HILLIARD LYONS

Consumer Staples
Analyst: Jeffrey S. Thomison, CFA
502.588.9137 / JThomison@hilliard.com
Institutional Sales Desk: George Moorin
502.588.9141 / GMoorin@hilliard.com
J.J.B. Hilliard, W.L. Lyons, LLC
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COMPANY UPDATE / ESTIMATE CHANGE / PRICE TARGET CHANGE

The Procter & Gamble Co.

PG — NYSE — Long-term Buy-1

Mixed 3Q Results; Maintain LT Buy Rating

Key Metrics

PG - NYSE (as of 4/26/17)		$87.74
Two-Year Price Target		$104.00
52-Week Range		$79.10 - $92.00
Shares Outstanding-Basic (mil.)		2,558
Market Cap. ($ mil.)		$224,404
3-Mo. Average Daily Volume		8,690,216
Institutional Ownership		62%
Total Debt/Total Capital (3/17)		36%
ROE (based on TTM core earnings ended 3/17)		19%
Book Value/Share (3/17)		$21.33
Price/Book Value		4.1x
Annual Dividend & Yield	$2.76	3.1%
EBITDA Margin (TTM ended 3/17)		20%

EPS FY 6/30 (excludes nonrecurring items)

	2016	Prior 2017E	Curr. 2017E		Prior 2018E	Curr. 2018E
1Q	$0.98		$1.03	A		
2Q	$1.04		$1.08	A		
3Q	$0.86		$0.96	A		
4Q	$0.79	$0.83	$0.80			
Year	$3.67	$3.86	$3.87		$4.10	$4.11
P/E	23.9x		22.7x			21.3x

Quarterly figures may not add to annual figure due to rounding.
All EPS figures exclude nonrecurring charges, businesses recently divested, and businesses in the process of being divested.

Revenue ($ mil)

	2016	Prior 2017E	Curr. 2017E		Prior 2018E	Curr. 2018E
1Q	$16,527		$16,518	A		
2Q	$16,915		$16,856	A		
3Q	$15,755		$15,605	A		
4Q	$16,102	$16,201	$16,121			
Year	$65,299	$65,400	$65,100		$67,000	$66,700

All revenue figures exclude businesses recently divested as well as businesses in the process of being divested.

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 reported mixed fiscal 3Q results.** Net sales of $15.6 billion for the March quarter were a bit below street consensus of $15.7 billion and our estimate of $15.8 billion. Key factors in the period were a slowdown in overall market growth and foreign currency exchange. The competitive environment was likely a factor as well, in our view. Organic sales rose 1% for the quarter, and were up in four of the five major business segments. Pricing and mix were neutral factors.

- **Margins were lower.** Core gross margin (excluding nonrecurring items) decreased 40 basis points, while core operating margin declined a more modest 10 basis points. A lower tax rate and share repurchases helped lead to core earnings per share of $0.96, up nearly 12% from a year ago and exceeding our estimate of $0.92 and street consensus of $0.94.

- **A stronger U.S. dollar continued to be a factor.** Currency-neutral core EPS for 3Q would have increased 15% versus the actual 12% gain. We expect foreign currency to be a headwind in 4Q as well.

- **Management reiterated past financial guidance.** This includes expected organic sales growth of 2-3% for the fiscal year, and core EPS growth at the mid-single digit rate. We have fine-tuned our FY17 and FY18 estimates.

- **We maintain our Long-term Buy rating.** We continue to believe an earnings rebound is underway, but slowed by macro factors. We generally view 3Q results favorably. Based on the progression of time and a higher forward earnings assumption, we are slightly raising our two-year price target by $4 to $104 per share. This assumes a price/earnings multiple similar to the current level. This suggests total return potential, including dividends, of about 12% on an annualized basis. Our Suitability rating on PG remains 1.

Note Important Disclosures on Pages 6-7.
Note Analyst Certification on Page 6.

