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BTN Research

October 25, 2018 www.btnresearch.com

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Procter & Gamble (PG) EQ Review Update-9/18 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 lowering our rating of Procter & Gamble (PG) to 3- (Minor Concern).

PG's adjusted EPS of $1.12 topped the consensus estimate by 3 cps in the 9/18 quarter. However, while our view of overall earnings quality has not deteriorated enough to warrant a 2 "Weak" rating, conditions did deteriorate, prompting us to lower our rating to 3- (Minor Concern) from 3+.

- Accounts payable days (DSP) jumped almost 6 days from the year-ago quarter to over 110 days as management continues to cite extending payment terms with suppliers. The current DSP represents a historical high and is near the top end of the group. We are skeptical of how much further this can be pushed to boost cash flow.

- An increase in the number of anti-dilutive shares and out of the money options from the diluted share base added 3 cps to diluted EPS in the quarter. This amount equals the reported earnings beat in the period.

- FX translation turned against the company in the 9/18 quarter, shaving 3% off sales growth and $0.10 per share off EPS. Further deterioration is not accounted for in guidance and the company was open in cautioning that price increases to offset FX and commodity pressures will not be felt until later in the 12/18 quarter.

- Advertising as a percentage of sales fell by 100 bps in the quarter. We estimate about half came from the impact of an accounting change with the rest due to leverage and savings. Given the company's push to combat rising costs with price increase, we are skeptical margins can continue to benefit in the advertising area.

Payables Resumed Their Rise

We noted earlier in the year that PG's accounts payables were rapidly outgrowing cost of sales, leading to a rise in days payables (DSPs) and a corresponding benefit to cash flow growth. While this trend moderated in the 6/18 quarter, it began again in the 9/18 quarter as DSPs jumped to over 110 days from 104.4 in the year-ago period and 105 in the previous quarter:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$8,484	$8,989	$8,343	$8,667
Accounts payable	$10,243	$10,344	$9,716	$9,740
Accounts payable DSPs	110.2	105.0	106.3	102.5

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$8,269	$8,299	$7,836	$8,298
Accounts payable	$9,458	$9,632	$8,076	$8,300
Accounts payable DSPs	104.4	105.9	94.0	91.3

The company cited extended payment terms with suppliers as a reason for the increase in payables in the liquidity section of its 10-Q filing. We are somewhat surprised by the sudden resurgence of payables growth given that management warned in the 10-K filing for the year ended 6/18 that it anticipated the "cash flow benefits from the extended payment terms could decline slightly over the next fiscal year." The 110 days registered in the 9/18 quarter represents a distinct recent historical high and we do not expect such a benefit to continue.

Exclusion of Anti-Dilutive Shares

Like all companies, PG excludes shares related to out of the money options or shares that are anti-dilutive (total proceeds upon exercise would have exceeded the market value of the underlying common shares.) The impact of the exclusion of anti-dilutive shares is seldom material to diluted EPS, but we note that it was material for PG in the 9/18 quarter. The following table shows reported diluted shares adjusted for excluded shares and the associated impact on diluted EPS:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Diluted shares	2,612.1	2,529.3	2,645.6	2,669.6
Shares Excluded	69.0	NA	54.0	24.0
Adjusted Share Count	2,681.1	2,529.3	2,699.6	2,693.6
Adjusted Net Income	$2,915	NA	$2,649	$3,174
Reported Diluted EPS	$1.12	NA	$1.00	$1.19
Diluted EPS on Adjusted Share Count	$1.09	NA	$0.98	$1.18

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Diluted shares	2,690.6	2,741.7	2,705.5	2,737.6
Shares Excluded	20.0	NA	7.0	27.0
Adjusted Share Count	2,710.6	2,741.7	2,712.5	2,764.6
Adjusted Net Income	$2,928	NA	$2,592	$2,956
Reported Diluted EPS	$1.09	NA	$0.96	$1.08
Diluted EPS on Adjusted Share Count	$1.08	NA	$0.96	$1.07

We can see that the increase in shares excluded from the diluted share count beginning in the 3/18 quarter which is likely the result the rapid share price decline at the beginning of the year. (Note that PG does not disclose share excluded from the fourth fiscal quarter periods.) Had it not been for the increase in the number of excluded shares, diluted EPS would have been 3 cps lower in the 9/18 quarter. We are skeptical that analysts' models are detailed enough to anticipate this impact which casts a shadow on the 3 cps EPS beat in the quarter.

FX Impacts

PG, like many companies, is seeing a growing negative impact from foreign currency translation. FX rates shaved 3% off of sales growth in the period, completely erasing the benefit of the 3% growth in volumes. Management quantified the bottom line impact of foreign exchange as a negative $0.10 per share and stated:

> *"In less than the three months since our last earnings release, the foreign exchange headwind on earnings increased by $400 million after tax, $900 million in total for the fiscal year. The Turkish lira devalued 25%, the Argentine peso more than 40%, the Indian rupee nearly 10%."*

Management noted in the conference call that current guidance does not take into consideration further deterioration of the FX position and also cautioned that price increases put in place to combat both FX and rising commodity costs will not take effect until later in the 12/18 quarter.

Cuts to Marketing

We note that the company cited lower advertising and promotion spending as a percentage of sales being a benefit to margins in the quarter.

> *"Marketing spending as a percentage of net sales decreased 100 basis points due to the positive scale impacts of the organic net sales increase, savings in agency compensation, production costs and advertising spending, and the impact of adopting the new standard on "Revenue from Contracts with Customers" which prospectively reclassified certain customer spending from marketing (SG&A) expense to a reduction of net sales."*

Note that if the new revenue standard had been in effect in the 9/17 quarter, it would have resulted in $77 million of advertising and promotional expense being reclassified as a reduction of sales. This represented about 45 basis points of revenue in the year-ago period, so we estimate about half of the 100-bps decline could have come from the change in accounting treatment. While advertising leverage is possible, the fact that the company is simultaneously trying to push through price increases to cover rising raw materials costs may require an increase in overall promotional and advertising expense, so we are hesitant to expect much more in the way to margin benefits from this area.

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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