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Consumer Staples
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COMPANY UPDATE / ESTIMATE CHANGE / PRICE TARGET CHANGE

The Procter & Gamble Co.

PG — NYSE — Long-term Buy-1

Decent 4Q Results; Maintain LT Buy Rating

Key Metrics

PG - NYSE (as of 7/28/17)		$90.21
Two-Year Price Target		$106.00
52-Week Range		$81.18 - $92.00
Shares Outstanding-Basic (mil.)		2,553
Market Cap. ($ mil.)		$230,333
3-Mo. Average Daily Volume		6,300,000
Institutional Ownership		60%
Total Debt/Total Capital (6/17)		36%
ROE (based on TTM core earnings ended 6/17)		19%
Book Value/Share (6/17)		$21.85
Price/Book Value		4.1x
Annual Dividend & Yield	$2.758	3.1%
EBITDA Margin (TTM ended 6/17)		26%

EPS FY 6/30 (excludes nonrecurring items)

	2016	2017	Prior 2018E	Curr. 2018E
1Q	$0.98	$1.03		$1.07
2Q	$1.04	$1.08		$1.14
3Q	$0.86	$0.96		$1.02
4Q	$0.79	$0.85		$0.92
Year	$3.67	$3.92	$4.11	$4.15
P/E	24.6x	23.0x		21.7x

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	2017	Prior 2018E	Curr. 2018E
1Q	$16,527	$16,518		$16,650
2Q	$16,915	$16,856		$17,300
3Q	$15,755	$15,605		$16,375
4Q	$16,102	$16,079		$16,675
Year	$65,299	$65,058	$66,700	$67,000

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 decent fiscal 4Q results, in our view.** Net sales of $16.1 billion were essentially even with the year ago level and a bit above street consensus. Key factors in the period were a 2% increase in organic sales (slightly below estimated market growth of 2.5%) and an offsetting impact from foreign currency exchange. In addition, the competitive environment remained a challenging factor. Organic sales were up in two segments, down in two, and flat in one. On a company-wide basis, pricing and mix were neutral factors.

- **Efficiency initiatives are coming through.** Core gross margin (excluding nonrecurring items) decreased 10 basis points due mainly to higher commodity costs, but core operating margin improved a substantial 210 basis points due to considerably lower SG&A expenses (including a decline in digital ad spending). Share repurchase activity helped lead to core earnings per share of $0.85, up nearly 8% from a year ago and exceeding our estimate of $0.80 and street consensus of $0.78.

- **Management issued FY18 financial guidance.** This included expected organic sales growth of 2-3% for the fiscal year, higher operating margin, higher interest expense, and a lower share count. This is expected to produce core EPS growth of 5-7%. We have updated our outlook, which includes 6% EPS growth to $4.15.

- **We maintain our Long-term Buy rating.** We believe an earnings rebound is underway, but slowed by macro and industry factors. With the progression of time bringing a higher forward earnings assumption, we are raising our two-year price target by $2 to $106 per share. This assumes a price/earnings multiple similar to the current level. This suggests total return potential, including dividends, of nearly 12% on an annualized basis. Our Suitability rating remains 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 4Q Ended			Twelve Months Ended		
	6/30/17	6/30/16	% chg.	6/30/17	6/30/16	% chg.
Net Sales	$16,079	$16,102	(0.1%)	$65,058	$65,299	(0.4%)
Cost of Products Sold	8,299	8,382	(1.0%)	32,535	32,909	(1.1%)
Gross Profit	7,780	7,720	0.8%	32,523	32,390	0.4%
Selling, Gen., & Admin. Exp.	4,831	5,218	(7.4%)	18,568	18,949	(2.0%)
Operating Income	2,949	2,502	17.9%	13,955	13,441	3.8%
Interest Expense, net	68	103	(34.0%)	294	397	(25.9%)
Other Expense (Income)	(46)	(287)	(84.0%)	404	(325)	N/A
Earnings Before Taxes	2,927	2,686	9.0%	13,257	13,369	(0.8%)
Taxes	725	678	6.9%	3,063	3,342	(8.3%)
Net Earnings from Contin. Oper.	2,202	2,008	9.7%	10,194	10,027	1.7%
Less: Earnings Attributable to Noncontrolling Interests	(13)	7	N/A	85	96	(11.5%)
Net Earnings Attrib. to PG	$2,215	$2,001	10.7%	$10,109	$9,931	1.8%
Diluted Earnings Per Share:						
As Reported, from Contin. Oper.	$0.82	$0.71	15.4%	$3.69	$3.49	5.7%
Incremental Restructuring	$0.02	$0.08		$0.10	$0.18	
Other/Rounding	$0.01	$0.00		$0.13	$0.00	
'Core' EPS	**$0.85**	**$0.79**	**7.6%**	**$3.92**	**$3.67**	**6.7%**
Avg. Diluted Shares Outst.	2,696	2,811	(4.1%)	2,740	2,844	(3.7%)
As a % of Net Sales:			bp. chg.			bp. chg.
Gross Profit	48.39%	47.94%	44	49.99%	49.60%	39
Operating Income	18.34%	15.54%	280	21.45%	20.58%	87
Earnings Before Taxes	18.20%	16.68%	152	20.38%	20.47%	(10)
Net Earnings from Contin. Oper.	13.69%	12.47%	122	15.67%	15.36%	31
Tax Rate	24.77%	25.24%	(47)	23.10%	25.00%	(189)