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

	Fiscal 3Q Ended			Nine Months Ended		
	3/31/17	3/31/16	% chg.	3/31/17	3/31/16	% chg.
Net Sales	$15,605	$15,755	(1.0%)	$48,979	$49,197	(0.4%)
Cost of Products Sold	7,836	7,915	(1.0%)	24,236	24,527	(1.2%)
Gross Profit	7,769	7,840	(0.9%)	24,743	24,670	0.3%
Selling, Gen., & Admin. Exp.	4,409	4,522	(2.5%)	13,737	13,731	0.0%
Operating Income	3,360	3,318	1.3%	11,006	10,939	0.6%
Interest Expense, net	50	113	(55.8%)	226	294	(23.1%)
Other Expense (Income)	(26)	(21)	23.8%	450	(38)	N/A
Earnings Before Taxes	3,336	3,226	3.4%	10,330	10,683	(3.3%)
Taxes	780	889	(12.3%)	2,338	2,664	(12.2%)
Net Earnings from Contin. Oper.	2,556	2,337	9.4%	7,992	8,019	(0.3%)
Less: Earnings Attributable to Noncontrolling Interests	34	33	3.0%	98	89	10.1%
Net Earnings Attrib. to PG	$2,522	$2,304	9.5%	$7,894	$7,930	(0.5%)
Diluted Earnings Per Share:						
As Reported, from Contin. Oper.	$0.93	$0.81	14.7%	$2.87	$2.78	3.2%
Incremental Restructuring	$0.03	$0.04		$0.08	$0.09	
Other Nonrecur. Items & Rounding	$0.00	$0.01		$0.13	$0.01	
Core EPS	**$0.96**	**$0.86**	**11.5%**	**$3.08**	**$2.88**	**6.9%**
Avg. Diluted Shares Outst.	2,706	2,835	(4.6%)	2,755	2,856	(3.5%)
As a % of Net Sales:			bp. chg.			bp. chg.
Gross Profit	49.79%	49.76%	2	50.52%	50.15%	37
Operating Income	21.53%	21.06%	47	22.47%	22.24%	24
Earnings Before Taxes	21.38%	20.48%	90	21.09%	21.71%	(62)
Net Earnings from Contin. Oper.	16.38%	14.83%	155	16.32%	16.30%	2
Tax Rate	23.38%	27.56%	(418)	22.63%	24.94%	(230)

Source: Company reports Note: June fiscal year

3Q earnings review. PG's fiscal 3Q delivered a 1% increase in organic sales compared to a 2% gain in the previous quarter. Pricing and mix had little effect, yet foreign exchange continued to be a headwind. The company's largest segment—Fabric & Home Care—posted a 1% gain in organic sales and a 1% increase in organic volume, as did the company's second-biggest segment—Baby, Feminine & Family Care. Another notable performance came from the Health Care segment, which has exceeded our expectations for several quarters in a row, with a 6% gain in organic sales and a 4% increase in organic volume for the quarter. Health Care businesses that did particularly well include oral care (power toothbrushes) and personal health care (strong cough and cold season).

While we were slightly disappointed in the top line, the lower margins were generally in line with our expectation. Gross margin was impacted by several factors, including currency and higher commodity costs. Core SG&A expenses were impacted by investments in marketing, sales resources, and research and development expenses. The tax rate was a bit lower than our expectation, and share repurchases also helped generate the slight EPS "beat" of $0.96 versus street consensus of $0.94.

Financial condition. The balance sheet remained solid, in our view. At March 31, 2017, cash and equivalents totaled $5.8 billion. Short-term investments available for sale totaled another $8.5 billion. Total debt (short-term plus long-term) was $30.4 billion, or 36% of total capitalization. Shareholders' equity was $54.5 billion.

For the quarter, operating cash flow was $3.0 billion. After $800 million in capital spending, free cash flow was $2.2 billion. During the quarter, PG paid $1.8 billion in common stock dividends and spent $2.0 billion on share repurchases.

Dividend increase. Earlier this month, 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 this time each year. We continue to find PG's dividend yield, currently 3.1%, a positive investment factor. The recent yield for the S&P Consumer Discretionary sector was 2.5%, while the yield for the S&P 500 was 2.0%.

