



COMPANY UPDATE / ESTIMATE CHANGE

Key Metrics

LANC - NASDAQ (as of 4/27/17)	\$123.20
Price Target	N/A
52-Week Range	\$112.36 - \$149.30
Shares Outstanding-Basic (mil.)	27.4
Market Cap. (\$ mil.)	\$3,373
3-Mo. Average Daily Volume	82,984
Institutional Ownership	52%
Total Debt/Total Capital (3/17)	0%
ROE (TTM ended 3/17)	24%
Book Value/Share (3/17)	\$20.42
Price/Book Value	6.0x
Annual Dividend & Yield	\$2.20 1.8%
EBITDA Margin (TTM ended 3/17, estim.)	19%

EPS FY 6/30 (excludes nonrecurring items)

	FY16	Prev. FY17E	Curr. FY17E	Prev. FY18E	Curr. FY18E
1Q	\$1.01		\$1.22	A	
2Q	\$1.25		\$1.42	A	
3Q	\$1.06		\$0.95	A	
4Q	\$1.12	\$1.17	\$1.14		
Year	\$4.44	\$4.90	\$4.73	\$5.00	\$4.95
P/E	27.7x		26.0x		24.9x

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

Revenue (\$ mil)

	FY16	Prev. FY17E	Curr. FY17E	Prev. FY18E	Curr. FY18E
1Q	\$294		\$291	A	
2Q	\$325		\$327	A	
3Q	\$288		\$294	A	
4Q	\$285	\$294	\$295		
Year	\$1,191	\$1,200	\$1,207	\$1,225	\$1,250

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 Angelic line of bread products was acquired in November 2016.*

Lancaster Colony Corporation

LANC — NASDAQ — Neutral-2

Unlike Recent Quarters, EPS Fell in 3Q

Investment Highlights

- **There was good and bad to LANC's 3Q.** Net sales for the quarter ended 3/31/17 rose 2.1% to \$293.8 million. Management had not issued financial guidance, but we expected flat sales due mainly to Easter (a typical benefit) falling in 4Q this year rather than 3Q last year. The sales gain included modest growth in both the Retail and Foodservice segments and the impact of a recent acquisition (Angelic Bakehouse). Challenges included lower market share in the refrigerated dressing category on the Retail side, and the impact of recent business rationalization (pruning some low-volume business) and deflationary pricing on the Foodservice side.
- **Unlike the first two quarters of FY17, 3Q profit declined.** Gross margin fell 87 basis points. SG&A expenses rose 11.3%, a reflection of some acquisition costs and increased spending on additional personnel and business initiatives to support future growth. This led to a 178 basis point drop in operating margin. As a result, diluted EPS decreased 10.4% to \$0.95 versus \$1.06 a year ago. Our estimate was \$1.09 and street consensus was \$1.07.
- **We have updated our financial estimates.** Though 4Q could have some Easter benefit, we see the competitive environment, overall pricing, and operating expenses keeping earnings in check. We have lowered our 4Q EPS projection a bit, leading to our new FY17 estimate of \$4.73. This is down from \$4.90 previously. We have also fine-tuned our FY18 EPS figure with a \$0.05 decrease to \$4.95.
- **Our Neutral rating on LANC is based on valuation.** The shares are trading at a premium valuation relative to the stock's historical average and to the Consumer Staples sector. We like the company quite a bit and would consider a rating upgrade at a lower valuation, assuming no change in company fundamentals.

Note Important Disclosures on Pages 6-7.

Note Analyst Certification on Page 6.

Exhibit 1**Lancaster Colony Corporation - Consolidated Statements of Income**

(figures in thousands except per share data and percentages)

