HILLIARD LYONS

Consumer Staples
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October 23, 2017

COMPANY UPDATE / ESTIMATE CHANGE / PRICE TARGET CHANGE

The Procter & Gamble Co.

PG — NYSE — Long-term Buy-1

Low Growth 1Q About As Expected

Key Metrics

PG - NYSE (as of 10/20/17)		$88.25
Two-Year Price Target		$105.00
52-Week Range		$81.18 - $94.67
Shares Outstanding-Basic (mil.)		2,537
Market Cap. ($ mil.)		$223,890
3-Mo. Average Daily Volume		6,570,000
Institutional Ownership		61%
Total Debt/Total Capital (9/17)		38%
ROE (based on TTM core earnings ended 9/17)		18%
Book Value/Share (9/17)		$21.84
Price/Book Value		4.0x
Annual Dividend & Yield	$2.758	3.1%
EBITDA Margin (TTM ended 9/17)		27%

EPS FY 6/30 (excludes nonrecurring items)

	2017	Prior 2018E	Curr. 2018E		Prior 2019E	Curr. 2019E
1Q	$1.03		$1.09	A		
2Q	$1.08	$1.14	$1.15			
3Q	$0.96	$1.02	$1.02			
4Q	$0.85	$0.92	$0.91			
Year	$3.92	$4.15	$4.17			$4.48
P/E	22.5x		21.2x			19.7x

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)

	2017	Prior 2018E	Curr. 2018E		Prior 2019E	Curr. 2019E
1Q	$16,518		$16,653	A		
2Q	$16,856	$17,300	$17,328			
3Q	$15,605	$16,375	$16,355			
4Q	$16,079	$16,675	$16,689			
Year	$65,058	$67,000	$67,025			$68,950

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

- **Fiscal 1Q results were generally in line with expectations.** Net sales rose 1% to $16.653 billion, about $40 million below street consensus but matching our estimate. Organic sales rose 1% due to higher volume. Challenging factors included decelerating market growth and the impact of recent hurricanes.
- **Stock repurchases helped earnings per share.** Core gross margin (excluding nonrecurring items) decreased 44 basis points due to higher commodity costs and foreign exchange impact. Core operating margin declined 37 basis points. Share repurchases led to a near 5% decline in the weighted average share count. This helped produce a 6% increase in core EPS to $1.09, ahead of our estimate and street consensus of $1.07.
- **FY18 financial guidance remained intact despite commodity cost headwinds stemming from the recent hurricanes in the Gulf Coast region.** Guidance includes expected organic sales growth of 2-3% for the fiscal year, all-in sales growth of 3%, higher operating margin, and a lower share count. This is expected to produce core EPS growth of 5-7%. We have fine-tuned our outlook, which includes 6% EPS growth to $4.17.
- **PG's nominated slate of Directors were recently voted to new terms.** Earlier this month shareholders voted to elect a slate of Directors nominated by the company, with activist shareholder Nelson Peltz barely falling short of the required votes that would have put him on the Board instead of a PG nominee.
- **We rate PG Long-term Buy.** We continue to believe an earnings rebound is underway, slowed by macro and industry factors. We are adjusting our two-year price target by $1 to $105 per share to reflect a slightly lower valuation assumption. This suggests total return potential, including dividends, of about 12% on an annualized basis. Our Suitability rating is 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 1Q Ended		
	9/30/17	**9/30/16**	**% chg.**
Net Sales	$16,653	$16,518	0.8%
Cost of Products Sold	8,129	7,991	1.7%
Gross Profit	8,524	8,527	(0.0%)
Selling, Gen., & Admin. Exp.	4,694	4,667	0.6%
Operating Income	3,830	3,860	(0.8%)
Interest Expense, net	66	96	(31.3%)
Other Expense (Income)	(82)	(63)	30.2%
Earnings Before Taxes	3,846	3,827	0.5%
Taxes	901	879	2.5%
Earnings from Contin. Oper.	2,945	2,948	(0.1%)
Less: Earnings Attrib. to Noncontrol. Int.	17	43	(60.5%)
Net Earnings Attrib. to PG	$2,928	$2,905	0.8%
Core EPS, diluted	**$1.09**	**$1.03**	**5.8%**
Avg. Diluted Shares Outst.	2,691	2,823	(4.7%)
As a % of Net Sales:			**bp. chg.**
Gross Profit	51.19%	51.62%	(44)
Selling, Gen., & Admin. Exp.	28.19%	28.25%	(7)
Operating Income	23.00%	23.37%	(37)
Earnings Before Taxes	23.09%	23.17%	(7)
Earnings from Contin. Oper.	17.68%	17.85%	(16)
Tax Rate	23.43%	22.97%	46

