Two Paths to Growth for Procter & Gamble (PG)

P&G must win in both developed and developing markets

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Key Takeaways

- **PG has divested over 100 brands to become leaner and more agile.** Now the question is how it can return to meaningful top line growth in both developed and developing markets.
- **Winning in developed markets means a focus on innovation – both on the product side as well as the marketing and sales side.**
- **Winning in developing markets means appealing to consumers in the growing middle class though "aspirational" products.** Capturing market share is not enough - the growing business must be profitable as well.
- **Acquisitions have been an important fuel for PGs growth historically but the Company will have to make smarter acquisitions to grow now, particularly in developing markets.**
- **Flawless execution on these strategies could deliver an incremental $12 billion in revenue through FY2020.**

Introduction

P&G has run out of runway. The 2006 acquisition of Gillette – the value of which equated to 10 years of the prior Owners' Cash Profits (OCP) – capped an orgy of acquisition-led growth. The Company milked that strategy as much as it could until managers realized the firm had become lumbering and bloated. Now, as it completes the shedding of over 100 brands and their associated costs, P&G is searching for a sustainable, profitable path to return to top line growth.

We think P&G has two routes to this growth – Developed and Developing markets. Business development strategies are very different for each, and both must be executed perfectly to justify much higher of a stock price.

Complicating matters is the rapidly changing face of global retail (Walmart and P&G – A $10 billion Marriage Under Strain). P&G will need to navigate this revolution successfully. P&G's portfolio of brands, which it has strengthened through recent divestitures, is a core point of leverage for its retailer relationships. Without this scale of multi-category brand leadership, P&G's ability to negotiate with retailers would be harmed.

As part of our valuation for Procter & Gamble Company (PG), IOI's team focused on understanding and projecting possible demand scenarios (see IOI's Chart Book on Procter & Gamble). There are essentially two paths down which P&G must execute to return to sustainable growth:

1. Winning the innovation battle in Developed Markets.
2. Wining the growing middle class in Developing Markets

Let's take each in turn and see what we believe they can bring to the revenue party.

Winning in Developed Markets

A clearly stated goal of P&G's recent brand divestures has been to improve the company's focus on its biggest brands in developed markets. Due to the relative consistency of consumer preferences across developed markets, reliable infrastructure (e.g., running water, electrical connections), and similarities in distribution systems, developed markets form the basis of P&G's real operational and financial leverage. To us, focusing resources on its biggest brands means delivering best-in-class: (1) Marketing and product innovation and (2) Product launch executions.

Investment in marketing and product innovation

We estimate that P&G will end up with another $6 or $7 billion of cash on its balance sheet from the divestitures[1] by the end of calendar 2016. On top, the company has done a wonderful job increasing cash productivity / profitability over the last 24 months.

To increase the consumer impact of P&G's marketing, some of this windfall could be directed to communication and retailer innovation. The recent Thank you, Mom and Like a girl campaigns revolutionized P&G's corporate image and the Always brand respectively. Both have contributed positively to business results as well as receiving a series of advertising awards. More importantly, both campaigns provide a vision for the kind of brand-to-consumer relationship P&G aspires to deliver across its brands – a two-way level of mutual knowledge that extends beyond product functionality. Additionally, the company is making great strides in digital customer acquisition, knowledge and retention. We believe this competency will become a core strength for P&G with time.

Post-Great Recession, developed market consumers have become more demanding of branded products and simultaneously less loyal to them. However, meaningful innovation on both the brand-to-consumer relationship and the products consumers use has consistently defined growing new businesses.

However, the rapid pace of change in the global retailer environment has been challenging, as both manufacturers and retailers seek to hold top spot in the minds and wallets of consumers. Value continues to play an important role, but the players are evolving – Amazon is selling diapers and all-generic chains like Aldi and Lidl are gaining traction in this post-Great Recession world. Consumers are becoming increasingly conscious of packaging waste in nearly all developed countries outside the US. While P&G's extensive portfolio of consumer-preferred brands represents a core strength, maintaining this position will require real innovation on new business models, retailer relationships and marketing message reach.