	Quarter Ended			Nine Months Ended		
	<u>3/31/17</u>	<u>3/31/16</u>	<u>% chg.</u>	<u>3/31/17</u>	<u>3/31/16</u>	<u>% chg.</u>
Net Sales	\$293,834	\$287,765	2.1%	\$911,968	\$906,619	0.6%
Cost of Sales	221,929	214,841	3.3%	665,690	682,134	(2.4%)
Gross Profit	71,905	72,924	(1.4%)	246,278	224,485	9.7%
SG&A Expense	32,253	28,980	11.3%	96,514	86,538	11.5%
Operating Income	39,652	43,944	(9.8%)	149,764	137,947	8.6%
Interest Inc. & Other (Exp.)	144	125	15.2%	437	42	N/A
Income Before Taxes	39,796	44,069	(9.7%)	150,201	137,989	8.8%
Taxes Based on Income	13,809	15,058	(8.3%)	51,858	46,839	10.7%
Net Income, Cont. Oper.	<u>\$25,987</u>	<u>\$29,011</u>	(10.4%)	<u>\$98,343</u>	<u>\$91,150</u>	7.9%
Diluted Earnings Per Share	\$0.95	\$1.06	(10.4%)	\$3.58	\$3.33	7.6%
Dividends Per Share	\$0.55	\$0.50	10.0%	\$1.60	\$1.46	9.6%
Avg. Shares Outst., diluted	27,442	27,376	0.2%	27,438	27,365	0.3%
As a % of Net Sales:			b.p. chg.			b.p. chg.
Gross Profit	24.47%	25.34%	(87)	27.01%	24.76%	224
SG&A Expense	10.98%	10.07%	91	10.58%	9.55%	104
Operating Income	13.49%	15.27%	(178)	16.42%	15.22%	121
Net Income	8.84%	10.08%	(124)	10.78%	10.05%	73
Tax Rate	34.70%	34.17%	53	34.53%	33.94%	58

Note: Current year three-month and nine-month figures exclude nonrecurring pension settlement costs.

Note: Dividend figure for nine months ended 3/31/16 excludes a special dividend of \$5.00 per share, paid on 12/31/15.

Source: Company reports

Note: June fiscal year; excludes nonrecurring items

Additional comments on 3Q results. Excluding the recent acquisition of Angelic Bakehouse (November 2016 transaction), the Retail operating segment generated a sales gain of just under 1%. Highlights included *New York Bakery* frozen garlic toast products, *Reames* noodles, and *Sister Schubert's* frozen dinner rolls. The refrigerated dressing category continued to pose challenges due to heightened competition. The Easter holiday occurring in the June quarter this year also had a negative impact on this year's March quarter. The Foodservice segment generated a sales gain just over 1% despite some deflationary pricing related to lower egg costs and recent business rationalization efforts aimed at improving efficiencies and margins.

SG&A expenses surged 11.3%, as the company added personnel in areas such as retail sales, marketing, product innovation, and plant operations. Efforts are being boosted in areas such as data analytics and employee training. Excluding one-time costs related to a pension settlement issue, operating income declined 9.8% with operating margin falling 178 basis points.

Diluted EPS declined by 10.4% to \$0.95, excluding the pension settlement item. This was much different from 1Q EPS growth of 20.5% and 2Q growth of 13.6%. There were no share repurchases in the quarter, though an authorization remains in place should management decide on that course of action. LANC shares declined in trading following the earnings release, falling more than \$6 per share, or 5%, on above-average volume yesterday (4/27/17).

Financial condition. The balance sheet remained in good shape, in our view. Cash and equivalents as of 3/31/17 were \$124.7 million. We believe inventories and accounts receivable were at reasonable levels. The current ratio was 3.2-to-1. As in recent quarters, there was no long-term debt. Shareholders' equity was \$559.1 million. The company has access to a \$150 million 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, paying and potentially raising dividends, or repurchasing shares.

Dividends. In November 2016, the company's Board of Directors raised the regular quarterly cash dividend by 10% to \$0.55 per share. This marked 54 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 54 consecutive years. The annualized rate of \$2.20 per share equates to a current yield of 1.8%. As a matter of comparison, the current yield on the S&P Consumer Staples index is currently 2.6%.

Recent acquisition. In November 2016, LANC entered into a definitive agreement to acquire all of the assets of Angelic Bakehouse, Inc., a privately held manufacturer and marketer of premium sprouted grain bakery products. The transaction closed on 11/17/16. The \$35 million purchase was funded with cash on hand. Annual sales for Angelic were approximately \$12 million. Management stated the impact of the acquisition on earnings per share is expected to be near neutral for the current fiscal year ending 6/30/17. The acquisition was consistent with LANC's focus on the branded "better for you" food category.

