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BTN Thursday Thoughts

Jeff Middleswart
Bill Whiteside, CFA
btnresearch.com

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Your success as a family…our success as a nation…depends not on what happens inside the White House, but on what happens inside your house.
-Barbara Bush

Lockheed Martin – Are the Pension Issues Finally Ending?

For many years, several of the defense contractors have looked cheap and well capitalized – until investors saw the pension plans. In the case of LMT, the pension obligations were typically larger than all the funded debt at the company:

($ in bills)	2017	2016	2015	2014	2013	2012	2011	2010
Funded Debt	$14.30	$14.30	$15.30	$6.10	$6.20	$6.30	$6.50	$5.00
Underfunded Pension	$15.60	$13.60	$11.60	$11.20	$9.20	$15.10	$13.30	$10.40
EBITDA	$7.10	$6.80	$5.70	$6.60	$5.50	$5.40	$5.00	$5.10
Free Cash Flow *	$5.30	$4.10	$4.20	$3.00	$3.70	$0.60	$3.30	$2.70
Debt/EBITDA	4.2x	4.1x	4.7x	2.6x	2.8x	4.0x	4.0x	3.0x

*Free Cash Flow excludes acquisitions. In 2017, FCF was helped by a $3.4 billion reduction in deferred tax liabilities. In 2012, a cash contribution to the pension plan that exceeded pension expense by $1.9 billion lowered Free Cash Flow.

It wasn't until LMT bought Sikorsky that funded debt topped the unfunded pension obligations. The Debt and Pension Obligations-to-EBITDA has been essentially 3-4x for years now. **What the bulls always argued was the company would not need to pay for the pensions, they could bill the government for the shortfall under CAS** (Government Cost Accounting Standards), therefore it should not be viewed as a future cash obligation. (We will describe this more below – but essentially, costs associated with a government program can be reimbursed including future pension obligations and adjustment costs). **The bears argued that LMT would need to fund its pension under FASB rules, which required it to cure shortfalls within 7-years and the government looked at this type of adjustment funding over a much longer time-frame.**

Here is what was happening over the last several years with LMT's pension:

($ in bills)	2017	2016	2015	2014	2013	2012	2011	2010
Discount Rate	3.63%	4.13%	4.38%	4.00%	4.75%	4.00%	4.75%	5.50%
Exp Rate of Return	7.50%	7.50%	8.00%	8.00%	8.00%	8.00%	8.00%	8.50%
Pension Cost	$1.40	$1.00	$1.10	$1.10	$1.90	$1.90	$1.80	$1.40
Funding by LMT	-	-	-	$2.00	$2.30	$3.60	$2.30	$2.20

The company was clearly paying a sizeable amount of cash into the pension every year from 2010-14. It was fighting against the falling discount rate, which was pushing up the total liability number and thus higher funding was not curing the shortfall until the discount rate increased in 2013. Net Accrued Losses have also been impacting the situation as actuarial assumptions on the discount rate, investment losses, and changes in longevity have modified. LMT saw this hit equity for a $12.6 billion in cumulative loss in recent years. Thus, shareholder equity has fallen from a recent peak of $4.9 billion in 2013 to -$0.6 billion in 2017.

In 2018, LMT is going to make a $5.0 billion contribution to its pension plan, which will bring the total to a little over $17.4 billion paid in since 2010. The many government rule changes have definitely helped, and we will discuss the Harmonization of the CAS and FAS (Financial Accounting Standards) rules below. We would side with the bears that LMT did have to fund the pension ahead of the government reimbursing the company.

There are three different standards that come into play regarding LMT's pension.

FAS – (Financial Accounting Standards) is what most people are familiar with in working with GAAP. Simply stated, a company recognized pension benefits as earned by employees with estimates for longevity, people who will leave early, and pay increases. These assumptions compute a service cost for the year. Another cost is interest expense computed by multiplying the discount rate by the total Pension Benefit Obligation. Those two costs are netted against an estimated return earned on Funded Assets in the Pension Plan (Estimated Rate of Return * Asset). The result is pension cost under FAS that may also be adjusted for changes in assumptions and actual net losses on pension assets. That is pension cost under GAAP and it reduces net income, but as a non-cash expense, is added back to cash flow.

