



COMPANY UPDATE / ESTIMATE CHANGE

Key Metrics

LANC - NASDAQ (as of 8/18/17)	\$116.47
Price Target	N/A
52-Week Range	\$114.42 - \$149.30
Shares Outstanding-Basic (mil.)	27.4
Market Cap. (\$ mil.)	\$3,197
3-Mo. Average Daily Volume	120,620
Institutional Ownership	54%
Total Debt/Total Capital (6/17)	0%
ROE (TTM ended 6/17)	19%
Book Value/Share (6/17)	\$21.02
Price/Book Value	5.5x
Annual Dividend & Yield	\$2.20 1.9%
EBITDA Margin (TTM ended 6/17, estim.)	18%

EPS FY 6/30 (excludes nonrecurring items)

	FY16	FY17	Prev. FY18E	Curr. FY18E
1Q	\$1.01	\$1.22		\$1.14
2Q	\$1.25	\$1.42		\$1.36
3Q	\$1.06	\$0.95		\$1.10
4Q	\$1.12	\$1.04		\$1.15
Year	\$4.44	\$4.62	\$4.95	\$4.75
P/E	26.2x	25.2x		24.5x

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

Revenue (\$ mil)

	FY16	FY17	Prev. FY18E	Curr. FY18E
1Q	\$294	\$291		\$297
2Q	\$325	\$327		\$334
3Q	\$288	\$294		\$301
4Q	\$285	\$290		\$298
Year	\$1,191	\$1,202	\$1,250	\$1,230

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.*

Lancaster Colony Corporation

LANC — NASDAQ — Neutral-2

EPS Decline for Fiscal 4Q

Investment Highlights

- **Similar to the previous quarter, 4Q sales rose but EPS declined.** Net sales for the quarter ended 6/30/17 rose 1.9% to \$289.8 million. Management had not issued financial guidance, but we expected sales growth of about 4%. Positive factors included some benefit of Easter occurring in 4Q this year rather than 3Q last year, contribution from the recent acquisition of Angelic Bakehouse, and organic growth from the Retail segment. Challenges included a decline in the Foodservice segment due to sluggish restaurant industry conditions including lower traffic.
- **Like the preceding quarter, profit declined.** Gross margin fell 141 basis points due to increased commodity costs, higher freight costs, and deflationary foodservice pricing. SG&A expenses rose 4.7%, a reflection of spending on additional personnel and business initiatives to support future growth. Diluted EPS decreased 7.1% to \$1.04 versus \$1.12 a year ago. Our estimate was \$1.14 and street consensus was \$1.12.
- **We have updated our fiscal 2018 financial model.** We have lowered our sales estimate by \$20 million to \$1.23 billion. We assume gross margin improvement but also higher operating expenses, leading to a 3% gain in EPS to \$4.75. This represents a decline of \$0.20 from our previous estimate.
- **We maintain our Neutral rating on LANC based on valuation.** Despite recent share price weakness, LANC is 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—including the product line and the management team—and believe it has the potential for stronger EPS growth than it has recently displayed. Assuming no change in company fundamentals, we would consider a rating upgrade at a lower valuation or signs of stronger EPS growth.