Beauty segment transaction with Coty. In October 2016, PG completed a Reverse Morris Trust transaction with Coty Inc., which sent the bulk of PG's beauty business to Coty. This included PG's global fine fragrances, salon professional, cosmetics and retail hair coloring business, and select hair styling brands. Affected brands included *Wella*, *Clairol*, *Sassoon*, *Nice & Easy*, *Max Factor*, and *Covergirl*, among others. The plan was part of PG's stated strategy to divest non-core businesses and focus on its most profitable and faster growing products. PG shareholders who tendered their shares received 3.9033 shares of COTY for each share of PG accepted in the exchange. PG accepted 104,969,205 tendered shares, which were then retired. The number of shares tendered by shareholders was 691,105,648, thus pro-rationing went into effect. In addition, about $1.4 billion of PG debt went to Coty.

We consider the transaction a net positive for PG, as it represented one of the biggest changes to the product portfolio in the company's recent history. The EPS impact of the departing Beauty brands is expected to be roughly offset on an annualized basis through a combination of overhead elimination, some debt reduction, and shares retired via the deal structure. Primary financial objectives of a now-streamlined PG include sustainable top and bottom line growth and cash generation that can propel shareholder value creation. The company now has about 65 brands classified under 10 categories.

Earnings outlook. Management provided financial guidance for FY17 (June year end), with reiterations of most key figures. Highlights of this outlook include:

- Organic sales are expected to rise by 2%-3%, unchanged from the previous view. Through the first nine months of the fiscal year, the company is at the low end of this range.
- Management expects foreign exchange and minor brand divestitures to reduce sales by 2%-3%, also unchanged from previous statements.
- Reported sales are expected to be down 1% to flat with the prior fiscal year; this compares to previous guidance of flat sales.
- Core EPS (including currency impacts but excluding nonrecurring items such as a one-time gain associated with the Coty transaction) are expected to rise in the mid-single digit percentage range from the $3.67 figure from FY16, unchanged from the previous view.

We have fine-tuned our financial model with minor changes to our previous figures. As noted in Exhibit 2, our current FY17 outlook includes net sales of $65.1 billion, or $300 million below our previous estimate. This represents a 0.3% decline from FY16. We assume gross and operating margin improvement for the year with core EPS at $3.87, one penny above our previous estimate and up 5% from the FY16 figure. We assume a 4% reduction in the weighted average share count due to the dual impact of share retirement resulting from the Coty transaction and ongoing repurchases as part of PG's existing buyback authorization.

We have made minor changes to our FY18 outlook. We assume sales of $66.7 billion, $300 million below our previous figure. We project gross and operating margin improvement, and a further decline in the weighted average share count. Our core EPS estimate is increased modestly by $0.01 to $4.11. This represents compounded annual growth in core EPS of approximately 6% over a two year period, with the challenged FY16 serving as the base year.

We believe much of the appeal of PG shares and the company outlook relates to the longer term. The company's product portfolio transformation is 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.

Exhibit 2
Consolidated Statements of Operations (figures in millions except percentages and per share data)