CAS – (Government Cost Accounting Standards) is how the company can bill the government for pension costs. CAS uses similar assumptions to calculate service cost based on current wages, longevity, etc. CAS also allows a company to bill additional expense to cover prior shortfalls between CAS forecasts and reality. This happens over time and is paid in arrears by the government. So, for example, let's assume that estimated wage growth was too low in prior years or that the discount rate used for CAS was too high. In either case, reality would show that not enough money was collected under CAS and the company could bill for not only current service cost, but also for past adjustments. The big difference in how CAS is accounted for is it shows up as revenues on the income statement. To the extent the receivables are paid in a timely manner, they come through as cash. So, whereas FAS resulted in a non-cash expense on the income statement and is added back on the cash flow statement – CAS represents cash revenues and is only adjusted on the cash flow statement if a portion was still listed as a receivable.

PAA – (Pension Adjustment Act under ERISA) this came into play in 2008 dealing with curing shortfalls in pension funding (the difference between Obligations and Assets). This law requires companies to cure shortfalls in funding over 7-years. Thus, many companies including LMT had to boost cash funding into pensions. It works more on actual assets and actual returns verses the calculated obligations. Thus, under FAS or CAS – computing expense involves an assumed rate of return multiplied by assets in the pension. LMT is currently using 7.5% and we have never seen a company that assumes a negative rate of return. However, if the fund does lose money, it is possible the funding shortfall increases and that creates a higher cash payment requirement into the fund.

The basic problems that LMT ran into in conforming to all these different sets of rules were CAS is the ultimate source of cash flow, but CAS used more lenient assumptions to minimize

cash payments and stretch them out. Meanwhile FAS/GAAP and ERISA were computing higher expenses, higher underfunding levels, and faster cash funding schedules. Historically, CAS used a discount rate that was much closer to the Expected Rate of Return on Assets. The higher the discount rate, the lower the Present Value of the future obligation becomes.

Everyone is aware that interest rates overall were declining after 2008 fairly rapidly. Thus, LMT was billing the government under CAS based on high and fairly stable discount rates and not showing very large funding shortfalls to recoup shortfalls based on unrealistic assumptions. At the same time, FAS was requiring falling discount rates that were already much lower that was driving up the PV of the future obligation and ERISA was there to mandate it cure the shortfalls in 7-years. In the table above, you can see the falling discount rates used by LMT and the hefty cash payments it was making into the pension plan between 2010-14.

What Has Changed?

For FAS expense, the government realized that with the FED cutting interest rates, it was driving down the discount rates for pension plans. In 2012, the MAP-21 Act was passed that allowed companies to use a 25-year average of yields on high quality bonds as the discount rate. With rates falling rapidly after 2008, this helped considerably. As seen above, the discount rate was declining until 2012 (it was 5.875% in 2009 and 4.000% in 2012), before suddenly rising 75bp in 2013. That was the result of the new rule. It was supposed to expire by the end of 2016. However, it was extended until 2021 and will phase out in 2024.

Even as each year a higher rate is pulled out of the average and replaced by a lower rate, the discount rate stopped moving down as rapidly. This overall increase in the discount rate also cut the size of the pension-funding deficit and the funding levels began to fall too. The company's goal is to keep it above 80%.

	2017	2016	2015	2014	2013	2012	2011	2010
ERISA Funded Status	83%	86%	90%	92%	90%	90%	>80%	>80%

The heavy funding before the MAP-21 change helped LMT essentially go to zero cash funding in years 2015-17. The $5 billion contribution in 2018 should boost this ratio again.

CAS- Harmonization is the other change that came about in 2013. This was designed to make payments under CAS more closely match some of the FAS rules. The basic changes were:

1. To have CAS use the yield on high-grade bonds also for the discount rate. This effectively lowered the discount rate under CAS accounting that before more closely followed the rate of return assumptions. Thus, PBO went up and assets were flat, so there was a larger short-fall in funding under CAS that could be billed to the government

2. To change the CAS amortization period of experienced gains and losses from 15 years to 10 years. As a result, the companies could bill and be paid more quickly.

3. To allow CAS to be billed for projected increases in benefits if they are written into a collective bargaining agreement. This allowed increases to be passed along more quickly also.

