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BTN Earnings Quality Review

April 19, 2018

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# EQ Review- Procter and Gamble (PG)- 3/18/18 Quarter

Procter and Gamble (PG) reported revenue growth of 4% in the 3/18 quarter, slightly ahead of Wall Street's estimates. However, almost all of that growth was a result of positive foreign currency movements as organic sales growth was a mere 1%. Earnings adjusted for one-time charges were $1 per share, in-line with Wall Street estimates.

Despite results hitting targets, the stock is down over 3% at the moment as the market reacts to news of price cuts and tough market conditions. Pricing was a negative 3% in grooming products, negative 1-2% in all other products groups, and negative 2% for the whole company. Management statements such as "challenging macro environment" and "the ecosystems in which we operate around the world are being disrupted and transformed" did not help either. PG affirmed its previous organic revenue growth guidance for 2-3% for fiscal 2018, but said it now expects it will be at the lower end of that range.

Core gross margin adjusted for FX was down 90 bps, weighed down by 100 bps of commodity cost increases, 110 bps of product and geographic mix, 40 bps of rising transportation costs, and 80 bps of pricing. Raw materials costs, transportation costs and pricing impacts will continue to be problems in the foreseeable future, in our view.

**We saw several other items of concern in the numbers:**

- **The dividend consumes 70% of free cash flow and the buyback plus the dividend exceed free cash flow**. Cash from the exercise of stock options has more than covered the shortfall until the most recent trailing-12 period. It appears the company will either have to scale back its buyback and/or its dividend growth. This may be problematic as the lower share count provided all the reported EPS growth in the period.

- **Accounts payable days of sales continue to increase and now stands at close to two months.** Without the increase in payables, operating cash flow would have actually declined in the trailing-12 period ended 3/18 as opposed to the reported 9% increase.

- **Accounts receivable jumped by over three days for the first time in several years.** While management discussed how retailer destocking has negatively impacted sales growth, the jump in receivables indicates that the company may have extended terms to its customers to meet its revenue targets. While some of this could be timing of collections, if DSO had remained flat with the 3/17 quarter, the 4% headline sales growth would have all but evaporated.

## Cash After Buyback Is Negative

PG's cash from operations increased by almost 9% in the trailing-12 period ended 3/18. This resulted in the percentage of free cash consumed by the dividend falling to 70% from 74.9% a year ago, as seen in the following table:

| | 3/31/2018 | 3/31/2017 | 3/31/2016 |
|---|---|---|---|
| T12 Operating Cash Flow | $14,356 | $13,204 | $15,284 |
| T12 Capex | $3,964 | $3,521 | $3,297 |
| T12 Free Cash Flow | $10,392 | $9,683 | $11,987 |
| T12 Dividends | $7,275 | $7,257 | $7,460 |
| **T12 Div % of T12 FCF** | **70.0%** | **74.9%** | **62.2%** |
| | | | |
| T12 Stock Repurchases | $6,334 | $5,004 | $3,854 |
| **T12 Cash After Buyback** | **-$3,217** | **-$2,578** | **$673** |
| T12 Impact of Stock Options/Other | $1,233 | $3,046 | $2,186 |

However, the company has also ramped up its buyback over the last three years, and **in the last two years, free cash has not covered the buyback and the dividend.** In trailing-12 periods ended 3/17 and 3/16, PG benefitted from the cash contribution from the exercise of stock options which more than covered for the buyback and dividend exceeding free cash. However, this is not a reliable source of cash flow as it depends on non-operating factors such as the stock price and investor sentiment. In fact, in the trailing-12 period ended 3/18, the cash impact of stock options fell off and was no longer able to cover the free cash shortfall. This may be marking a turning point where the company can no longer continue its aggressive buyback. The 2%+ reduction in share count has been an important boost to reported EPS growth, actually providing all of the positive growth reported in the 3/18 quarter. It has also helped keep the growth in the cash cost of the dividend under control.

## Cash Flow Continues to Benefit from Squeezing Suppliers

As noted in our initial review of PG, the company's cash flow has been boosted by rising accounts payable, indicating it is being successful at squeezing its suppliers. Days payable in the 3/18 quarter rose by over 7 days year-over-year and 3.4 days sequentially, as seen in the following table:

| | 3/31/2018 | 12/31/2017 | 9/30/2017 | 6/30/2017 | 3/31/2017 | 12/31/2016 |
|---|---|---|---|---|---|---|
| Sales | $16,281 | $17,395 | $16,653 | $16,079 | $15,605 | $16,856 |
| Accounts payable | $9,716 | $9,740 | $9,458 | $9,632 | $8,076 | $8,300 |
| Sales YOY growth | 4.3% | 3.2% | 0.8% | -0.1% | -1.0% | -0.3% |
| Accounts pay YOY growth | 20.3% | 17.3% | 4.8% | 3.3% | 3.6% | 7.6% |
| Sales Seq growth | -6.4% | 4.5% | 3.6% | 3.0% | -7.4% | 2.0% |
| Accounts pay Seq growth | -0.2% | 3.0% | -1.8% | 19.3% | -2.7% | -8.0% |
| **Accounts pay DSPs** | **54.5** | **51.1** | **51.8** | **54.7** | **47.2** | **44.9** |

This is a trend among the consumer products companies struggling to show cash flow growth and is not in itself a bad thing. However, the number is up from the mid-30s just four years ago, and we question how much longer this pace of improvement can continue. **We estimate the increase in payables added over $1.6 billion to operating cash flow to the trailing-12 period ended 3/18 versus only $280 million to the year-ago comparable period, thus accounting adding $1.4 billion to reported operating cash flow growth. This means without the benefit of rising payables, cash from operations would have actually declined in the most recent twelve-month period, rather than the reported 9% increase.**

## Accounts Receivables Jumped in the Quarter

We noted that PG's accounts receivable jumped to 28.9 days in the 3/18 quarter, up 25.5 in the year-ago period. This is the first increase of more than three days in recent history.

| | 3/31/2018 | 12/31/2017 | 9/30/2017 | 6/30/2017 | 3/31/2017 | 12/31/2016 |
|---|---|---|---|---|---|---|
| Sales | $16,281 | $17,395 | $16,653 | $16,079 | $15,605 | $16,856 |
| Accounts Receivable | $5,149 | $5,182 | $4,942 | $4,594 | $4,358 | $4,729 |
| Sales YOY growth | 4.3% | 3.2% | 0.8% | -0.1% | -1.0% | -0.3% |
| Accounts Rec YOY growth | 18.2% | 9.6% | 4.9% | 5.1% | -5.1% | 0.2% |
| Sales Seq growth | -6.4% | 4.5% | 3.6% | 3.0% | -7.4% | 2.0% |
| Accounts Rec Seq growth | -0.6% | 4.9% | 7.6% | 5.4% | -7.8% | 0.3% |
| **Accounts Rec DSOs** | **28.9** | **27.2** | **27.1** | **26.1** | **25.5** | **25.6** |

This was not discussed on the conference call. We will be interested to see the liquidity discussion in the 10-Q to see if there is more color there. Management mentioned several times on the call that retailer destocking has negatively impacted recent sales growth. **However, the elevated increase in receivables could be an indication that PG extended more generous terms to meet its sales targets in the quarter. While some of the increase could have been due to timing of collections, if DSOs had remained at the same level as the 3/17 quarter, it would have removed virtually all of the reported increase in sales in the 3/18 period**.

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