Source: Company reports Note: June fiscal year

4Q earnings review. PG's fiscal 4Q delivered a 2% increase in organic sales compared to a 1% gain in the previous quarter. Organic volume was up 2%, but foreign exchange had a negative 2% impact. Pricing and mix had little effect, yet foreign exchange continued to be a headwind. All-in sales were essentially flat, yet were above the recent street consensus figure. The company's largest segment—Fabric & Home Care—posted a 5% gain in organic sales as volume benefited from recent product innovations. The company's second-biggest segment—Baby, Feminine & Family Care—posted flat organic sales. A notable performance came from the Beauty segment, which saw a 5% gain in organic sales due in part to a strong performance from the skin & personal care and hair care product lines. Grooming (impacted by price cuts in the shaving business) and Health Care (competitive activity and reduced pricing) each posted 1% declines in organic sales.

While net sales essentially matched our expectation, we were pleasantly surprised by the 210 basis point gain in core operating margin (excludes nonrecurring items that are embedded in GAAP-based figures in Exhibit 1). This gain reflected productivity cost savings and a slight net benefit from foreign exchange. The productivity savings came from areas such as overhead, agency fees, and ad production costs. Digital ad spending declined in the period, although some of this reflected a decision to temporarily restrict spending in digital forums where management felt ads were not being placed in accordance with agreed upon specifications.

Exhibit 2
Fiscal 2017 - Segment Sales and Margin Summary (figures in millions except percentages)

Full Year	Sales	% chg.	Pre-tax Earnings	% chg.	Pre-tax Margin	Net Earnings	% chg.	Net Margin
Beauty	$11,429	0%	$2,546	(3%)	22.28%	$1,914	(3%)	16.75%
Grooming	6,642	(3%)	1,985	(1%)	29.89%	1,537	(1%)	23.14%
Health Care	7,513	2%	1,898	5%	25.26%	1,280	2%	17.04%
Fabric & Home Care	20,717	0%	4,249	0%	20.51%	2,713	(2%)	13.10%
Baby, Femin., Family Care	18,252	(1%)	3,868	(4%)	21.19%	2,503	(6%)	13.71%
Corporate	505	20%	(1,289)	N/A	N/A	247	N/A	N/A
Total	$65,058	0%	$13,257	(1%)	20.38%	$10,194	2%	15.67%

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

Source: Company reports Note: June fiscal year

Financial condition. The balance sheet remained solid, in our view. At June 30, 2017, cash and equivalents totaled $5.5 billion. Short-term investments available for sale totaled another $9.5 billion. Total debt (short-term plus long-term) was $31.6 billion, or 36% of total capitalization. Shareholders' equity was $55.7 billion.

