BEHIND THE NUMBERS
Quality of Earnings Analysis
April 23, 2021

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

The Procter & Gamble Company (PG)
Earnings Quality Update- 3/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating on PG of 4+ (Acceptable).

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

Summary

PG reported non-GAAP EPS of $1.26 which was 7 cps ahead of consensus. We saw some minor one-time benefits, but the beat remains intact after adjustment.

- Other income jumped by $81 million from an unrealized gain on an equity investment that became publicly traded during the quarter. This added about 2.5 cps to earnings in the period and was not adjusted out of non-GAAP earnings.

- Accounts payable days jumped to 122 in the 3/21 period from 109 in the year-ago quarter. The company said about half that was due to extending payment terms on suppliers. Just glancing at the balance sheet, accounts payable was a $63 million cash source in the 9 months ended 3/21 compared to a $796 million use of cash in the comparable year-ago period.

- Inventory DSI jumped to 60.5 in the 3/21 quarter from 55.6 in the 3/20 quarter. Inventories were lower last year from pandemic demand but comparing this year to the 3/19 quarter's level of 57.2, inventories still look a little bit high. The company said this was a result of increasing safety stock levels during the pandemic as well as commodity cost increases.

The company utilizes the FIFO method of inventory valuation and it is raising prices so we expect the higher future COGS should be offset by higher prices.

- This is the third straight quarter where PG did not add back “incremental restructuring charges” to non-GAAP earnings. As a reminder, PG always spends roughly $500 million a year in restructuring efforts, but it only adds back charges that it considers incremental to its ongoing restructuring costs. In the 3/21 quarter, the company spent $134 million on restructuring efforts with none added back to non-GAAP EPS. In the 3/20 quarter, the company incurred $222 million in charges and added $141 million back. Looking back, there have been several quarters where PG incurred a lower level of total charges than it did in the 3/21 quarter but added material amounts back to non-GAAP results. This seemingly arbitrary adding back of expenses was the basis of our past criticism. We view the lack of restructuring add-backs as a positive to earnings quality, but analysts must review the level of charges every quarter to quantify the impact of any material YOY changes in restructuring spending.

- Free cash flow does not cover the buyback and dividend with sales of investment securities and stock option exercises covering the gap. The investment securities balance is now 0 and stock option exercise is hardly a reliable source of financing. Debt is low and the company has cash on hand to help, so the buyback is not in immediate danger of being trimmed. However, we do not see this as a sustainable capital allocation strategy, and this is the main factor keeping us from upgrading the company to a 5 (Strong).

- Over 55% of assets are comprised of goodwill and intangibles ($64 billion.) The Appliances reporting unit has a fair value well above carrying value, and the Shave Care unit’s fair value exceeds its carrying value by more than 20%. However, the fair value of the Gillette intangibles ($14 billion) only “approximated” carrying value as of the 12/20 review. PG disclosed that a 25 bps decline in expected growth rate or a 25 bps increase in the discount rate would reduce the carrying value of the Gillette intangibles by 6%, or $840 million. Remember that the Shave Care unit already took an $8.3 billion write-down in the 6/19 quarter.

Supporting Detail

Buyback Is Funded by Stock Options and Sales of Securities

With the restructuring add backs gone (for now), the one item that keeps us from rating PG a 5 (Strong) is the fact that the company's buyback is not covered by cash flow after the dividend. The following table shows cash flow data for the last three fiscal years ended June:

	FY 2020	FY 2019	FY 2018
Operating Cash Flow	$17,403	$15,242	$14,687
Capex	$3,073	$3,347	$3,717
Free Cash Flow	$14,330	$11,895	$10,970
Dividend	$7,789	$7,498	$7,310
Buyback	$7,405	$5,003	$7,004
Cash Flow After Buyback	-$864	-$606	-$3,344
Sales of investment securities	$6,151	$3,628	$3,928
Impact of Stock Options and Other	$1,978	$3,324	$1,177
Cash and Equivalents	$16,181	$4,239	$2,569
Available for Sale investment Securities	$0	$6,048	$9,281

We can see that free cash flow more than covers the company's flagship dividend but regularly fails to cover the buyback as well. Keep in mind that this analysis does not take into consideration acquisitions that have totaled more than $4 billion in the periods examined. Despite this, PG's debt has not constantly risen as we see with some buyback-dependent companies. This is due to a combination of sales of investment securities and cash from the exercise of stock options. As we can see at the bottom of the table, the investment securities balance has fallen to 0, and given the volatile nature of stock option exercises, we do not view that as a high-quality source of financing to be relied upon.

PG still has cash on hand and net debt/EBITDA is still below 1x, so the buyback is not in immediate jeopardy by any means. However, this is not a sustainable capital allocation strategy.

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 Concern)- 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 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 upcoming quarters. 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.

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.