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January 24, 2019
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Procter and Gamble (PG) EQ Update- 12/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	3-

*For an explanation of the *EQ Review Rating* scale, please refer to the end of this report

We are maintaining our earnings quality rating of 3+ (Minor Concern).

PG reported adjusted EPS of $1.25, 4 cps ahead of the consensus estimate. While the company raised the high-end of its fiscal 2019 organic revenue growth forecasted range from 2-3% to 2-4%, it left its EPS growth range intact.

While we consider PG's earnings quality to be reasonable, we are keeping our rating in the "Minor Concern" category due to some material benefits to growth that could reverse in upcoming quarters as well as the fact that free cash flow does not cover the buyback.

- **Results continue to benefit from lower advertising spending.** The 10-Q indicates that advertising and marketing fell 130 bps as a percentage of sales. In addition, $82 million in advertising spending in the year-ago quarter was recorded in SG&A expense whereas those amounts are now recorded as a reduction of sales. This indicates that about 50 bps of the reduction in the marketing spending percentage was a result of this accounting change. However, this leaves behind an 80 bps reduction (130 bps-50 bps) in advertising spend as a percentage of sales. Management noted in the call:

  "And if I look, for example at our marketing spending as a percentage of sales, because of all the productivity initiatives that I described earlier, that number -- while we have a stronger marketing program than we've ever had with higher reach that we're investing in as we reduce access to frequency, reduce agency and

production costs, et cetera, so very strong advertising program, it's not costing us more per, if you will, dollar of revenue gained."

We are all for efficiency, but elsewhere management highlights the competitive nature of the industry and the possibility it will have to increase prices to offset rising costs and negative FX. We remain concerned that higher advertising and marketing spending could be a source of disappointment. Also, note that the substantial benefit to headline operating margin percentage from the accounting change will be gone in two quarters.

- **A lower effective tax rate was a material tailwind**. Management has been guiding to a fiscal 2019 effective tax rate of 19-20%. Therefore, we think the reported 17.8% effective rate in the quarter could have added around 2 cps to adjusted earnings versus analysts' models.

- **Tighter working capital continues to boost cash flow as days payable jumped by 3 days over last year.** However, the increase in days payable is slowing. PG has done a remarkable job of minimizing working capital as receivables and inventories have been trending near industry-low levels for some time. However, with payables now well north of 100 days and the growth slowing, this key source of cash flow growth is fizzling out.

- **As we have noted before, PG's free cash flow does not cover the dividend and the buyback. However, the roughly 2% reduction in share count regularly provides a meaningful portion of the EPS growth**. With net debt at about 1.7 times EBITDA and the dividend consuming about 65% of free cash flow, the safety of the dividend is not in question- but the longer-term growth rate certainly is.

- **We do note that earnings growth was penalized by a little more than 2 cps from lower gains from minor asset sales in the year-ago period which were not adjusted out of non-GAAP EPS.** This could be viewed as offsetting the benefit from the lower tax rate in assessing the quality of the earnings beat.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recent reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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