For the fiscal year, operating cash flow was approximately $12.8 billion. After $3.4 billion in capital spending, free cash flow was $9.4 billion. During the year, the company paid $7.2 billion in dividends and spent $15.0 billion on share repurchases through traditional buybacks and shares that were exchanged as part of the Beauty Brands transaction with Coty Inc. (see discussion on page 4).

Shareholder of note. In February 2017, activist shareholder Nelson Peltz, through his investment entity Trian Partners, disclosed a 1% ownership stake in PG and soon thereafter began pursuit of a Board seat. PG's annual shareholders meeting is normally held in October. Peltz is believed to be an advocate for more aggressive changes at PG, though we are generally supportive of PG's vast transformation over the past year or so, including management/organizational changes as well as considerable product line divestitures. While we are generally satisfied with PG's actions, we believe the presence of Peltz as an activist shareholder and potential Board member could be a positive factor in delivering value to shareholders.

Dividend increase. 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 continue to find PG's dividend yield, currently 3.1%, a positive investment factor. The recent yield for the S&P Consumer Staples sector was 2.7%, 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 more 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. In addition to reporting 4Q FY 17 results, management provided financial guidance for the FY18 year. Highlights of this outlook include:

- Organic sales are expected to rise by 2%-3%.
- Reported sales are expected to be up 3%.
- Core EPS (including currency impacts but excluding nonrecurring items such as a one-time gain associated with the Coty transaction) are expected to rise 5-7% from $3.92 in FY17. This would represent a range of $4.12-$4.19 in FY18.
- The 1Q period is expected to produce the slowest growth in organic sales and EPS due to recent price reductions taken in the Gillette business (Grooming segment) and a tough year-over-year comparison.

We have updated our financial model. As noted in Exhibit 4, our FY18 outlook includes net sales of $67.0 billion, a 3.0% increase from FY17. We assume gross and operating margin improvement for the year with core EPS at $4.15, which is $0.04 above our previous estimate and up 6% from the FY17 figure. We assume a 2.2% reduction in the weighted average share count due to the dual impact of share retirement resulting from the recent Coty transaction and ongoing repurchases as part of PG's existing buyback authorization.

We believe much of the appeal of PG shares and the company outlook relates to the longer term. 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.

We believe one area needing further corrective measures is market share, which the company has lost in several product areas. Although the competitive environment is tough, in our view, we believe PG can win back some share by further concentration (and spending) on product innovation, performance, packaging, and advertising.

Valuation. PG shares are currently trading at 21.7x our FY18 core EPS estimate of $4.15. The median forward multiple for PG over the past fifteen years is 20.0x. This reflects a generally rising valuation over the past seven 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 1.1x the forward multiple on the S&P 500, equal to the stock's historical premium over the past fifteen years. Similarly, PG's forward multiple is 1.0x 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 essentially 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 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 remains Long-term Buy. We are raising our two year price target by $2 to $106 per share, based on the progression of time bringing a 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 nearly 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.