Note: figures are presented on a non-GAAP basis, excluding restructuring expenses

Source: Company reports Note: June fiscal year

1Q segment highlights. PG's 1Q of FY18 delivered a 1% increase in organic sales compared to a 2% gain in the previous quarter; this reflected decelerating market growth for the consumer packaged goods industry. Organic volume was up 1%, as pricing, mix, and foreign exchange had no net impact for the quarter. All-in sales rose just under 1% to $16.653 billion, in line with our estimate but $40 million below street consensus. The company's largest segment—Fabric & Home Care—posted a 2% gain in organic sales as volume benefited from recent product innovations and marketing support. The company's second-biggest segment—Baby, Feminine & Family Care—posted a 1% decline in organic sales due in part to competitive activity in Europe. Noteworthy results also came from the Grooming segment, which saw a 6% decline in organic sales due to past price reductions, mainly on *Gillette* products in the U.S.

Financial condition. The balance sheet is in decent shape, in our view. At September 30, 2017, cash and equivalents totaled $5.024 billion. Short-term investments available for sale totaled another $10.983 billion. Total debt (short-term plus long-term) was $34.214 billion, or 38% of total capitalization. Shareholders' equity was $55.415 billion.

For the quarter, operating cash flow was $3.631 billion. After $1.132 billion in capital spending, free cash flow was $2.499 billion. During the quarter, the company paid $1.823 billion in dividends and spent $2.502 billion on share repurchases.

Exhibit 2
Fiscal 1Q - Segment Sales and Margin Summary (figures in millions except percentages)

1Q FY18	Sales	% chg.	Pre-tax Earnings	% chg.	Pre-tax Margin	Net Earnings	% chg.	Net Margin
Beauty	$3,138	5%	$836	7%	26.64%	$632	7%	20.14%
Grooming	1,577	(5%)	414	(22%)	26.25%	329	(21%)	20.86%
Health Care	1,902	2%	455	(8%)	23.92%	305	(5%)	16.04%
Fabric & Home Care	5,383	2%	1,179	4%	21.90%	769	6%	14.29%
Baby, Femin., Family Care	4,545	(1%)	964	(8%)	21.21%	630	(10%)	13.86%
Corporate	108	2%	(97)	N/A	N/A	205	N/A	N/A
Total	$16,653	1%	$3,751	0%	22.52%	$2,870	0%	17.23%

	Vol. with acquis. & divest.	For. exch. impact	Pricing	Mix	Other	Net sales gr.
Beauty	0%	0%	1%	4%	0%	5%
Grooming	(1%)	1%	-3%	(2%)	0%	(5%)
Health Care	0%	1%	1%	0%	0%	2%
Fabric & Home Care	2%	0%	0%	0%	0%	2%
Baby, Femin., Family Care	(1%)	0%	(1%)	0%	1%	(1%)
Total	1%	0%	0%	0%	0%	1%

Note: Figures are as reported, including restructuring expenses

Source: Company reports Note: June fiscal year

Recent shareholder vote on director slate. 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. In a narrow vote at PG's annual shareholders meeting on October 10, the majority of PG shareholders re-elected the slate of Directors proposed by the company, thereby denying Peltz a coveted Board seat. Peltz/Trian could appeal the close outcome in hopes of re-tabulation. Peltz stated he believes he should be added to PG's Board regardless of the voting outcome.