Outlook. We have updated our 4Q and FY17 estimates to reflect current business conditions and our latest margin assumptions. We have slightly increased our 4Q sales estimate, yet lowered our EPS projection due mainly to an updated gross margin assumption. We had already anticipated boosted SG&A spending for the quarter, though no significant retail product introductions should result in lower slotting expense. Pricing is expected to be stable. Our 4Q EPS estimate is lowered by \$0.03 to \$1.14. Reflecting this and actual 3Q results, our FY17 EPS estimate is lowered by \$0.17 to \$4.73.

We have also fine-tuned our fiscal 2018 outlook. We added \$25 million to our sales estimate based on updated views regarding the Retail product line, the high quality customer portfolio in the Foodservice segment (outpacing overall industry growth), and a full year contribution from Angelic Bakehouse. Our EPS estimate is lowered by \$0.05 to \$4.95 after figuring a lower gross margin assumption.

In sum, we 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 the competitive environment 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 an upper single-digit rate on a compounded annual basis.

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 grow EPS. LANC management does not provide financial guidance.

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 about 26 times our FY17 EPS estimate and 25x our FY18 estimate. Over the past fifteen years, LANC has traded in a range of approximately 11 to 29 times estimated forward earnings with a median of about 18 times. Over a more recent five year period, the median forward P/E multiple has been about 23 times.

We believe factors that may have had an influence on LANC's valuation in recent years 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, we believe some investors may consider LANC a logical acquisition candidate for a larger food company, which could also be affecting valuation.

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. The Foodservice business has been outpacing overall industry results due to the company's customer base, which features some of the faster growing restaurant chains in the country. Greater geographic distribution, new customers, and margin expansion resulting from operating efficiencies and price increases represent potential sources of earnings growth, in our view. Also, future acquisitions are possible.

We consider stock valuation the primary reason for our Neutral rating. Assuming no change in company fundamentals, we could consider a more favorable rating at a lower valuation. 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**Lancaster Colony Corporation - Consolidated Statements of Income** (figures in thousands except per share data and percentages)

	FY14	FY15	FY16	1Q17	2Q17	3Q17	4Q17E	FY17E	FY18E
Net Sales	\$1,041,075	\$1,104,514	\$1,191,109	\$291,361	\$326,773	\$293,834	\$295,032	\$1,207,000	\$1,250,000
Cost of Sales	792,507	846,822	891,480	210,727	233,034	221,929	215,675	881,365	911,000
Gross Profit	248,568	257,692	299,629	80,634	93,739	71,905	79,357	325,635	339,000
SG&A Expense	94,801	102,831	115,059	29,880	34,381	32,253	31,440	127,954	131,250
Operating Income	153,767	154,861	184,570	50,754	59,358	39,652	47,917	197,681	207,750
Interest Inc. & Other (Exp.)	(488)	(309)	63	87	206	144	40	477	200
Income Before Taxes	153,279	154,552	184,633	50,841	59,564	39,796	47,957	198,158	207,950
Taxes Based on Income	52,293	52,866	62,869	17,441	20,608	13,809	16,545	68,403	71,743
Net Income	\$100,986	\$101,686	\$121,764	\$33,400	\$38,956	\$25,987	\$31,412	\$129,755	\$136,207
Diluted EPS.	\$3.69	\$3.72	\$4.44	\$1.22	\$1.42	\$0.95	\$1.14	\$4.73	\$4.95
Dividends Per Share ~	\$1.72	\$1.82	\$1.96	\$0.50	\$0.55	\$0.55	\$0.55	\$2.15	\$2.32
Dividend Payout Ratio	47%	49%	44%					45%	47%
Avg. Shares Outst., diluted	27,308	27,327	27,373	27,430	27,441	27,442	27,475	27,447	27,500
% Year Over Year Chg.:									
Net Sales	2.69%	6.09%	7.84%	(0.93%)	0.62%	2.11%	3.71%	1.33%	3.56%
Gross Profit	1.58%	3.67%	16.27%	18.64%	12.14%	(1.40%)	5.61%	8.68%	4.10%
SG&A Expense	4.42%	8.47%	11.89%	14.57%	9.22%	11.29%	10.23%	11.21%	2.58%
Operating Income	(0.10%)	0.71%	19.18%	21.17%	13.90%	(9.77%)	2.78%	7.10%	5.09%
Net Income	(2.77%)	0.69%	19.75%	20.89%	12.88%	(10.42%)	2.61%	6.56%	4.97%
As a % of Net Sales:									
Gross Profit	23.88%	23.33%	25.16%	27.67%	28.69%	24.47%	26.90%	26.98%	27.12%
SG&A Expense	9.11%	9.31%	9.66%	10.26%	10.52%	10.98%	10.66%	10.60%	10.50%
Operating Income	14.77%	14.02%	15.50%	17.42%	18.16%	13.49%	16.24%	16.38%	16.62%
Net Income	9.70%	9.21%	10.22%	11.46%	11.92%	8.84%	10.65%	10.75%	10.90%
Tax Rate	34.12%	34.21%	34.05%	34.30%	34.60%	34.70%	34.50%	34.52%	34.50%