On the product side, P&G's new product pipeline has been drier than a Swiss doctor's sense of humor for over a decade. P&G has been expert at evolutionary, sustaining product creation across their brands, but real breakthroughs have been harder to come by. Swiffer – introduced in 1999 – is an example of the power of a meaningful consumer innovation. Lightweight, easy to use, versatile and handy, its introduction supplanted the use of brooms, mops and dust rags for most indoor cleaning tasks. Today, it delivers north of $500 million in annual sales. Febreeze, P&G's latest billion-dollar brand, is another example of the company's skill in creating entirely new categories, but that too is a product of the late 90's. This kind of new-to-the-world, category defining product innovation is an important driver of developed market revenue growth, in our opinion, and P&G will have a difficult time expanding its revenues if it can't manage to do it.

There are opportunities to create innovative products that will drive growth in mature, developed markets. For example, personal / household-services and shared-service markets are evolving throughout the developed world among younger, "millennial" consumers. P&G's largest brands like Gillette, Tide and Pampers, which command so much consumer trust, could find viable product + service combinations in this space. But the company has been late to the party on the "service clubs model" (e.g., Dollar Shave Club in grooming) evolving in these categories.

The greying of the developed world also affords P&G and its competitors the chance to innovate in home health care and personal wellness. However, P&G has been virtually silent in this space outside the adult female incontinence category (Always Discreet). Brands like

[1] Analysts calling for a breakup are misguided, in our view. A breakup of P&G would only serve to weaken the hands of the resulting smaller entities and would be a strategic disaster. Divesting brands that contributed marginally to revenue and very little to profit for both P&G and its retailer partners leaves the Company a stronger manufacturer.

Vicks, Crest/Oral B, New Chapter, NyQuil and Metamucil as well as the company's rapid diagnostics JV partnership with Alere (Alere is currently in talks to be acquired by Abbott – ABT) are all established, well-regarded brands. Creating innovative products under these brand umbrellas targeted at the global aging consumer demographic seems reasonable and would further leverage P&G's powerful developed market distribution networks.

As shown in our recently published ChartBook on P&G, the firm's Owners' Cash Profit margins have been running in the high teens percentages. Recently the company has committed to a $10 billion cost savings program powered by a reengineering of its product supply chain on top of additional cash from divestitures in the bank. With these resources, P&G looks well positioned to put additional capital to work without materially harming profitability.

Product launch execution

Recently, some important innovation launches have met with negative PR issues. Tide Pods launch and category share growth has been slowed by child safety concerns and recommended dosage issues. The Pampers with DryMax launch was severely sidelined by alleged diaper rash links to the product. Launch issues like these not only do financial damage to the product launches and internal project rates of return, but they can durably harm consumers' trust in the brands – a far more serious consequence.

P&G couldn't have done more to prevent these issues arising (the company's product understanding and use research is second-to-none), but its initial dismissive handling of them has left investors wondering if the company has become tone deaf to consumer and retailer concerns post-launch. Information and misinformation alike travels as fast as a Facebook message can be posted these days. Consumers want to interact with brands and products in a more influential and partnering sort of way than even 10 years ago. P&G's execution must flawlessly meet, and ideally lead, this challenge. Interestingly, this "rededication" to execution showed up in the company's 2015 annual report.

Financial projections

We see an incremental $6.5 to $7.0 billion of potential revenue from successfully growing developed markets.

Executing on the above elements could add as much as $6.8 billion to developed market revenues over the next four years. We calculate this by assuming the company spends an additional $7 billion on Marketing and R&D in the coming years (roughly an incremental $1.5 billion per year, reducing cash from operations by about 10%) and then applying a rate of return on those dollars that is roughly in line with IOI's historical best-case investment efficacy (8%). The incremental $1.5 billion per year is akin to assuming the company invests the cash it receives from its divestitures back in the business over 5 years with no additional contribution from Product Supply cost savings / rationalizations in this period. Those incremental $1.5 billion over five years could add as much as $8.5 billion of revenue growth to our FY2015 / 2016 base case.

