BTN Earnings Quality Review

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Procter and Gamble (PG)

Procter and Gamble (PG) reported earnings on Tuesday (1/23) of $1.19 after adjustment for acquisitions, divestitures and one-time items. This was almost 5% above consensus expectations. Nevertheless, the stock has been down over concerns that the company is still unable to realize any real pricing power and remains unable to offset increasing raw materials inflation. Despite 150 basis points of productivity improvements, rising costs and lower pricing still resulted in a currency-neutral core operating profit decline of 30 basis points. These pressures are well documented as name brand consumer packaged goods producers are all continuing to struggle with a cautious consumer and the ever more competitive consumer retail environment. This note does not attempt to weigh in on the near-to-medium term outlook for these factors, but suffice it to say that none of these company managements appear to be expecting a dramatic turnaround in the current environment in 2018.

Nevertheless, we do note some other items of concern in recent results:

Accounts payable growth is boosting cash flow

As noted above, slow growth and cost pressures have conspired to keep a lid on PG's cash flow growth in the last few years:

	12/31/2017	12/31/2016	12/31/2015
T12 Operating Cash Flow	$14,043	$13,442	$15,558
T12 Capex	$3,855	$3,520	$3,317
T12 Free Cash Flow	$10,188	$9,922	$12,241
T12 Div % of T12 FCF	**71.0%**	**74.0%**	**60.5%**

However, cash flow has been getting a boost from the company lengthening the time it takes to pay its suppliers. The following table shows accounts payable and the calculation of accounts payable days of sales:

Quarter ended:	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Sales	$17,395	$16,653	$16,079	$15,605	$16,856	$16,518
Accounts payable	$9,740	$9,458	$9,632	$8,076	$8,300	$9,024
Sales YOY growth	3.2%	0.8%	-0.1%	-1.0%	-0.3%	-0.1%
Accounts payable YOY growth	17.3%	4.8%	3.3%	3.6%	7.6%	16.3%
Sales Seq growth	4.5%	3.6%	3.0%	-7.4%	2.0%	2.6%
Accounts payable Seq growth	3.0%	-1.8%	19.3%	-2.7%	-8.0%	-3.2%
Accounts payable DSPs	**51.1**	**51.8**	**54.7**	**47.2**	**44.9**	**49.9**

The company stated in its 10-Q filing for the quarter that the increase in payables was "primarily driven by extended payments term with our suppliers…" Accounts receivable and inventories both increased during the period. Accounts receivable DSOs jumped by almost two days over the year-ago quarter, which the company blamed on the quarter ending on a weekend, resulting in lower collections. We are not overly alarmed by the increase in receivables but will monitor it going forward. Likewise, inventory DSIs jumped by 2 days, which we will discuss more in the next section. However, the increase in payables more than offset these two drains on cash flow. The following table shows the components of the company's cash flow conversion cycle, or number of days its takes the company to convert a dollar of sales into a dollar of profits:

Quarter ended:	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
DSO	27.2	27.1	26.1	25.5	25.6	26.0
DSI	54.0	55.7	50.8	55.4	52.6	56.3
DSP	51.1	51.8	54.7	47.2	44.9	49.9
Days to convert	30.1	31.0	22.3	33.6	33.3	32.5

Days to convert fell from 33.3 to 30.1, yet it would have increased if not for the payables increase. This trend has been going on for some time. The following table shows the conversion cycle by year for the last five fiscal years.

Fiscal year ended:	**6/30/2017**	**6/30/2016**	**6/30/2015**	**6/30/2014**	**6/30/2013**
DSO	25.8	24.4	25.1	29.0	28.8
DSI	51.9	52.3	53.7	60.2	60.9
DSP	54.0	52.1	42.6	38.4	38.8
Days to convert	23.6	24.6	36.2	50.7	50.9

While all the working capital ratios have shown good long-term improvement, days payable has been the biggest contributor to improvement in the cash collection cycle. Also, this longer-term perspective shows that days payable stands at a definite historical low, calling into question how much more the company can lean on its suppliers to boost cash flow growth.

Inventories jumped in the quarter

As mentioned above, inventory DSI's jumped by 2.6 days over the year-ago quarter. The company attributed the increase to increased sales and new product initiatives. However, we think it is worth pointing out that most of the increase in DSIs came from an increase in finished goods, as seen in the following table which breaks out the increase in DSIs by inventory components:

Quarter ended:	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Materials and supplies days	15.5	14.9	14.4	15.4	15.4	15.5
In-Progress days	6.1	6.5	5.8	5.9	5.7	6.2
Finished Goods days	32.5	34.3	30.6	34.1	31.5	34.6
DSIs	54.0	55.7	50.8	55.4	52.6	56.3

It is possible that the increase in finished goods could be related to the company building up a supply of new products to be launched at the opening of the March quarter, so our concern level is not especially high. However, so much of the increase being centered in finished goods is always a concern, and we will be looking for a moderation of inventory levels in the March results.

Ongoing restructuring charges

Recurring restructuring charges are always an item of concern as they introduce the possibility that management is labeling expenses that should be considered operational as being "one-time," and then presenting an earnings figure with these charges adjusted out. This encourages investors to completely forget about them as if the expense never happened. In our mind, the larger and more frequent the charges, the more likely it is such manipulation is occurring.

PG has been undergoing restructuring activities for years. So much so, that even management began to cast some of these expenses as being "regular." Consider the following disclosure from PG's most recent 10-Q:

> "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 (million) annually."

The company presents adjusted earnings data with "incremental charges" added back in. These incremental amounts are deemed to be over and above the previously-referenced recurring charges. The incremental amounts have ranged from $400 million to over $620 million in the last three years alone. Investors must trust the company's judgement as to whether a restructuring expense is classified as ongoing, and therefore charged against current earnings, or incremental and added back in for analytical and valuation purposes. Considering that the $250 million to $500 million recurring charge range amounts to roughly 30-70 basis points as a percentage of sales, the potential definitely exists for adjusted results to be significantly impacted.

With this in mind, we think it is interesting to examine the company's earnings and revenue performance versus consensus, as shown in the following table:

	Adjusted EPS vs Consensus	Reported revenue vs. consensus
12/17	4.5%	0.0%
9/17	1.2%	**-0.2%**
6/17	8.7%	0.5%
3/17	2.1%	**-0.8%**
12/16	1.7%	0.2%
9/16	5.2%	0.2%
6/16	6.0%	1.7%
3/16	5.3%	**-0.3%**
12/15	5.8%	**-0.3%**
9/15	3.6%	**-2.9%**
6/15	5.7%	**-0.8%**
3/15	**-0.2%**	**-1.5%**

Note that in the last three years, PG has missed consensus revenue seven out of 12 quarters, yet it has missed earnings targets only once in the same time period. While this is not conclusive in itself, it certainly gives the impression that management has a greater degree of flexibility in what it reports as earnings versus sales. Restructuring charges have been 3-5% of adjusted net income during that period. While we are not alleging that all of the charges represent operational amounts, it does not take much in the way of executive pay being allocated to restructuring activities or asset writedowns leading to lower depreciation in order for these amounts to account for a material portion of the observed profit beats.

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