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			Fiscal Year Ended		
	<u>6/30/17</u>	<u>6/30/16</u>	<u>% chg.</u>	<u>6/30/17</u>	<u>6/30/16</u>	<u>% chg.</u>
Net Sales	\$289,874	\$284,490	1.9%	\$1,201,842	\$1,191,109	0.9%
Cost of Sales	217,388	209,346	3.8%	883,078	891,480	(0.9%)
Gross Profit	72,486	75,144	(3.5%)	318,764	299,629	6.4%
SG&A Expenses	29,867	28,521	4.7%	126,381	115,059	9.8%
Pension Settlement & Other	(4)	0		17,635	0	
Operating Income	42,623	46,623	(8.6%)	174,748	184,570	(5.3%)
Interest Inc. & Other (Exp.)	331	21		768	63	
Income Before Taxes	42,954	46,644	(7.9%)	175,516	184,633	(4.9%)
Taxes Based on Income	14,467	16,030	(9.8%)	60,202	62,869	(4.2%)
Net Income, Cont. Oper.	<u>\$28,487</u>	<u>\$30,614</u>	(6.9%)	<u>\$115,314</u>	<u>\$121,764</u>	(5.3%)
Diluted EPS, GAAP-based	\$1.04	\$1.12	(7.1%)	\$4.20	\$4.44	(5.4%)
Dividends Per Share *	\$0.55	\$0.50	10.0%	\$2.15	\$1.96	9.7%
Avg. Shares Outst., diluted	27,446	27,399	0.2%	27,440	27,373	0.2%
As a % of Net Sales:			b.p. chg.			b.p. chg.
Gross Profit	25.01%	26.41%	(141)	26.52%	25.16%	137
SG&A Expenses	10.30%	10.03%	28	10.52%	9.66%	86
Operating Income	14.70%	16.39%	(168)	14.54%	15.50%	(96)
Net Income	9.83%	10.76%	(93)	9.59%	10.22%	(63)
Tax Rate	33.68%	34.37%	(69)	34.30%	34.05%	25

* Excludes special dividend of \$5.00 per share paid on 12/31/15

Source: Company reports

Note: June fiscal year

Additional comments on 4Q results. Excluding the acquisition of Angelic Bakehouse (November 2016 transaction), total 4Q sales rose just under 2%. As with the previous quarter, the Retail segment fared better than the Foodservice segment.

Sales from the Retail segment rose 6.1% and produced about 53% of LANC's total sales. The segment benefited from both organic and acquisition-related growth. Product highlights included *Olive Garden* salad dressings, *Sister Schubert's* frozen dinner rolls, and *New York Bakery* frozen garlic toast products. The refrigerated dressing category remained quite competitive. Angelic Bakehouse (sprouted grain bakery products) contributed about \$3 million to the quarter's sales. Also, the Easter holiday occurring in 4Q this year (vs. 3Q last year) had a positive impact on sales due mainly to demand for *Sister Schubert's* products.

The Foodservice segment's sales decline reflected a sluggish restaurant industry environment that included lower same-store sales and store traffic. Overall deflationary pricing and some foregone sales (company choice due to profitability issue) also impacted the top line.

Cost of sales rose at a faster rate than sales due to increased commodity costs (including soybean oil and garlic) and higher freight costs, among other factors. Operating costs also rose faster than sales, a reflection of "foundational investments" in the business to support growth and facilitate future cost savings.

Financial condition. The balance sheet remained in good shape, in our view. Cash and equivalents as of 6/30/17 were \$143.1 million, up from \$118.0 million a year ago despite cash uses such as \$59 million in dividend payments and \$35 million for the acquisition of Angelic Bakehouse in November 2016. Inventories and accounts receivable were at reasonable levels, in our view. The current ratio was 3.9-to-1. As in recent quarters, there was no long-term debt. Shareholders' equity was \$575.9 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, and paying dividends.

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 1.9%. As a matter of comparison, the current yield on the S&P Consumer Staples index is currently 2.7%. We believe LANC's dividend rate is likely to be raised again around November 2017, but likely at a rate lower than the 10% increase last year.

Outlook. We have updated our FY18 estimates to reflect current business conditions and our latest assumptions for the year. The Retail segment should benefit from a full year of contribution from Angelic Bakehouse and planned new product introductions from a variety of the established brands. The Foodservice segment will implement several initiatives aimed to generating more sales for existing and new customers. SG&A expenses are expected to remain elevated at least during the first half of the fiscal year due to investments in personnel and strategic programs, as well as higher trade spending and marketing expenses early in the year. We believe gross margin can rise for the year despite expectations for commodity costs to be a net unfavorable factor for the year.

We have lowered our fiscal 2018 sales estimate by \$20 million and lowered our gross margin assumption by 25 basis points. Our diluted EPS estimate is lowered by \$0.20 to \$4.75. We assume no major changes to the tax rate or share count.

