



COMPANY UPDATE / ESTIMATE CHANGE

Key Metrics

LANC - NASDAQ (as of 10/27/17)	\$130.80
Price Target	N/A
52-Week Range	\$113.33 - \$149.30
Shares Outstanding-Basic (mil.)	27.4
Market Cap. (\$ mil.)	\$3,583
3-Mo. Average Daily Volume	128,250
Institutional Ownership	52%
Total Debt/Total Capital (9/17)	0%
ROE (TTM ended 9/17)	20%
Book Value/Share (9/17)	\$21.56
Price/Book Value	6.1x
Annual Dividend & Yield	\$2.20 1.7%
EBITDA Margin (TTM ended 9/17, estim.)	17%

EPS FY 6/30 (excludes nonrecurring items)

	FY16	FY17	Prev. FY18E	Curr. FY18E
1Q	\$1.01	\$1.22		\$1.07 A
2Q	\$1.25	\$1.42	\$1.36	\$1.32
3Q	\$1.06	\$0.95	\$1.10	\$1.08
4Q	\$1.12	\$1.04	\$1.15	\$1.15
Year	\$4.44	\$4.62	\$4.75	\$4.62
P/E	29.5x	28.3x		28.3x

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

Revenue (\$ mil)

	FY16	FY17	Prev. FY18E	Curr. FY18E
1Q	\$294	\$291		\$299 A
2Q	\$325	\$327	\$334	\$334
3Q	\$288	\$294	\$301	\$300
4Q	\$285	\$290	\$298	\$297
Year	\$1,191	\$1,202	\$1,230	\$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 1Q

Investment Highlights

- **Similar to recent quarters, 1Q sales rose but EPS declined.** Net sales for the quarter ended 9/30/17 rose 2.6% to \$298.9 million, in line with our expectation. Positive factors included a solid performance from the Retail segment, which benefited from organic growth, and contribution from Angelic Bakehouse (November 2016 acquisition). Challenges included lower volume in the Foodservice segment due in part to sluggish restaurant industry conditions.
- **Like recent quarters, profit declined.** Gross margin fell 242 basis points due to increased commodity costs and higher freight costs. SG&A expenses rose 4.3%, with the increase mostly related to Angelic. Diluted EPS decreased 12.1% to \$1.07 versus \$1.22 a year ago. Our estimate was \$1.14 and street consensus was \$1.11.
- **We have fine-tuned our fiscal 2018 financial model.** We are maintaining our annual sales estimate but lowering our EPS estimate by \$0.13 to \$4.62 to reflect our updated margin assumptions. This would represent flat earnings compared to last year.
- **Valuations are 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 based on sluggish earnings and stock valuation.** We like the company's product line, business segments (retail and foodservice), and management team. We believe it has the potential for solid EPS growth when key factors (such as commodity costs and competitive environment) 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**Consolidated Statements of Income** (figures in thousands except per share data and percenta

	Quarter Ended		% chg.
	9/30/17	9/30/16	
Net Sales	\$298,916	\$291,361	2.6%
Cost of Sales	<u>223,439</u>	<u>210,727</u>	6.0%
Gross Profit	75,477	80,634	(6.4%)
SG&A Expense	<u>31,151</u>	<u>29,880</u>	4.3%
Operating Income	44,326	50,754	(12.7%)
Interest Inc. & Other (Exp.)	<u>358</u>	<u>87</u>	311.5%
Income Before Taxes	44,684	50,841	(12.1%)
Taxes Based on Income	<u>15,298</u>	<u>17,441</u>	(12.3%)
Net Income	<u>\$29,386</u>	<u>\$33,400</u>	(12.0%)
Diluted E.P.S.	\$1.07	\$1.22	(12.1%)
Dividends Per Share ~	\$0.55	\$0.50	10.0%
Avg. Shares Outst., diluted	27,451	27,430	0.1%
As a % of Net Sales:			b.p. chg.
Gross Profit	25.25%	27.67%	(242)
SG&A Expense	10.42%	10.26%	17
Operating Income	14.83%	17.42%	(259)
Net Income	9.83%	11.46%	(163)
Tax Rate	34.24%	34.30%	(1)

Source: Company reports

Note: June fiscal year

Additional comments on 1Q results. As in recent quarters, the Retail segment (sales up 6.2%) fared better than the Foodservice segment (down 1.4%). Organic sales at the Retail segment rose 4.0%, with volume growth from *Sister Schubert's* frozen dinner rolls, *Marzetti* caramel dip, *Olive Garden* dressings, and *New York Bakery* frozen garlic bread products. The acquisition of Angelic Bakehouse (November 2016) added 2.2% to the segment's overall sales growth.

