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Procter & Gamble (PG) EQ Review-6/19 Qtr.

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 raising our earnings quality rating to 3+ (Minor Concern).

PG's adjusted EPS of $1.10 beat the consensus target for its fourth fiscal quarter by 5 cps. The company also topped consensus top-line estimates. We saw little in the way of artificial benefits to earnings in the quarter, but view the almost $9 billion Shave Care writedown as an obvious negative. In addition, we consider the ongoing restructuring charges and the unfunded buyback to be long-term detriments to the quality of reported earnings.

- PG recorded an impairment charge of $6.8 billion to write down goodwill related to its Shave Care unit. After the charge, the carrying value of the remaining goodwill was $12.6 billion. As a result of the methodology used in the impairment test, the estimated fair value of the remaining goodwill is 20% above its carrying value. In addition, the company incurred impairment charges of $1.6 billion related to its Gillette indefinite-lived intangible asset which had a $14.1 billion remaining amount on the balance sheet. Shave Care accounts for about 8% of total company revenue. The writedown is a reflection on the price the company paid for Gillette back in 2005.

- As we have noted many times before, restructuring charges are a constant fixture in PG's results. The company has a somewhat unique procedure of adding back to adjusted earnings only the amount of restructuring charges it deems to be "incremental" to "normal" restructuring spending. We monitor the patterns of the company's labeling of its restructuring charges for unusual activity such as an unusual decline in the amount of total restructuring charges left in "core" earnings. We have seen no signs of manipulation in recent periods. Nevertheless, the sizeable amounts of "incremental charges" being excluded from adjusted earnings every quarter for years calls into question the quality of the adjusted earnings. The current program is set to run through 2020 and we will frankly be surprised if a new program is not announced before the current one is complete.

- Cash flow from operations for the fiscal year ended 6/19 increased by 2.5%. Inventory days jumped by approximately 3 over the year-ago quarter to support new products and we are not especially concerned with the jump. Receivables days also increased slightly. Both items were an increased use of cash during the year, but this was more than offset by an 11-day YOY jump in accounts payables days due to the company stretching payment terms on suppliers. With payables at an astounding 115 days, we don't see how the company can squeeze much cash flow out of its suppliers. We also note that capex declined by $370 million, falling to 4.9% of sales from 5.6% a year ago and providing a huge tailwind to reported free cash flow growth and the free cash flow conversion ratio. Despite this boost, free cash flow still does not cover both the dividend and the buyback.

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.

Disclosure

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