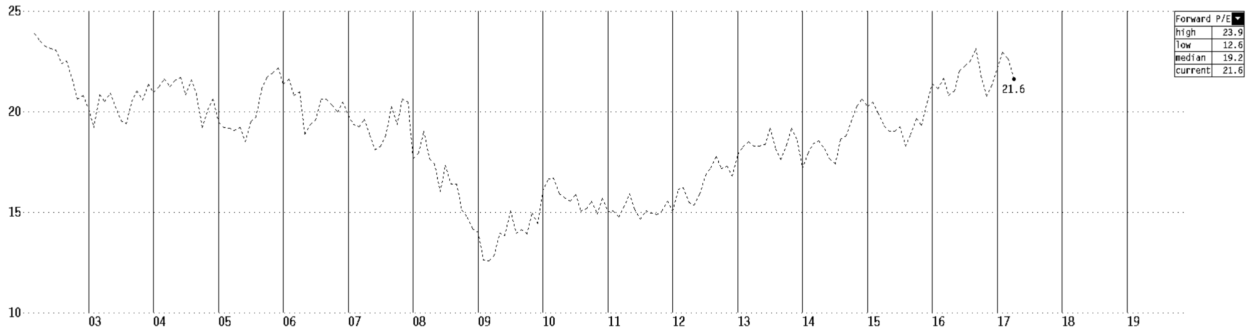
	FY18E	% chg.	FY17E	% chg.	FY16	% chg.	FY15	% chg.
Net Sales	$66,700	2.5%	$65,100	(0.3%)	$65,299	(7.7%)	$70,749	(4.9%)
Cost of Products Sold	32,800	1.9%	32,200	(2.2%)	32,909	(11.2%)	37,056	(5.1%)
Gross Profit	33,900	3.0%	32,900	1.6%	32,390	(3.9%)	33,693	(4.7%)
Venezuela Charge	0		0		0		2,028	N/A
Selling, Gen., & Admin. Exp.	19,480	2.0%	19,100	0.8%	18,949	(8.1%)	20,616	(3.9%)
Operating Income	14,420	4.5%	13,800	2.7%	13,441	21.6%	11,049	(20.6%)
Interest Expense, net	390	(2.5%)	400	0.8%	397	(16.8%)	477	(21.4%)
Other Expense (Income)	(200)	N/A	200	N/A	(325)	(26.1%)	(440)	113.6%
Earnings Before Taxes	14,230	7.8%	13,200	(1.3%)	13,369	21.4%	11,012	(18.5%)
Taxes	3,415	10.1%	3,102	(7.2%)	3,342	22.6%	2,725	(4.4%)
Net Earnings from Cont. Oper.	10,815	7.1%	10,098	0.7%	10,027	21.0%	8,287	(22.2%)
Less: Earnings Attributable to Noncontrolling Interests	110	0.0%	110	14.6%	96	(11.1%)	108	(23.9%)
Net Earnings Attrib. to PG	$10,705	7.2%	$9,988	0.6%	$9,931	21.4%	$8,179	(22.2%)
Diluted EPS:								
As Reported, from Contin. Oper	$3.99		$3.66		$3.49		$2.84	
Restructuring Charges	$0.11		$0.08		$0.18		$0.17	
Venezuela & Misc. Charges	$0.00		$0.00		$0.00		$0.75	
Other	$0.01		$0.13		$0.00		$0.01	
Core EPS	**$4.11**	6.4%	**$3.87**	5.4%	**$3.67**	(2.3%)	**$3.76**	(2.3%)
Avg. Diluted Shares Outst.	2,680	(1.8%)	2,730	(4.0%)	2,844	(1.4%)	2,884	(0.7%)
As a % of Net Sales:		**bp. chg.**		**bp. chg.**		**bp. chg.**		**bp. chg.**
Gross Profit	50.82%	29	50.54%	94	49.60%	198	47.62%	8
Selling, Gen., & Admin. Exp.	29.21%	(13)	29.34%	32	29.02%	(12)	29.14%	29
Operating Income	21.62%	42	21.20%	61	20.58%	497	15.62%	(308)
Earnings Before Taxes	21.33%	106	20.28%	(20)	20.47%	491	15.56%	(259)
Net Earnings from Cont. Oper.	16.21%	70	15.51%	16	15.36%	364	11.71%	(261)
Tax Rate	24.00%	50	23.50%	(150)	25.00%	25	24.75%	364
Dividend Data:	**FY17E**		**FY17E**		**FY16**		**FY15**	
Dividends Paid in FY, per share	$2.780	3.0%	$2.700	1.6%	$2.658	2.5%	$2.594	5.9%
Dividend Payout Ratio	68%		70%		72%		69%	

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

Valuation. PG shares are currently trading at 22.9x our FY17 core EPS estimate and 21.5x our FY18 estimate. This equates to an approximate 22x multiple on expected forward earnings. As noted in Exhibit 3 below, the median forward multiple for PG over the past fifteen years is 19.2x. This reflects a generally rising valuation over the past seven years, similar to the S&P Consumer Discretionary sector valuation and, to a lesser extent, the S&P 500.