These rules were transitioned into effect over 5-years – 0% in year 1, 25% in year 2, 50% in year 3, 75% in year 4, and 100% in year 5. They are now in full effect. So, the trend has been to allow higher CAS-related income for the companies. Here is what LMT has been reporting:

$ in mm	2017	2016	2015	2014	2013	2012	2011	2010
CAS	$2,248	$1,921	$1,527	$1,520	$1,466	$1,111	$899	$988
FAS	$1,372	$1,019	$1,127	$1,144	$1,948	$1,941	$1,821	$1,442
CAS/FAS Spread	$876	$902	$400	$376	-$482	-$830	-$922	-$454

Remember, CAS is income and FAS is expense. LMT is forecasting $1 billion in income from the CAS/FAS spread in 2018. That will be helped largely by the funding more of the pension assets in 2018 and having the expected rate of return on the assets reduce pension expense under FAS.

Also remember, from a cash flow standpoint, CAS is largely cash revenues and FAS is a non-cash expense. Cash funding to the pension plan represents a use of cash. In this area also, LMT has benefitted considerably of late. This assumes all the CAS income is paid in a particular year and part does not remain a receivable. So, treat this as a proxy:

$ in mm	2017	2016	2015	2014	2013	2012	2011	2010
CAS	$2,248	$1,921	$1,527	$1,520	$1,466	$1,111	$899	$988
Pension funding	$46	$23	$5	$2,000	$2,250	$3,837	$2,285	$2,240
CAS/contrib Spread	$2,202	$1,898	$1,522	-$480	-$784	-$2,726	-$1,386	-$1,252

LMT went from seeing pensions consume over $2 billion in cash per year to generating over $2 billion in cash per year with the CAS Harmonization rules. LMT is forecasting that after a $5 billion payment in 2018, it will not have a material cash payment to the pension plan in 2019 or 2020.

LMT froze its pension for non-union people and is transitioning new-hires away from defined benefit plans

> ***"Many of our employees are covered by qualified defined benefit pension plans*** *and we provide certain health care and life insurance benefits to eligible retirees (collectively, postretirement benefit plans). We also sponsor nonqualified defined benefit pension plans to provide for benefits in excess of qualified plan limits.* ***Non-union employees hired after December 2005 do not participate in our qualified defined benefit pension plans,*** *but are eligible to participate in a qualified defined contribution plan in addition to our other retirement savings plans.* ***They also have the ability to participate in our retiree medical plans, but we do not subsidize the cost of their participation in those plans*** *as we do with employees hired before January 1, 2006.* ***Over the last few years, we have negotiated similar changes with various labor organizations such that new union represented employees do not participate in our defined benefit pension plans.***
>
> ***In June 2014, we amended certain of our qualified and nonqualified defined benefit pension plans for non-union employees; comprising the majority of our benefit obligations; to freeze future retirement benefits.*** *The calculation of retirement benefits under the affected defined benefit pension plans is determined by a formula that takes into account the participants' years of credited service and average compensation. The freeze will take effect in two stages.* ***On January 1, 2016, the pay-based component of the formula used to determine retirement benefits was frozen so that future pay increases, annual incentive bonuses or other amounts earned for or related to periods after December 31, 2015 are not used to calculate retirement benefits. On January 1, 2020, the service-based component of the formula used to determine retirement benefits will also be frozen so that participants will no longer earn further credited service for any period after December 31, 2019.*** *When the freeze is complete, the majority of our salaried employees will have transitioned to an enhanced defined contribution retirement savings plan. As part of the November 6, 2015 acquisition of*

> *Sikorsky, we established a new defined benefit pension plan for Sikorsky's union workforce that provides benefits for their prospective service with us. The Sikorsky salaried employees participate in a defined contribution plan. We did not assume any legacy pension liability from UTC."*

This should have the impact of reducing the service cost component of pension expense that builds Pension Obligations over time. It should also create more transition expenses. Overall, this should reduce pension expense under FAS and CAS. LMT will continue to fund remaining shortfalls with cash as needed. Also, most of the time – defined contribution plans like 401-k's get some matching, profit sharing components paid by the employer. LMT will need to pay for some of those in cash.

How Will Pensions Impact the Future?

The transition to CAH Harmonization is over. Having it phase in 25% per year was a great tailwind to grow earnings and cash flow in recent years. We would expect the rate of change to for CAS/FAS income to peak and perhaps start to decline in 2019. **This may be important because the swing in CAS/FAS income has been $1.8 billion** from being a -$922 million drag in 2011 to an $876 million source of income in 2017. Total operating income – with the acquisition of Sikorsky in 2015 – has grown from just over $4 billion to $5.9 billion over that same time. The CAS/FAS income has played a huge role in income gains for LMT. It's unlikely to disappear and operating profit did rise in 2017 by $372 million with CAS/FAS declining by $26 million. But, if this becomes a smaller figure overall after 2018 – earnings growth could suffer at LMT.