Trian Fund Management is a New York-based hedge fund and current holder of an estimated 1.5% stake in PG. Peltz, its leader, has a history of Board experience with numerous public companies. Peltz/Trian feels PG could use his acumen in navigating the consumer packaged goods environment more efficiently and more profitably, for the benefit of shareholders. The recent election of Directors does not have an impact on our investment opinion on PG. We respect Peltz and would have been comfortable with his involvement. We consider PG's current Board and management capable of effectively guiding the company through a transformation process that has included significant divestitures and cost cutting.

Given the substantial number of votes in favor of Peltz, perhaps PG management and Board are reminded of some shareholder discontent and will give credence to his suggestions and views as a knowledgeable shareholder, if not a Board member. Finally, we feel one negative aspect of the situation is the estimated $60 million PG spent in its campaign of support for its nominated Directors, this coming at a time when there are numerous potential uses of the company's cash. First and foremost, this includes investments in the business to spur growth. Secondarily, this includes potential acquisitions, debt reduction, share repurchases, and dividend increases.

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 consider PG's dividend yield, currently 3.1%, a positive investment factor. The recent yield for the S&P Consumer Staples sector was 2.8%, while the yield for the S&P 500 was 2.3%.

Earnings outlook. In addition to reporting 1Q FY18 results, management reaffirmed previously issued financial guidance for the fiscal year. Highlights of this outlook include:

- Organic sales are expected to rise by 2%-3%.
- All-in 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.

Results from 1Q are expected to represent the slowest growth in organic sales and EPS of all FY18 quarters due in part to a tough year-over-year comparison in 1Q, the impact on shipping from the recent natural disasters, and a related run-up in commodity costs. Also, the company will soon approach the anniversary of price reductions in the Grooming (*Gillette*) segment. Finally, productivity savings are expected to build as the year progresses.

We have fine-tuned our financial model. As noted in Exhibit 3, our FY18 outlook includes net sales of $67.025 billion, a 3.0% increase from FY17. We assume gross and operating margin improvement for the year with core EPS at $4.17, which is $0.02 above our previous estimate and up 6% from the FY17 figure. We assume a 2.4% reduction in the weighted average share count due to the dual impact of share retirement resulting from the recent transaction with Coty, Inc. (beauty brand divestitures) and ongoing share 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 attention is market share, which the company has lost in several product areas in recent years. Although the competitive environment is tough, in our view, we believe PG can win back some share by further concentration on product innovation, performance, packaging, and marketing. We believe some progress has recently been made on this initiative, with 14 of the company's top 20 brands growing or holding share positions in the recent 1Q.

Valuation. We note current valuations on PG have an upward bias due to current sluggish earnings. PG shares are now trading at 20.9x our estimate of forward earnings. 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 trading at roughly 1.0x the forward multiple on the S&P 500 compared to a historical premium of 1.1x over the past fifteen years. PG's forward multiple currently represents 1.1x that of the S&P Consumer Staples forward multiple, 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. 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 only 14% of PG's recent annual sales and 6% of annual profits.

