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Procter & Gamble (PG) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
3+	NA

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

We initiate coverage of Procter and Gamble (PG) with a 3+ (Minor Concern)

Our previous reviews of PG included discussion of the challenges the company has faced from competition, pricing pressure and rising raw materials costs. All of these factors remain in play, but our EQ Review Rating incorporates only our view of the quality and sustainability of earnings and cash flows.

- We previously cited a three-day jump in accounts receivable days of sales (DSO) in the 3/18 quarter as being an item of concern. DSOs fell back in line in the 6/18 quarter coming in essentially flat with the year-ago quarter and down 3 days from the 3/18 quarter. We are therefore no longer concerned about receivables balances and note that PG has the lowest DSOs of any of the consumer or household goods companies.

- We also cited in the 3/18 quarter that the company has been stretching payment terms on its suppliers. This appears to have leveled off in the 6/18 quarter as payables days of cost of sales (DSPs) fell over 1 day from the year-ago quarter and almost 2 days sequentially. While we view it as a positive sign, management admits that this source of cash flow growth could dissipate in upcoming quarters.

- We expressed concern in previous reviews about the fact that PG's cash flow cannot cover its dividend and its aggressive buyback. While its net debt/EBITDA of under

1.6 gives it some room to run, longer-term this remains a problem as lower share count has been providing most of the reported growth in adjusted EPS.

Growth in Payables Has Levelled Off, Taking Away Key Tailwind

We have noted in previous reviews that accounts payable days of cost of sales (DSPs) have been rising as the company has been stretching its payment terms with suppliers. However, this trend appears to have reversed in the 6/18 quarter, as shown in the following table:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Accounts Payable DSPs	104.5	106.3	102.5	104.9
	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Accounts Payable DSPs	105.9	94.0	91.3	101.6

This was the first such decline in several quarters, and management addressed this issue in the 10-K:

> *"Accounts payable, accrued and other liabilities increased, generating $1.4 billion of cash.* ***This was primarily driven by extended payment terms with our suppliers*** *and an increase in fourth quarter marketing activity versus the prior year. These factors, along with offsetting impacts of foreign exchange, drove a 2-day increase in days payable outstanding.* ***Although difficult to project due to market and other dynamics, we anticipate incremental cash flow benefits from the extended payment terms with suppliers could decline slightly over the next fiscal year."***

We see no reason for a sharp reversal of payables terms in the upcoming year, it appears that a key source of cash flow growth is fading.

Dividend and Buyback Outlook

We have noted our overall concern with the fact that PG's cash flow is not sufficient to cover the buyback and the dividend. For the fiscal year ended 6/18, operating cash flow of $14.9 billion, cap-ex of $3.7 billion, cash dividends of $7.3 billion and $7 billion in share repurchases left a $3.2 billion cash shortfall.

	FY 2018
T12 Operating Cash Flow	$14,867
T12 Capex	$3,717
T12 Free Cash Flow	$11,150
T12 Dividends	$7,310
Dividend % of FCF	66%
T12 Stock Repurchases	$7,004
Cash After Buyback	-$3,164

Management's mid-point EPS guidance of $4.45 per share implies net income of approximately $11.7 billion. In its outlook, the company also stated that is expects free cash flow productivity of at least 90% which implies free cash flow could be as low as $10.5 million, or over $600 million below FY 2018's level. The company also expects to pay "over $7 billion in dividend and repurchases and up to $5 billion in stock in fiscal 2019." This implies another shortfall of more than $1.5 billion. In addition, the pending $4 billion acquisition of Merck's OTC business will likely add to the company's debt load.

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.

Disclosure

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