are comfortable with our Suitability rating of 1 and our view of PG as a core holding in equity portfolios and for desired exposure to the Consumer Staples sector.

Suitability. Our Suitability rating of 1 (on a 1-to-4 scale with 1=most conservative and 4=most aggressive) reflects factors such as PG's large market capitalization, diverse product portfolio with large market share positions, history of earnings and dividend growth over time, and a healthy financial condition. As such, we believe PG is suitable for a wide range of investors.

Risks. As a worldwide consumer products company, there are numerous factors that could affect operations and possibly the stock price. These include changes in consumer demand for the company's products, competition, pricing pressures, changes in input costs (such as commodity prices, raw materials, and labor), risks associated with international operations such as exchange rate fluctuations and geopolitical risks, relationships with retail trade customers, and the global economy. The recent divestiture of non-core businesses is another key investment factor, as it represents a considerable change to the company's profile. We also note the recent changes in the Board of Directors, including two new members, one of whom we consider an activist investor with a considerable history of Board experience at public companies.

Exhibit 3
Consolidated Statements of Operations (figures in millions except percentages and per share data)

	FY19E	% chg.	FY18E	% chg.	FY17	% chg.	FY16	% chg.
Net Sales	$69,000	3.0%	$67,000	3.0%	$65,058	(0.4%)	$65,299	(7.7%)
Cost of Products Sold	34,650	2.4%	33,850	4.0%	32,535	(1.1%)	32,909	(11.2%)
Gross Profit	34,350	3.6%	33,150	1.9%	32,523	0.4%	32,390	(3.9%)
Venezuela Charge	0		0		0		0	
Selling, Gen., & Admin. Exp.	19,425	1.2%	19,200	3.4%	18,568	(2.0%)	18,949	(8.1%)
Operating Income	14,925	7.0%	13,950	(0.0%)	13,955	3.8%	13,441	21.6%
Interest Expense, net	325	(7.1%)	350	19.0%	294	(25.9%)	397	(16.8%)
Other Expense (Income)	(110)	(12.0%)	(125)	N/A	404	N/A	(325)	(26.1%)
Earnings Before Taxes	14,710	7.2%	13,725	3.5%	13,257	(0.8%)	13,369	21.4%
Taxes	3,163	0.2%	3,157	3.1%	3,063	(8.3%)	3,342	22.6%
Net Earnings from Cont. Oper.	11,547	9.3%	10,568	3.7%	10,194	1.7%	10,027	21.0%
Less: Earnings Attributable to Noncontrolling Interests	115	4.5%	110	29.4%	85	(11.5%)	96	(11.1%)
Net Earnings Attrib. to PG	$11,432	9.3%	$10,458	3.5%	$10,109	1.8%	$9,931	21.4%
Diluted EPS:								
As Reported, from Contin. Oper	$4.40		$3.92		$3.69		$3.49	
Restructuring Charges	$0.05		$0.05		$0.10		$0.18	
Venezuela & Misc. Charges	$0.00		$0.00		$0.00		$0.00	
Other	$0.05		$0.23		$0.13		$0.00	
Core EPS	**$4.50**	7.0%	**$4.20**	7.3%	**$3.92**	6.7%	**$3.67**	(2.3%)
Avg. Diluted Shares Outst.	2,600	(2.4%)	2,665	(2.7%)	2,740	(3.7%)	2,844	(1.4%)
As a % of Net Sales:		bp. chg.		bp. chg.		bp. chg.		bp. chg.
Gross Profit	49.78%	30	49.48%	(51)	49.99%	39	49.60%	198
Selling, Gen., & Admin. Exp.	28.15%	(50)	28.66%	12	28.54%	(48)	29.02%	(12)
Operating Income	21.63%	81	20.82%	(63)	21.45%	87	20.58%	497
Earnings Before Taxes	21.32%	83	20.49%	11	20.38%	(10)	20.47%	491
Net Earnings from Cont. Oper.	16.74%	96	15.77%	10	15.67%	31	15.36%	364
Tax Rate	21.50%	(150)	23.00%	(10)	23.10%	(189)	25.00%	25
Dividend Data:	**FY19E**		**FY18E**		**FY17**		**FY16**	
Dividends Paid in FY, per share	$2.890	3.7%	$2.788	3.3%	$2.698	1.5%	$2.658	2.5%
Dividend Payout Ratio	64%		66%		69%		72%	

Note: Continuing operations exclude the Pet Care, Battery, and certain Beauty businesses in all presented years.

Source: Company reports and Hilliard Lyons estimates Note: June fiscal year

Additional information is available upon request.

Prices of other stocks mentioned: Coty Inc. - COTY - $20.77
Novartis AG (ADS) - NVS - $87.21

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

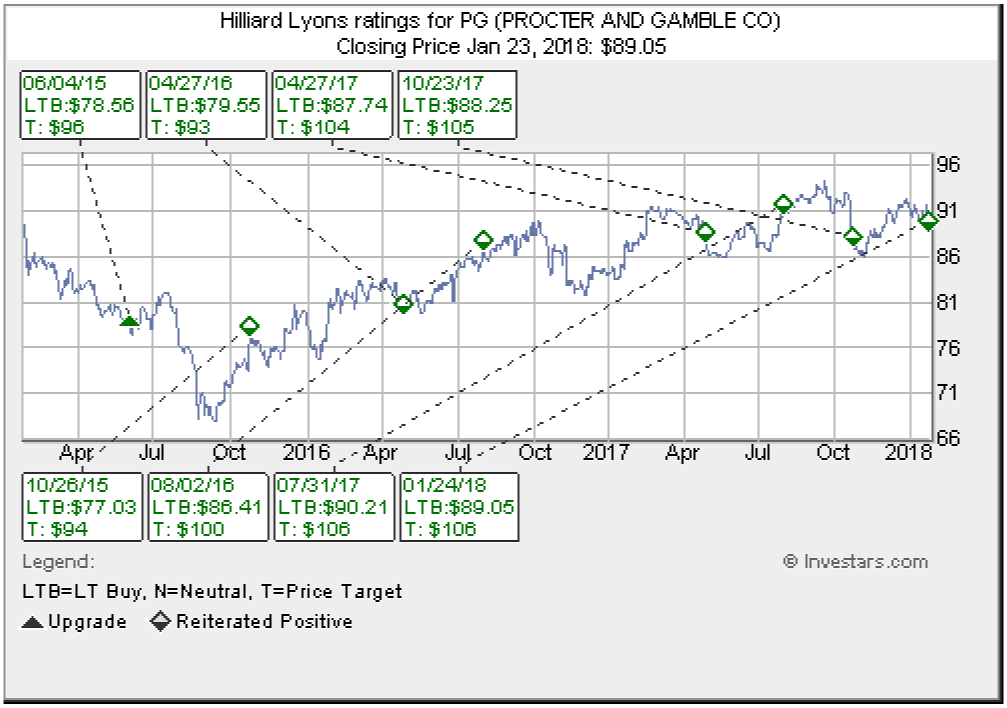
Buy - We believe the stock has significant total return potential in the coming 12 months.
Long-term Buy - We believe the stock is an above average holding in its sector, and expect solid returns to be realized over a longer time frame than our Buy rated issues, typically 2-3 years.
Neutral - We believe 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

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