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 a mid- to 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 boost EPS. We believe EPS growth can be in the upper single-digit range in most years, though our fiscal 2018 outlook calls for just 3% growth. 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 24.5 times our fiscal 2018 EPS estimate. Over the past ten years, LANC has traded in a range of approximately 11 to 31 times estimated forward earnings with a median of about 18 times. Over the past five years, the median forward P/E multiple has been about 23 times.

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, which could also be affecting valuations.

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 of the faster growing and well-respected 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 likely, in our view, although we have not factored any in our outlook.

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 or with indications of greater EPS 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**Lancaster Colony Corporation - Consolidated Statements of Income** (figures in thousands except per share data and percentages)

	FY14	FY15	FY16	1Q17	2Q17	3Q17	4Q17	FY17	FY18E
Net Sales	\$1,041,075	\$1,104,514	\$1,191,109	\$291,361	\$326,773	\$293,834	\$289,874	\$1,201,842	\$1,230,000
Cost of Sales	792,507	846,822	891,480	210,727	233,034	221,929	217,388	883,078	899,500
Gross Profit	248,568	257,692	299,629	80,634	93,739	71,905	72,486	318,764	330,500
SG&A Expense	94,801	102,831	115,059	29,880	34,381	32,253	29,867	126,381	132,000
Operating Income	153,767	154,861	184,570	50,754	59,358	39,652	42,619	192,383	198,500
Interest Inc. & Other (Exp.)	(488)	(309)	63	87	206	144	331	768	250
Income Before Taxes	153,279	154,552	184,633	50,841	59,564	39,796	42,950	193,151	198,750
Taxes Based on Income	52,293	52,866	62,869	17,441	20,608	13,809	14,465	66,323	68,271
Net Income	\$100,986	\$101,686	\$121,764	\$33,400	\$38,956	\$25,987	\$28,485	\$126,828	\$130,479
Diluted EP.S.	\$3.69	\$3.72	\$4.44	\$1.22	\$1.42	\$0.95	\$1.04	\$4.62	\$4.75
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%					47%	49%
Avg. Shares Outst., diluted	27,308	27,327	27,373	27,430	27,441	27,442	27,446	27,440	27,475
% Year Over Year Chg.:									
Net Sales	2.69%	6.09%	7.84%	(0.93%)	0.62%	2.11%	1.89%	0.90%	2.34%
Gross Profit	1.58%	3.67%	16.27%	18.64%	12.14%	(1.40%)	(3.54%)	6.39%	3.68%
SG&A Expense	4.42%	8.47%	11.89%	14.57%	9.22%	11.29%	4.72%	9.84%	4.45%
Operating Income	(0.10%)	0.71%	19.18%	21.17%	13.90%	(9.77%)	(8.59%)	4.23%	3.18%
Net Income	(2.77%)	0.69%	19.75%	20.89%	12.88%	(10.42%)	(6.95%)	4.16%	2.88%
As a % of Net Sales:									
Gross Profit	23.88%	23.33%	25.16%	27.67%	28.69%	24.47%	25.01%	26.52%	26.87%
SG&A Expense	9.11%	9.31%	9.66%	10.26%	10.52%	10.98%	10.30%	10.52%	10.73%
Operating Income	14.77%	14.02%	15.50%	17.42%	18.16%	13.49%	14.70%	16.01%	16.14%
Net Income	9.70%	9.21%	10.22%	11.46%	11.92%	8.84%	9.83%	10.55%	10.61%
Tax Rate	34.12%	34.21%	34.05%	34.30%	34.60%	34.70%	33.68%	34.34%	34.35%

~ 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 - \$79.31
 Berkshire Hathaway (parent of McLane Co.) - BRK'B - \$177.56
 Darden Restaurants, Inc. (parent of Olive Garden) - DRI - \$83.99

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.	
	# of <u>Stocks Covered</u>	% of <u>Stocks Covered</u>	<u>Banking</u>	<u>No Banking</u>
Rating				
Buy	38	30%	11%	89%
Hold/Neutral	77	61%	8%	92%
Sell	11	9%	0%	100%

As of 9 August 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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