In addition, higher interest rates should lower CAS Income as well as FAS expense and shrink the underfunded part of the pension in both cases. LMT estimates that a 0.25% change in the discount rates changes the pension obligation by $1.5 billion and the FAS pension cost by $115 million. Rising interest rates should also cost LMT more cash interest expense on the debt they use to finance the $5 billion contribution to the pension plan in 2018. Given that FAS is non-cash, CAS is cash income, and Interest Expense is a cash cost – this should lead to lower cash flow from this area post 2018.

Also, don't forget there are multiple sets of books being used here. LMT's financial statements use FAS, which is GAAP accounting to assess the pension plan's status. They also use ERISA rules to determine how much if any cash contributions are required. However, CAS is paying adjustments to catch-up on the pension shortfall and it is paying based on the shortfall under CAS accounting. CAS assumptions have traditionally favored

making CAS shortfalls smaller than FAS and use longer-term time horizons than ERISA. Thus, forecasts that CAS is about to pay in another $9-$10 billion based on FAS underfunding levels after the $5 billion contribution, may be overstating what CAS is still going to fund. Therefore, CAS income could decline faster than FAS expense too and make the CAS/FAS income figure fall rapidly.

We noted above that LMT is moving employees to contribution plans and it will likely have to pay matching contributions. It is doing that already – only it is using common stock to pay for it at this point:

> *"We maintain a number of defined contribution plans, most with 401(k) features, that cover substantially all of our employees. Under the provisions of our 401(k) plans, we match most employees' eligible contributions at rates specified in the plan documents. Our contributions were $613 million in 2017, $617 million in 2016 and $393 million in 2015, the majority of which were funded using our common stock. Our defined contribution plans held approximately 35.5 million and 36.9 million shares of our common stock as of December 31, 2017 and 2016."*

One of the bigger issues that could impact LMT as this pension catch-up and transition slows is this has been a huge source of cash flow for the company. LMT has also conditioned investors to expect rising dividends and sizeable stock repurchases. There is little margin here to continue all that unless CAS cash flow keeps rising. Just look at the last few years:

$ in mm	2017	2016	2015
Net CAS Cash	$2,202	$1,898	$1,522
Total Cash Ops	$6,476	$5,189	$5,101
% of CFO from net CAS	34%	37%	30%
Capital Spend	$1,177	$1,063	$939
Free Cash Flow	$5,299	$4,126	$4,162
Dividend	$2,163	$2,048	$1,932
Dividend % FCF	41%	50%	46%
Stock Repurchase	$2,001	$2,096	$3,071
Cash after Div/Repo	$1,135	-$18	-$841

These are years where CAS has provided growing cash with minimal pension contributions being made by LMT. In every other year since 2010, except 2017, LMT has essentially spent all its free cash flow on dividends and repurchases. What happens as CAS-provided cash

flow declines? It's unlikely to disappear – so we are not saying one-third of cash flow is going to vanish. However, a drop of $1 billion may not be unreasonable. Before the Harmonization catch-up, CAS was bringing in $900 million to $1.1 billion per year. And during that time, LMT was making annual contributions of over $2 billion to the pension plan. That's unlikely to happen again too. So, LMT has gone from an abnormally bad situation to an abnormally good situation since 2010. A normal year in 2019 or 2020 could see the pension cash flow situation drop from over $2 billion to about $1 billion.

The potential problem is LMT has added some new cash needs. It will have borrowed $5 billion that it has to pay interest on and eventually, likely repay. It will still have some pension funding contributions to make in the future. It is now incurring $600 million in 401-k costs per year and that is likely to grow as more people are moved toward that situation. If they issue stock to cover that, they will need to buy back even more stock for the repurchase plan to work as planned. Yet, the dividend and the repurchases already consume nearly all of Free Cash Flow before factoring in anything new that requires cash or a reduction in CAS post 2018.

EQ Review- Colgate-Palmolive Company (CL)

We are initiating a regular review of Colgate's (CL) earnings given its popularity and the fact that like many of its consumer products peers, it is considered by many to be a premium dividend stalwart, destined to maintain and increase its dividend forever because it always has and because people will always brush their teeth.