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	$69,200	3.3%	$67,000	3.0%	$65,058	(0.4%)	$65,299	(7.7%)
Cost of Products Sold	33,700	2.4%	32,900	1.1%	32,535	(1.1%)	32,909	(11.2%)
Gross Profit	35,500	4.1%	34,100	4.8%	32,523	0.4%	32,390	(3.9%)
Venezuela Charge	0		0		0		0	
Selling, Gen., & Admin. Exp.	19,740	2.3%	19,300	3.9%	18,568	(2.0%)	18,949	(8.1%)
Operating Income	15,760	6.5%	14,800	6.1%	13,955	3.8%	13,441	21.6%
Interest Expense, net	375	4.2%	360	22.4%	294	(25.9%)	397	(16.8%)
Other Expense (Income)	(60)	N/A	(50)	N/A	404	N/A	(325)	(26.1%)
Earnings Before Taxes	15,445	6.6%	14,490	9.3%	13,257	(0.8%)	13,369	21.4%
Taxes	3,707	6.6%	3,478	13.5%	3,063	(8.3%)	3,342	22.6%
Net Earnings from Cont. Oper.	11,738	6.6%	11,012	8.0%	10,194	1.7%	10,027	21.0%
Less: Earnings Attributable to Noncontrolling Interests	110	4.8%	105	23.5%	85	(11.5%)	96	(11.1%)
Net Earnings Attrib. to PG	$11,628	6.6%	$10,907	7.9%	$10,109	1.8%	$9,931	21.4%
Diluted EPS:								
As Reported, from Contin. Oper	$4.38		$4.07		$3.69		$3.49	
Restructuring Charges	$0.06		$0.08		$0.10		$0.18	
Venezuela & Misc. Charges	$0.00		$0.00		$0.00		$0.00	
Other	$0.00		$0.00		$0.13		$0.00	
Core EPS	**$4.44**	7.1%	**$4.15**	5.9%	**$3.92**	6.7%	**$3.67**	(2.3%)
Avg. Diluted Shares Outst.	2,653	(1.0%)	2,680	(2.2%)	2,740	(3.7%)	2,844	(1.4%)
As a % of Net Sales:		**bp. chg.**		**bp. chg.**		**bp. chg.**		**bp. chg.**
Gross Profit	51.30%	41	50.90%	90	49.99%	39	49.60%	198
Selling, Gen., & Admin. Exp.	28.53%	(28)	28.81%	27	28.54%	(48)	29.02%	(12)
Operating Income	22.77%	69	22.09%	64	21.45%	87	20.58%	497
Earnings Before Taxes	22.32%	69	21.63%	125	20.38%	(10)	20.47%	491
Net Earnings from Cont. Oper.	16.96%	53	16.44%	77	15.67%	31	15.36%	364
Tax Rate	24.00%	0	24.00%	90	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	65%		67%		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 - $20.54

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

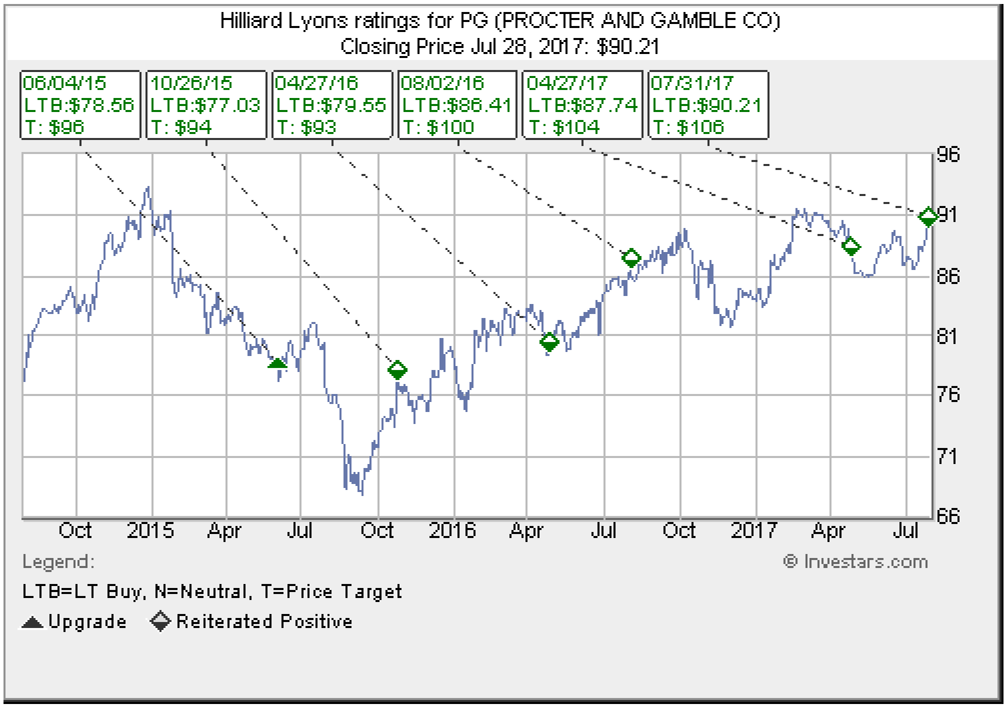
Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

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	36	29%	14%	86%
Hold/Neutral	79	63%	5%	95%
Sell	10	8%	0%	100%

As of 7 July 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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