We 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 is Long-term Buy. We are lowering our two year price target by $1 to $105 per share in a fine tuning measure based on a slightly lower valuation assumption. Specifically, we assume a price/earnings multiple of 21.0x on expected forward earnings two years from now. This is similar to the multiple on our estimate of forward earnings today and slightly 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 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	$68,950	2.9%	$67,025	3.0%	$65,058	(0.4%)	$65,299	(7.7%)
Cost of Products Sold	33,920	2.0%	33,240	2.2%	32,535	(1.1%)	32,909	(11.2%)
Gross Profit	35,030	3.7%	33,785	3.9%	32,523	0.4%	32,390	(3.9%)
Venezuela Charge	0		0		0		0	
Selling, Gen., & Admin. Exp.	19,500	2.4%	19,050	2.6%	18,568	(2.0%)	18,949	(8.1%)
Operating Income	15,530	5.4%	14,735	5.6%	13,955	3.8%	13,441	21.6%
Interest Expense, net	325	(7.1%)	350	19.0%	294	(25.9%)	397	(16.8%)
Other Expense (Income)	(110)	(12.0%)	(125)	N/A	404	N/A	(325)	(26.1%)
Earnings Before Taxes	15,315	5.5%	14,510	9.5%	13,257	(0.8%)	13,369	21.4%
Taxes	3,676	5.5%	3,482	13.7%	3,063	(8.3%)	3,342	22.6%
Net Earnings from Cont. Oper.	11,639	5.5%	11,028	8.2%	10,194	1.7%	10,027	21.0%
Less: Earnings Attributable to Noncontrolling Interests	95	5.6%	90	5.9%	85	(11.5%)	96	(11.1%)
Net Earnings Attrib. to PG	$11,544	5.5%	$10,938	8.2%	$10,109	1.8%	$9,931	21.4%
Diluted EPS:								
As Reported, from Contin. Oper	$4.41		$4.09		$3.69		$3.49	
Restructuring Charges	$0.07		$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	**$4.48**	7.4%	**$4.17**	6.4%	**$3.92**	6.7%	**$3.67**	(2.3%)
Avg. Diluted Shares Outst.	2,620	(2.1%)	2,675	(2.4%)	2,740	(3.7%)	2,844	(1.4%)
As a % of Net Sales:		**bp. chg.**		**bp. chg.**		**bp. chg.**		**bp. chg.**
Gross Profit	50.80%	40	50.41%	42	49.99%	39	49.60%	198
Selling, Gen., & Admin. Exp.	28.28%	(14)	28.42%	(12)	28.54%	(48)	29.02%	(12)
Operating Income	22.52%	54	21.98%	53	21.45%	87	20.58%	497
Earnings Before Taxes	22.21%	56	21.65%	127	20.38%	(10)	20.47%	491
Net Earnings from Cont. Oper.	16.88%	43	16.45%	78	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 - $15.85

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

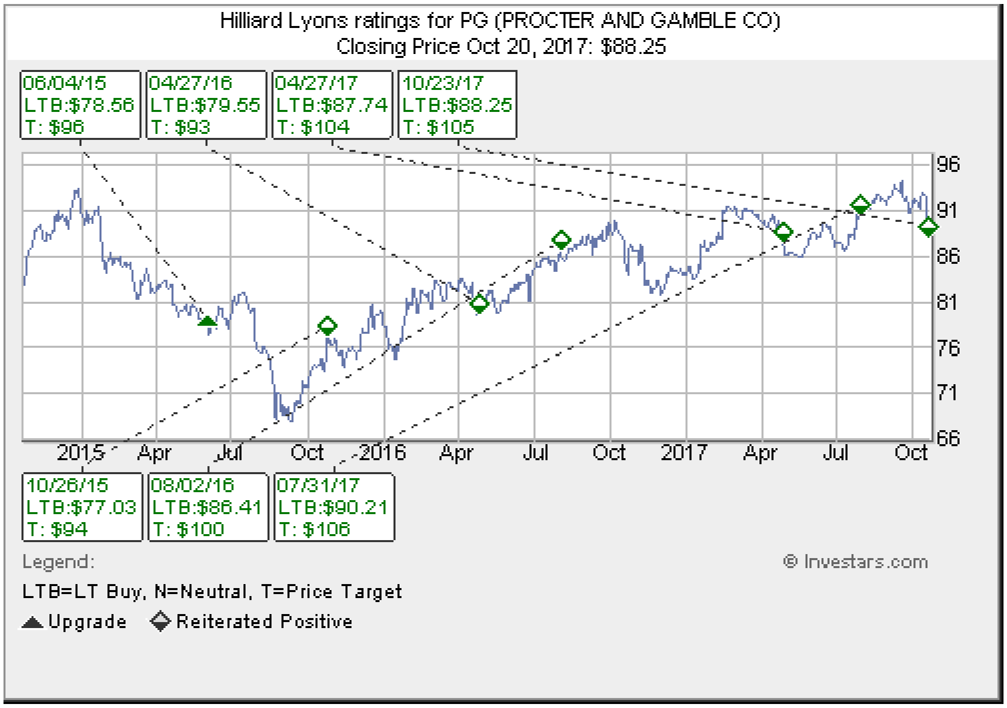
Hilliard Lyons' analysts receive bonus compensation based on Hilliard Lyons' profitability. They do not receive direct payments from investment banking activity.

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	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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