While CL's recent earnings do not contain much in the way of accounting red flags such as rising inventories or receivables, we do note several items of concern with its results:

- **CL struggles to maintain positive unit growth.** Recent 3% unit growth took price cuts to produce which resulted in a gross margin decline. The company plans to increase prices again in 2018 which could hit unit growth as it has in the past.

- **Recent unit growth also required a huge increase in advertising which contributed to an 80 bps decline in operating margin**. With advertising expected to increase again in 2018 and the likelihood of higher raw materials costs, we do not see how meaningful margin improvement can be achieved in 2018.

- **Cash from operations has not grown in 5 years.** The dividend consumes over 60% of free cash and rising. The dividend and the buyback consume more than free cash flow. While recent results have benefitted from cash from stock option exercises, this is not a reliable source of cash. While not an immediate concern, unless something changes dramatically, the company cannot continue to maintain the buyback and grow the dividend without taking on additional debt.

- **CL has been incurring regular restructuring charges for years** amounting to 6-9% of pre-charge operating profit each year calling into question the quality of non-GAAP earnings.

- **Return on investment adjusted for stock buybacks is about 14% and has actually declined** over the course of the company's restructuring program.

Unit Growth Only Comes with Price Cuts

All of the consumer products companies are faced with the same obstacles to growth including increasing price competition, consumers' acceptance of private label brands, rising raw materials costs, and a retailer customer base that grows stronger by the year. CL management addressed the slowing growth in all of its categories in the fourth quarter conference call:

> *"Now before this year, we have consistently delivered against our 4% to 7% long-term organic revenue growth target, although as we have seen more towards the lower end since the financial crisis.* ***You may recall that, that range was determined when global growth for our categories was around 4% to 5% per year on a fairly consistent basis. Of course, if you look at our categories over the last 12 to 18 months, they've been growing at roughly a 2% rate,*** *slightly up, as I commented earlier, in the fourth quarter.* ***But the 2% we've been operating in was developed markets moving closer to 0 with developing markets coming down from a high single-digits to the mid single-digits. Now while we believe these growth rates are beginning to improve, we think it's appropriate to plan with an assumption that category growth rate will be below those heavy historical levels even if it's greater than what we've seen in the most recent past. So as we look forward, starting with 2018, we think it more probable that our categories will grow in a 2% to 4% range.*** *And on top of this growth, we believe that we will return to consistent market share growth behind the strength of our brands, our increased investment, our ability to innovate and in our market execution. And we believe, from a consumption point of view, we're already seeing signs of that.* ***So, this combination of category growth and market share growth should put us in the range of 3% to 5% top line organic growth rate, and that's the stance we are taking for 2018 and beyond."***

Management noted that in the fourth quarter its categories saw some improvement and it was gaining share in most areas, but it admitted that sales were less robust than it had hoped. The following table shows a breakdown of sales growth for the last eight quarters:

	12/31/2017	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016
Unit Volume	3.0%	1.5%	-1.0%	-2.0%	-1.0%	1.5%*	1.5%*
Pricing	-1.0%	0.0%	1.0%	2.5%	2.5%	3.0%	3.0%
Currency	2.5%	1.5%	-0.5%	-0.5%	-1.5%	-2.5%	-5.5%
Organic Growth	2.0%	1.5%	0.0%	0.5%	1.5%	4.5%	4.5%
Reported Sales Growth	4.5%	3.0%	-0.5%	0.0%	1.5%	-3.5%	-5.5%

*9/16 and 6/16 unit volume growth adjusted for divestiture of Venezuela operations.

While unit volume did turn positive in the last two quarters, it has taken two profit margin-busting moves to do it - lower pricing and higher advertising. After several periods of rising prices and lackluster unit growth, CL lowered prices in the back half of the year. The lower prices were seen across almost all geographies:

	12/31/2017	9/30/2017	6/30/2017	3/31/2017
North America (21% of sales)				
Unit Volume	4.5%	3.0%	-2.0%	-5.0%
Pricing	-3.5%	-4.0%	-1.5%	-0.5%
Latin America (25% of sales)				
Unit Volume	4.0%	3.0%	2.5%	0.0%
Pricing	-1.5%	2.5%	4.5%	7.0%
Europe (16% of sales)				
Unit Volume	6.0%	3.0%	-1.0%	0.5%
Pricing	-2.0%	-2.0%	0.5%	-1.0%
Asia Pacific (17% of sales)				
Unit Volume	1.0%	0.0%	-2.0%	-1.0%
Pricing	1.5%	0.0%	-1.5%	0.0%
Africa/Eurasia (6% of sales)				
Unit Volume	-0.5%	-4.5%	-7.5%	-6.5%
Pricing	0.0%	2.5%	4.5%	7.0%
Hill's Pet Nutrition (15%)				
Unit Volume	0.0%	1.0%	-1.5%	-4.0%
Pricing	0.5%	0.0%	2.0%	4.0%

While the US has seen the most prominent decline in prices, Latin America and Europe have also seen declines. Not surprisingly, those markets are the only ones that have

registered unit growth greater than 1% in those periods. This perfectly illustrates the balancing act faced by the consumer products companies in what remains a very price sensitive market. To achieve unit growth and maintain market share, they must cut prices, but doing so destroys gross margins:

	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Sales	$3,892	$3,974	$3,826	$3,762
Adjusted Gross Margin	60.4%	60.4%	60.7%	60.7%
Adjusted Operating Margin	25.9%	25.0%	26.3%	25.0%
Advertising Expense	$369	$405	$399	$400
% of sales	9.5%	10.2%	10.4%	10.6%

	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Sales	$3,721	$3,867	$3,845	$3,762
Adjusted Gross Margin	60.8%	60.4%	60.2%	60.0%
Adjusted Operating Margin	27.9%	26.4%	26.3%	24.7%
Advertising Expense	$297	$339	$394	$398
% of sales	8.0%	8.8%	10.2%	10.6%

CL's gross margin fell in the 12/17 quarter as lower prices and higher raw materials costs more than offset the benefits of its ongoing restructuring program (which we will discuss in a later section).

Management has predicted that adjusted gross margin will improve substantially in 2018 as it will apparently try to push through higher pricing again:

> *"…we expect our gross margin to be up 50 to 75 basis points as a combination of pricing and productivity from our funding-the-growth initiatives should more than offset higher raw material costs."*

Given the rising costs of oil and other raw materials and the obvious price sensitivity of the market, it seems a daunting enough task to maintain gross margin let alone show that type of improvement absent a dramatic change in market conditions.

As we explore in the next section, pricing is not the only margin-killing lever the company has pulled to produce unit growth.

Advertising Expense is Skyrocketing

The low single-digit unit growth seen in the last couple of quarters has taken more than gross margin-compressing price cuts to achieve. As the table above shows, the company also ramped up its advertising spend by 150 bps as a percentage of sales and an eye-popping 24% on a year-over-year dollar basis. Management has indicated that the rising advertising spend will continue in 2018:

> *"We expect another year of increased advertising spending in 2018, both on an absolute basis and as a percentage of net sales."*

Between price cuts, raw material price increases and higher advertising, adjusted operating income margin fell by 80 bps in 2017. It is difficult to see how meaningful expansion can occur in 2018 given this headwind.

Dividend Is Consuming an Increasing Percentage of Cash

Given the pressures discussed above, it is not surprising that CL has been unable to show meaningful growth in cash from operations over the last five years. However, the company's dividend has continued to grow and consequently consume an increasing amount of cash flow:

	12/31/2017	12/31/2016	12/31/2015	12/31/2014	12/31/2013
Operating Cash Flow	$3,054	$3,141	$2,949	$3,298	$3,204
Capex	$553	$593	$691	$757	$670
Free Cash Flow	$2,501	$2,548	$2,258	$2,541	$2,534
Dividends	$1,529	$1,508	$1,493	$1,446	$1,382
Dividend % of Free Cash Flow	61.1%	59.2%	66.1%	56.9%	54.5%
Buyback	$1,399	$1,335	$1,551	$1,530	$1,521
Cash After Dividend and Buyback	($427)	($295)	($786)	($435)	($369)
Shares outstanding	887.8	898.4	909.7	924.3	939.9
Proceeds from Exercise of Stock Options	$507	$446	$347	$371	$339

Note that capital spending has declined partly from lower spending on the company's restructuring initiatives. However, this benefit to growth cannot continue as the company will have to eventually spend to grow and maintain its capital base, and if history is any guide, future restructurings are highly likely.