Winning in Developing Markets

Successfully becoming the product(s) of choice for a growing middle class is the playbook that put P&G where it is today. As the middle class grew in America between the end of WWII in 1945 and the beginnings of middle class stagnation in 1985, P&G's revenues went from $343 million to over $13 billion[2], generating a staggering compound annual growth rate of nearly 10%! Procter & Gamble is a master of selling into a growing middle class whose consumers are experiencing increasing purchasing power and electing to spend more of their disposable income on premium household items.

Based on this, and P&G's success at growing with the middle classes in Western Europe and Japan, we are confused by a) Sell-Side analysts' assertions that P&G cannot win in developing markets and b) why P&G seems to have strayed from its successful and well-worn playbook. The path to greatness for P&G in developing markets is to patiently obtain greater than fair share of the growing consumer product spending of the middle classes in India, China, Eastern Europe,

[2] *Rising Tide – Lessons from 165 Years of Brand Building at Procter & Gamble* (2004) Dyer, Dalzell and Oleganio

Latin America and Southeast Asia. While these markets are individually different from one another and challenging for "foreigners", they are rather homogenous internally in terms of the consumer behaviors and needs that drive P&G's product categories.

The chart below – taken from Organization for Economic Co-Operation and Development (OECD) projections - shows the potential power of middle class growth between now and 2030. According to the OECD's projections, by 2030 over 90% of the world's middle class will be from developing countries. If P&G aspires to growth, it has no choice but to win with consumers in these nations.