Exhibit 3
Historical Forward P/E Multiple



Source: Baseline

Additionally, PG shares are currently trading at 1.2x the forward multiple on the S&P 500, equal to its historical premium over the past fifteen years. PG's forward multiple is 1.1x that of the S&P Consumer Staples sector, also in line with the historical premium over the past fifteen years.

Opinion. We consider the "heavy lifting" phase of PG's product portfolio transformation to be complete, with the divestiture of numerous beauty brands having recently been completed. Over the past few years, changes at the company have related to the product portfolio (divestitures), operating execution (efficiency improvements), and leadership (CEO and Chairman changes). Over the past two years, the company has divested, discontinued, or consolidated over 100 brands. Combined, these brands represented about 14% of PG's recent annual sales and 6% of annual profits.

We continue to 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 FY17 and FY18. 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. 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.

Our rating on PG remains Long-term Buy. We are raising our two year price target by $4 to $104 per share. This reflects the progression of time and a slightly higher forward earnings assumption. We assume a price/earnings multiple of just under 22x on expected forward earnings two years from now. This is similar to the current multiple on our estimate of forward earnings yet above the fifteen-year median forward multiple. 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 on PG is 1 (on a 1-to-4 scale with 1=most conservative and 4=most aggressive). Factors behind this rating include a large market capitalization, diverse product portfolio with strong 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.

Additional information is available upon request.

Prices of other stocks mentioned: Coty Inc. - COTY - $18.12

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

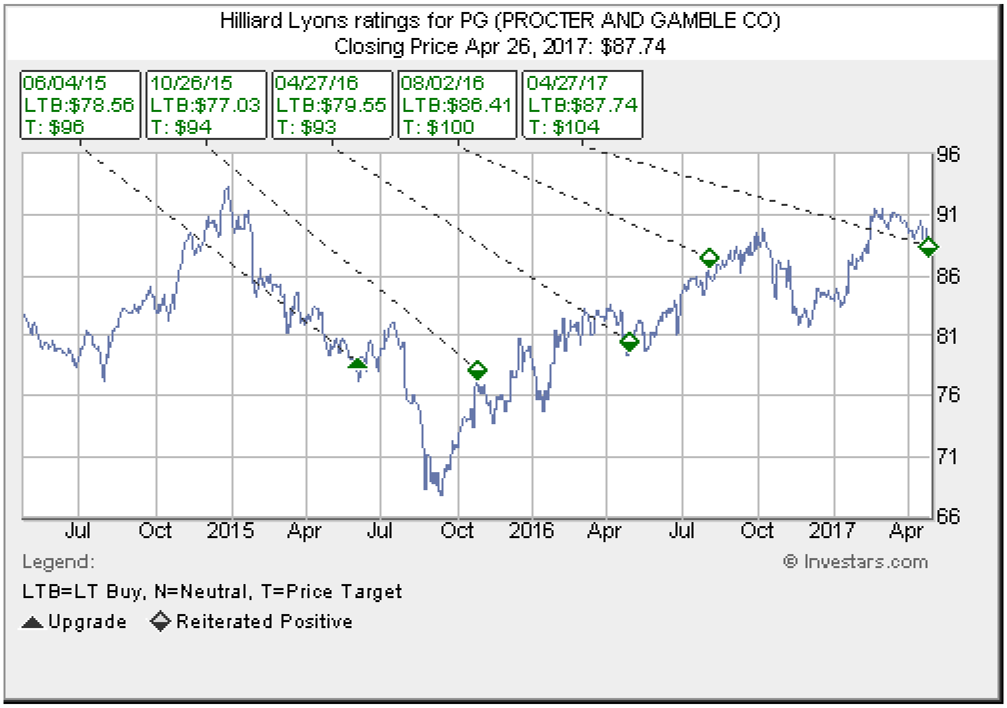
Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

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



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.

	Hilliard Lyons Recommended Issues		Investment Banking Provided in Past 12 Mo.	
Rating	**# 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

Other Disclosures

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