The Foodservice segment's sales decline reflected a sluggish restaurant industry environment that included lower 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 (including soybean, dairy ingredients, eggs, and garlic) and higher freight costs. SG&A expenses also rose faster than sales, a reflection of the Angelic acquisition as well as investments in the business to support future growth.

Financial condition. The balance sheet remained in good shape, in our view. Cash and equivalents as of 9/30/17 were \$157.1 million. Inventories and accounts receivable were at reasonable levels, in our view. The current ratio was 3.5-to-1. As in recent quarters, there was no long-term debt. Shareholders' equity was \$590.5 million. The company has access to nearly \$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 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 dividend rate of \$2.20 per share equates to a current yield of 1.7%. 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 probably at a rate lower than the 10% increase last year.

Outlook. We have fine-tuned our FY18 estimates to reflect 1Q results and our views on the remainder of the year. The Retail segment should benefit from popular brands, some new products, and a full year of contribution from Angelic Bakehouse. The Foodservice segment will implement several initiatives aimed to generating sales from 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. One notable change to our outlook: we now assume a slight gross margin decline for all of FY18 rather than our previous view of a slight increase.

We maintain our FY18 sales estimate of \$1.230 billion, but our EPS estimate is lowered by \$0.13 to \$4.62 (flat with FY17) to reflect our margin adjustment. We assume no major changes to the tax rate or share count.

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 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 flat earnings. 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 28.3x our fiscal 2018 EPS estimate and roughly 27.0x our projection of twelve-month forward earnings. Over the past ten years, LANC has traded in a range of approximately 11x to 31x estimated forward earnings with a median of 18.4x. Over the past five years, the median forward P/E multiple is a loftier 23.8x.

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**Lancaster Colony Corporation - Consolidated Statements of Income** (figures in thousands except per sha

	FY14	FY15	FY16	FY17	FY18E
Net Sales	\$1,041,075	\$1,104,514	\$1,191,109	\$1,201,842	\$1,230,000
Cost of Sales	792,507	846,822	891,480	883,078	905,250
Gross Profit	248,568	257,692	299,629	318,764	324,750
SG&A Expense	94,801	102,831	115,059	126,381	131,900
Operating Income	153,767	154,861	184,570	192,383	192,850
Interest Inc. & Other (Exp.)	(488)	(309)	63	768	500
Income Before Taxes	153,279	154,552	184,633	193,151	193,350
Taxes Based on Income	52,293	52,866	62,869	66,323	66,512
Net Income	\$100,986	\$101,686	\$121,764	\$126,828	\$126,838
Diluted E.P.S.	\$3.69	\$3.72	\$4.44	\$4.62	\$4.62
Dividends Per Share ~	\$1.72	\$1.82	\$1.96	\$2.15	\$2.32
Dividend Payout Ratio	47%	49%	44%	47%	50%
Avg. Shares Outst., diluted	27,308	27,327	27,373	27,440	27,470
% Year Over Year Chg.:					
Net Sales	2.69%	6.09%	7.84%	0.90%	2.34%
Gross Profit	1.58%	3.67%	16.27%	6.39%	1.88%
SG&A Expense	4.42%	8.47%	11.89%	9.84%	4.37%
Operating Income	(0.10%)	0.71%	19.18%	4.23%	0.24%
Net Income	(2.77%)	0.69%	19.75%	4.16%	0.01%
As a % of Net Sales:					
Gross Profit	23.88%	23.33%	25.16%	26.52%	26.40%
SG&A Expense	9.11%	9.31%	9.66%	10.52%	10.72%
Operating Income	14.77%	14.02%	15.50%	16.01%	15.68%
Net Income	9.70%	9.21%	10.22%	10.55%	10.31%
Tax Rate	34.12%	34.21%	34.05%	34.34%	34.40%

~ Excludes \$5.00 per share special dividend paid in FY13 and 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 - \$88.17
 Berkshire Hathaway (parent of McLane Co.) - BRK'B - \$188.59
 Darden Restaurants, Inc. (parent of Olive Garden) - DRI - \$83.33

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 Stocks Covered	% of Stocks Covered	Banking	No Banking
Buy	39	32%	8%	92%
Hold/Neutral	74	60%	9%	91%
Sell	8	7%	0%	100%
Restriction	2	2%	100%	0%

As of 5 October 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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