In addition, we note that the company regularly spends large sums buying back shares. Cash after spending on dividend and buybacks has been substantially negative for the last five years. However, this has been offset by cash provided by the exercise of stock options. We do not see this as a reliable source of cash, as the amount in any given year will depend on the company's stock price. Even after factoring in the cash inflow from stock options, the company is essentially spending all its available cash flow on the buyback and dividend. **This can't continue at the rate it is going without the company either cutting the buyback, slowing the dividend growth, or taking on debt. This is not an immediate problem, but it is one more example of how the consumer products companies cannot be relied upon by dividend investors to be the sure-fire source of never-ending dividend growth that they have been in the past.**

Restructuring Charges

Like all the consumer products companies, CL seems to be perpetually engaged in restructuring activities. Its latest program, the "Global Growth and Efficiencies Program", began in the fourth quarter of 2012. It was later expanded in 2014, 2015 and 2017 and is expected to run through 2019. Amounts spent so far are shown below:

	12/31/2017	12/31/2016	12/31/2015	12/31/2014	12/31/2013	12/31/2012
Pretax Restructuring Charges	$333	$228	$254	$286	$371	$89
Pre-Charge Operating Income	$3,922	$4,065	$3,043	$3,843	$3,927	$3,978
% of Pre-Charge Op. Inc	8.5%	5.6%	8.3%	7.4%	9.4%	2.2%

These charges have regularly been a meaningful part of pre-charge income. They are recorded in cost of sales, SG&A and other (income) expense on the income statement, but CL presents non-GAAP results in which these amounts are added back. The size and regularity of the charges increases the likelihood that expenses that should be considered operating in nature are being lumped in to the charges, thus overstating the non-GAAP profits. Consider the company's disclosure on the makeup of the cumulative charges from 2012-2017:

Employee-Related Costs	50%
Incremental Depreciation & Asset Impairments	10%
Implementation costs from exit activities (including contract termination)	20%
Implementation of new strategies	20%

Employee-related costs pertain to severance costs resulting from headcount reductions and facility relocations. However, costs such as implementation costs from exit activities and the cost of implementing new strategies are much less defined and seem likely to include costs that the company would have incurred as a normal part of its business. We admit that in our analysis of margins in sections above, we utilized the non-GAAP numbers to account for the volatile nature of these charges from period-to-period. However, ignoring these charges as if they never occurred is giving a false sense of the true profitability of the company. Note that the company estimates that 80% of the charges will result in cash expenditures. The balance is made up of asset write-offs that represent shareholder capital spent at some time in the past, even if they are not resulting in cash spending in the current periods.

The company's current target for the end of the program is 2019. Investors should view the expansion of the program or announcement of a new one with a large degree of skepticism.

Actual Returns Are Less Than Stellar

The headline return numbers of over 60% ROI are impossibly high and are a result of the exhaustion of shareholders' equity from a long history of buybacks. However, if we adjust shareholders' equity for the treasury shares balance, we can get a better idea of the real returns CL is generating. In keeping with the spirit of our contention that restructuring charges are real expenses, we will amortize the restructuring charges incurred since 2012 over the last five years.

	12/31/2017	12/31/2016	12/31/2015	12/31/2014	12/31/2013
Pre-Charge Operating Income	$3,922	$4,065	$3,043	$3,843	$3,927
Amortized Restructuring Costs Since 2012	$294	$294	$294	$294	$294
Adjusted Return	$3,628	$3,771	$2,749	$3,549	$3,633
Total Debt	$6,577	$6,533	$6,548	$6,148	$5,657
Cash	$1,535	$1,315	$970	$1,089	$962
Net Debt	$5,042	$5,218	$5,578	$5,059	$4,695
Reported Shareholders' Equity	$243	$17	-$44	$1,385	$2,536
Treasury Stock	$20,181	$19,135	$18,102	$16,862	$15,633
Adjusted Equity	$20,424	$19,152	$18,058	$18,247	$18,169
Adjusted Capital	$25,466	$24,370	$23,636	$23,306	$22,864
Adjusted pretax ROI	14%	15%	12%	15%	16%

CL’s sub15% pretax ROI is certainly not remarkable, and we question whether it justifies the company’s multiple of almost 16 times EBTIDA.

In addition, it is worth noting that despite the restructuring efforts, the company’s return on investment is actually down from five years ago.

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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