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Procter & Gamble (PG) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4+	3+

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are raising our earnings quality rating to 4+ (Acceptable) from 3+ (Minor Concern)

PG reported strong organic growth across all segments and a solid earnings beat of 21 cps. Most notably, the quarter contained no non-GAAP adjustments and minimal restructuring charges for the first time in recent memory, prompting us to raise our earnings quality rating.

Items that Deteriorated

- Accounts payable days of sales rose YOY by almost 5 days continuing the ongoing trend as the company admitted to extending payment terms on suppliers. However, payable days fell sequentially and the growth appears to be peaking. Stretching payables has been a key part of cash flow growth and the lower sequential decline in payables accounted for about $170 million of the $570 million growth in operating cash flow in the quarter.
  (Concern level: MEDIUM)

- Depreciation and amortization declined YOY adding about 1.6 cps to earnings growth. We assume this is likely due to assets becoming fully depreciated but remaining in service. We assign this a low level of concern as the benefit paled in comparison to the quarterly beat, but note that the tailwind could reverse in upcoming quarters as capital spending rises again.
(Concern level: LOW)

Items that Improved

- PG did not post any non-GAAP adjustments for incremental restructuring charges for the first time in recent memories. The ongoing nature and size of these charges has eroded the quality of non-GAAP earnings, in our opinion. The 2017 program is complete on schedule, but the skeptical side of us is expecting another large program to be announced in the next couple of quarters.

Payable Days Remain Elevated but Have Stabilized

(Concern Level- Medium)

Like many consumer products companies we follow, PG has milked cash from accounts payable by stretching payment terms on suppliers. The 9/20 quarter saw days payable rise YOY by almost 5 days to 120 although the figure declined sequentially indicating a levelling off in growth.

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Trade Accounts Payable	$11,935	$12,071	$10,464	$10,781
Cost of Products Sold	$9,142	$8,942	$8,716	$8,869
Days Payable	120.1	122.8	109.3	111.8

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Trade Accounts Payable	$10,951	$11,260	$10,207	$10,266
Cost of Products Sold	$8,723	$8,938	$8,427	$8,919
Days Payable	115.5	114.6	109.0	105.9

Management admitted in the 10-Q that cash flow benefitted to a degree from extended payment terms which we consider a very low-quality source of cash flow growth. We note that the smaller sequential decline in accounts payable in the 9/20 quarter versus the comparable year-ago periods accounted for about $170 million of the $570 million growth in cash from operations in the quarter.

Depreciation and Amortization Declining

(Concern level- LOW)

PG's depreciation and amortization declined despite net PPE and amortizable intangibles remaining essentially flat:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Depreciation & Amortization	$671	$814	$799	$677
Net PPE	$20,876	$20,692	$20,459	$21,250
Intangibles	$23,814	$23,792	$23,834	$23,980

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Depreciation & Amortization	$723	$820	$711	$650
Net PPE	$20,901	$21,271	$20,993	$20,822
Intangibles	$24,002	$24,215	$25,836	$25,947

While the company does not disclose depreciation expense, we know that amortization of intangible assets fell by about $10 million YOY, meaning the bulk of the decline in D&A came from depreciation. We saw no change in estimated depreciable lives in the 10-K and suspect the decline, which started in the 6/20 quarter, is traceable to certain assets becoming fully depreciated but remaining in service and thus not being removed from the net PPE figure. The YOY decline in the 9/20 quarter added about 1.6 cps to EPS growth which pales next to the earnings beat in the quarter, so we attach a low level of concern to the matter. However, PG has cut capital spending plans in the COVID environment which will likely reverse soon. Therefore, this mild tailwind could reverse at some point in the next few quarters as the company reaccelerates capital spending.

No Incremental Restructuring Charges

We were pleasantly surprised to see that the company did not make any non-GAAP adjustments to its reported earnings in the quarter other than for currency adjustments. PG has always been one of the worst offenders for taking never-ending restructuring charges and this is the first quarter in recent memory that GAAP earnings were not adjusted upwards by adding back "incremental" restructuring charges.

PG has a unique way of addressing its restructuring actions. It states in its SEC filings that:

> *"The Company has historically incurred an ongoing annual level of restructuring-type activities to maintain a competitive cost structure, including manufacturing and workforce optimization. Before-tax costs incurred under the ongoing program have generally ranged from $250 to $500 annually."*

While it does not add back these "regular restructuring charges" to non-GAAP results. However, it does call them out in the MD&A and often mentions their impact on margin progressions. Our question has always been "if they are a regular part of business, why are they being called out at all?"

However, in addition to the ongoing charges, the company also conducts specific restructuring actions. The latest plan was announced in 2017. PG classified costs that were deemed to be a part of this restructuring action to be "incremental" and these amounts were added back to profits as a non-GAAP adjustment. The large size of these regular amounts coupled with the subjectivity of the process has, in our opinion, materially reduced the quality of the non-GAAP figures.

For perspective, the following table shows the components of restructuring charges as a percentage of non-GAAP earnings before taxes. These charges have been large relative to adjusted earnings with the percentage mix of ongoing versus incremental swinging wildly.

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Adjusted Net Income Attributable to PG	$4,277	$3,026	$3,058	$3,735
"Ongoing" Charges	$22	$136	$81	$88
Incremental Charges	$0	$226	$141	$17
Total Charges	$22	$362	$222	$105
Total Charges % of Adjusted Net Income	0.5%	12.0%	7.3%	2.8%

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Adjusted Net Income Attributable to PG	$3,623	$2,901	$2,789	$3,272

"Ongoing" Charges	$62	$160	$72	$100
Incremental Charges	$31	$164	$44	$77
Total Charges	$93	$324	$116	$177
Total Charges % of Adjusted Net Income	2.6%	11.2%	4.2%	5.4%

PG has been promising that the 2017 plan would be done at the end of 2020 and it appears this timeline has been met. This is the main factor in us raising our earnings quality rating. However, being the skeptics that we are, we are fully expecting the announcement of a new multi-year $100 million+ plan to be announced in the next couple of quarters.

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 recently 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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