~ Excludes \$5.00 per share special dividend paid in FY13 and FY16.

Source: Lancaster Colony Corporation and Hilliard Lyons estimates

Note: June fiscal year, excludes nonrecurring items

Additional information is available upon request.

Prices of other stocks mentioned: Wal-Mart Stores, Inc. - WMT - \$75.44
 Berkshire Hathaway (parent of McLane Co.) - BRK'B - \$166.55
 Darden Restaurants, Inc. (parent of Olive Garden) - DRI - \$85.96

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

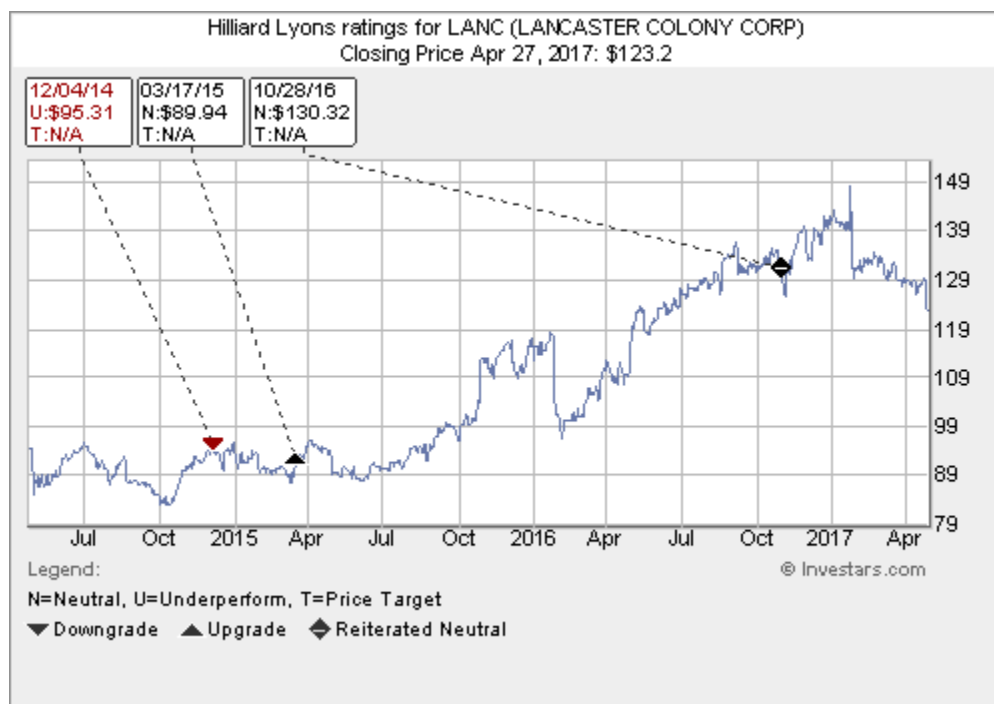
2 - A historically secure company which could be cyclical, has a shorter history than a "1" or is subject to event driven setbacks

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

Rating	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
	# of Stocks Covered	% of Stocks Covered	Banking	No Banking
Buy	36	30%	14%	86%
Hold/Neutral	71	58%	6%	94%
Sell	15	12%	7%	93%

As of 5 April 2017



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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