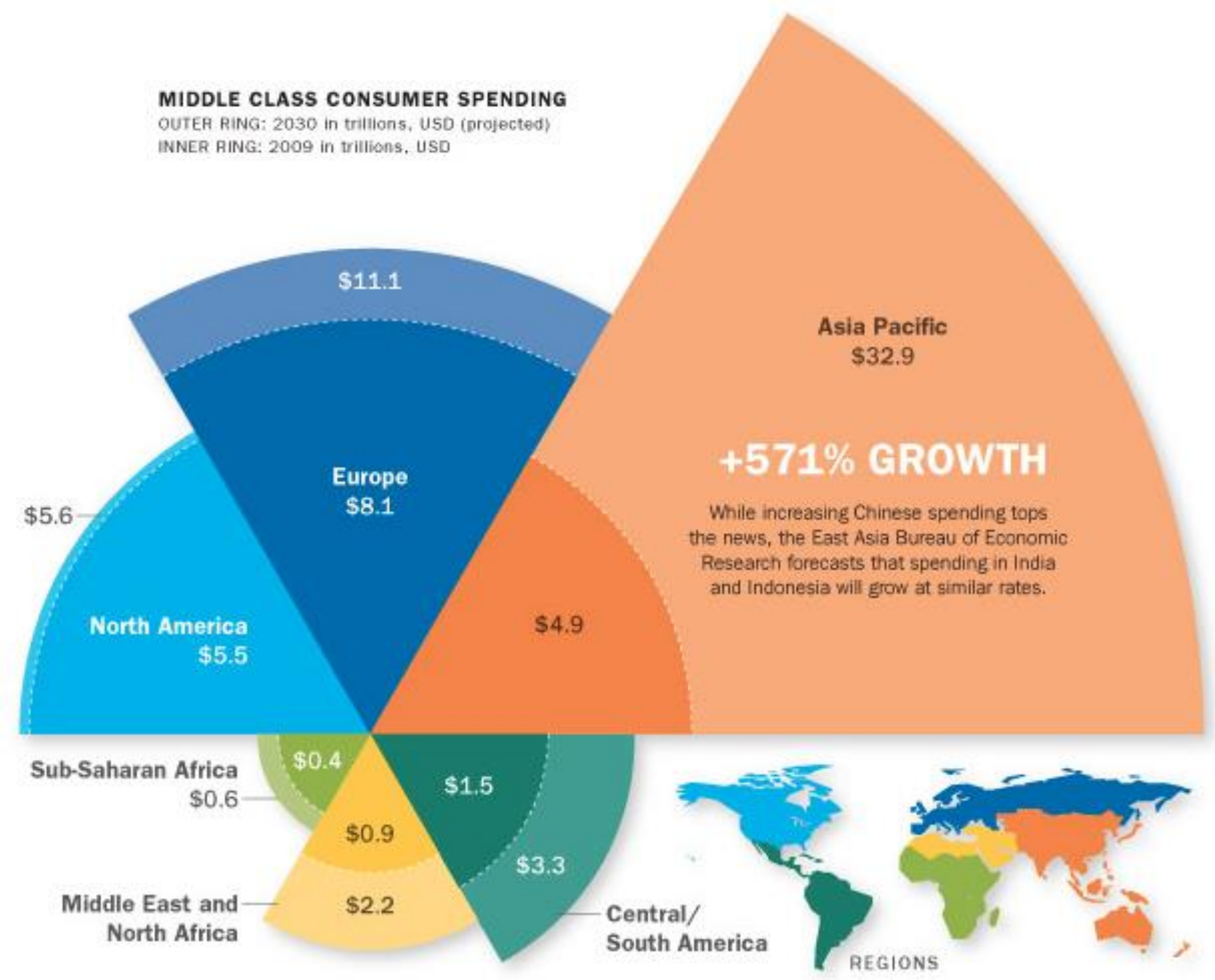

Figure 1. Source: OECD Study on Global Middle Class population growth

Here are some core strategic steps P&G can take to deliver developing markets growth, while patiently realizing that there's little marketers can do to affect the pace of middle class growth directly. Public and fiscal policy in these countries will impact the pace of middle class growth and their purchasing power directly. There is only so much they can do. But for every marginal dollar of spending that the middle class has in disposable income, P&G must capture more than fair share of that dollar vs. competition. How does it do that?

Build "aspirational" brands and products

Volume growth and share growth will almost certainly be small at the start because building a brand that consumers aspire to buy, but cannot immediately afford, implies a slower process that requires patient nurturing. P&G should certainly be mindful of delivering superior value here, but it must create the premium brand relationships that the middle class *wants to buy* supported by products that get local consumers talking. This kind of superior product-driven innovation is a core element of P&G's history.

Resist empty share points

Team IOI argues that CFO John Moeller's and CEO AG Lafley's combined focus on getting to profitability in developing markets is the most important element in the whole of the Company's FY2016 strategic plan. We believe newly appointed CEO David Taylor will continue this focus. Gaining share at the expense of profitability as the premium producer is a loser's game. The math doesn't work and it's not in P&G's culture to produce and market "value products" just to participate in a given market. Producing and marketing products that lose money to win market share in a developing region is the same as eating chips when you are hungry rather than a proper meal. The chips might get you through but they are empty calories from a health standpoint and profitless sales represent empty share points for the health of P&G's business.

Acquire intelligently

While some people look down on the strategy of "buying revenues", sometimes the best answer to quickly gain scale and / or offer locally relevant, premium brands is to acquire. P&G arguably did a wonderful job of this in the developed markets during the late 90's into 2005, culminating in the Gillette transaction. One look at the revenue and profit results subsequent to this acquisitive period in the figure below shows that acquisitions have made a permanent, positive impact on P&G's business.

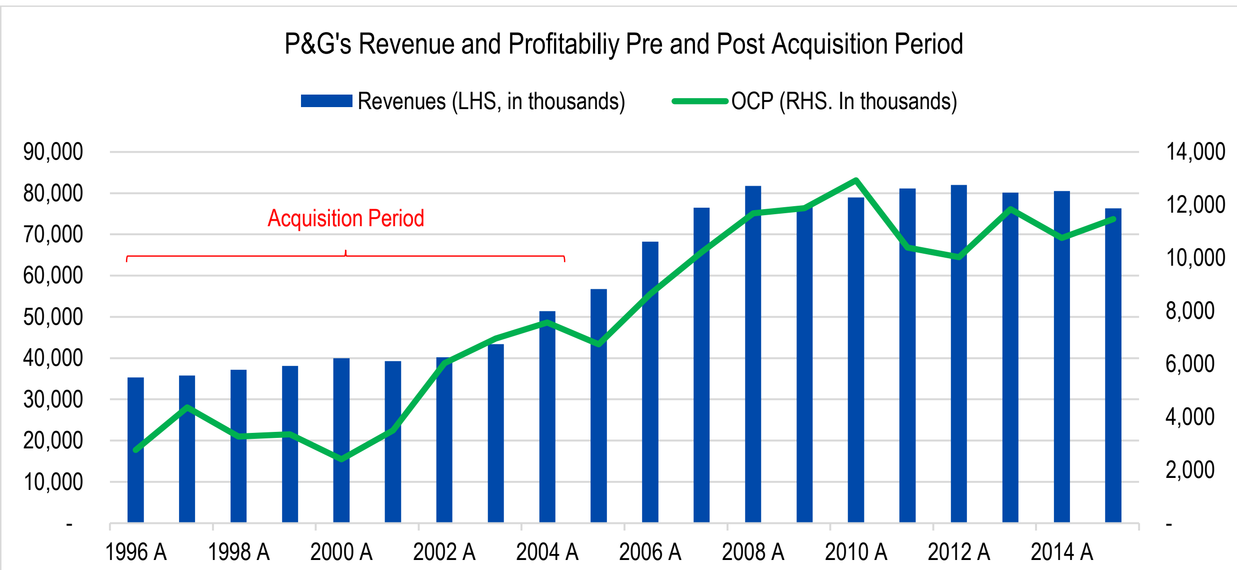

Figure 2. Source: Company Statements, IOI Analysis

True, P&G acquired some brands and businesses that didn't do a good job of driving profit and revenue in this mix and it's been shedding those businesses. We argue that this indicates P&G is a smarter acquirer than in the pre-Gillette period. Even in the face of a fairly aggressive shareholder cash return plan and its historical aversion to the use of debt financing, we believe the firm will likely turn to acquisitions as a viable strategy for growth and that the probable acquisitions are in these developing markets. They would be smaller in size / price and strategically material to achieving the goals above. If we are wrong about P&G's improved acquisition acumen, medium-term cash flow growth at the firm – one of our key valuation drivers – is likely to be weak.

Financial Projections

We see developing markets able to provide an incremental $8 billion in revenues over the coming five years.

Executing on the above elements could add as much as $8 billion to developing market revenues over the next five years (constant-currency basis). We calculate this by assuming middle class consumption growth globally proceeds according to the 10-year projected CAGR predicted by the Brookings Institution in 2011, ~7.6%, and then assume P&G's developing markets revenues grow by 1% ahead of that (due to its need to capture greater than fair share of their spending). Is this reasonable? P&G's developing market revenues have grown at a roughly 7% clip through end FY2013/2014. With P&G's focus on profitable share, it's possible that emerging market revenue growth could stall out a bit in the near term but the growth of the middle class and P&G's focus on premium performance, aspirational products could generate this 8-9% growth rate in emerging market revenues by 2020.

Summing Up P&G's Case for Growth

Combining our best-case projections for developed and developing markets implies revenue growth of $6.8 billion from developed markets and $5.5 billion from developing markets. This creates a best-case revenue scenario of roughly an incremental $12 billion (CAGR = 4.3%) that is, in our view, reasonable for P&G. Remember this analysis is a "revenue potential" growth analysis and one that ends up slightly ahead of our own projections (+$2 billion vs. IOI's best case model). Our valuation model seeks to project a best case that that is stretching, but also bounded, in a sense, by our analysis of historical performance. This analysis shows accurately the potential that is out there to be captured and some entirely viable ways P&G might do so.