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Signs of Life at Procter & Gamble (PG)

Our valuation of P&G from May 2016 is put to the test by promising FY2016 financial results.

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Key Takeaways

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- **PG released it's FY2016 results on August 9 giving us more data on the Company.** Now the question is how does this new data match up with our IOI valuation framework?
- **The final results from 2016 push our valuation range up less than 10% with the most likely cases in the $80 - $85/share range.**
- **P&G is making progress on improving revenues and continuing to drive profitablity.** Both developed, and maybe more importantly, developing markets are showing signs of strengthening underlying business on the back of management's improved focus.
- **M&A remains on the table as a potential growth driver, but consistent with IOI's analysis, it will be smarter and more in the "bolt on", "strategic" arena.**

Introduction

P&G is showing signs of returning to growth and, consistent with our learnings from IOI's Tear Sheet valuation, ChartBook and Two Paths to Growth piece, they are making progress in both developed and developing markets by executing on branding and innovation.

The Company released its financial performance results for the full FY2016 on August 9th, 2016 and showed a company whose business is strengthening. Much of this is shrouded by P&G's ongoing restructuring. Indeed, the headline numbers show revenues falling by over 12% vs. last year. Adjusting for the divestitures of over 100 brands to Coty, Berkshire Hathaway and Mars, P&G's sales and volume were up vs. last year in all 5 segments. In fact, P&G's strongest performance on the top and bottom lines came in their last quarter. Profitability is on the cusp of record Owners Cash Profit margins and the Company is set to return some $14Bn to shareholders in 2017 through share count reductions and dividends.

This note takes a quick look at the full FY2016 results relative to IOI's projections and then utilizes the data from the Management Discussion and Analysis (MD&A) section of the 10-K combined with the FY2016 Results Conference Call to see what changes, if any, we might make to our valuation thinking on our key drivers of growth and performance:

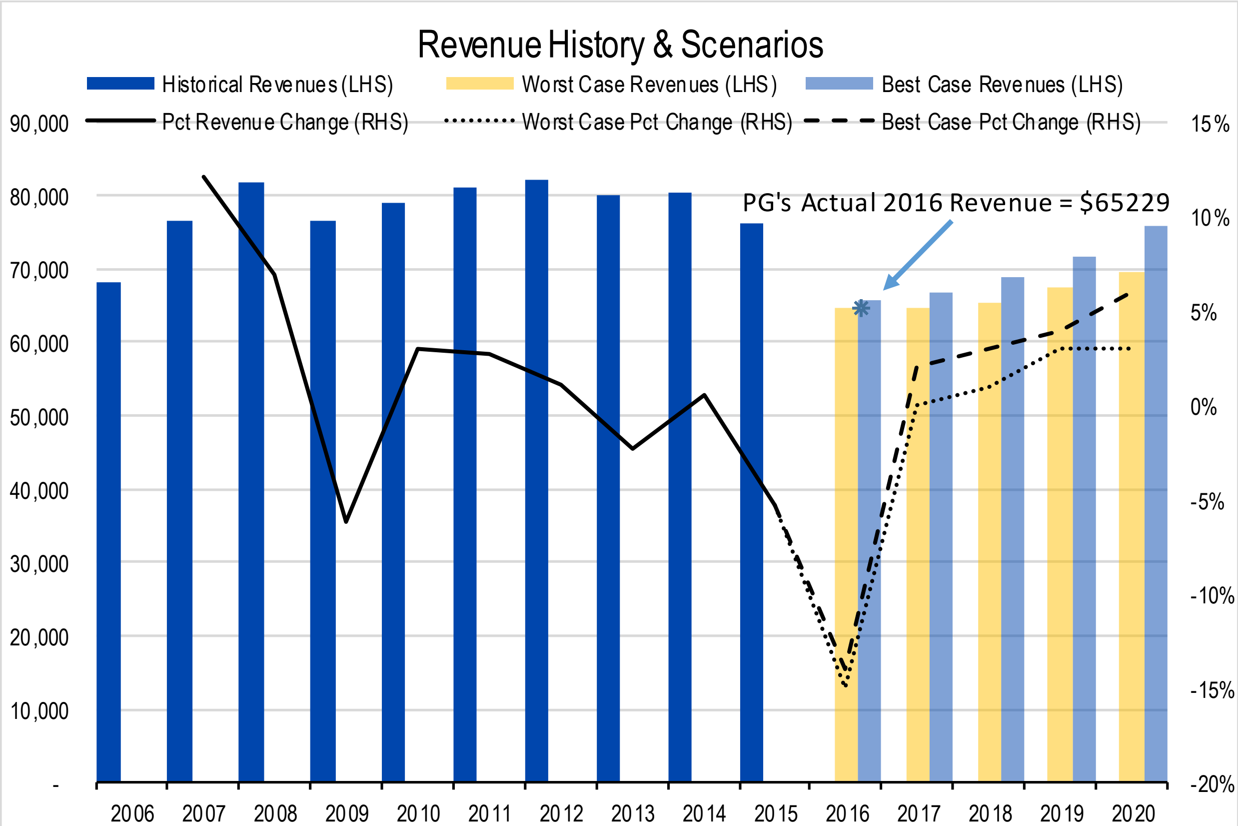
- Revenues
- Owners Cash Profits (calculated as Cash From Operations less the cost to keep the current business running)
- Investment Efficacy

What we find is that our valuation range for Procter and Gamble ticks up less than 10% to $62 - $102/share – largely due to our model mechanics. Our projections for revenue growth rate, profit margins and net expansionary cash flows remain as they were in our May reports.

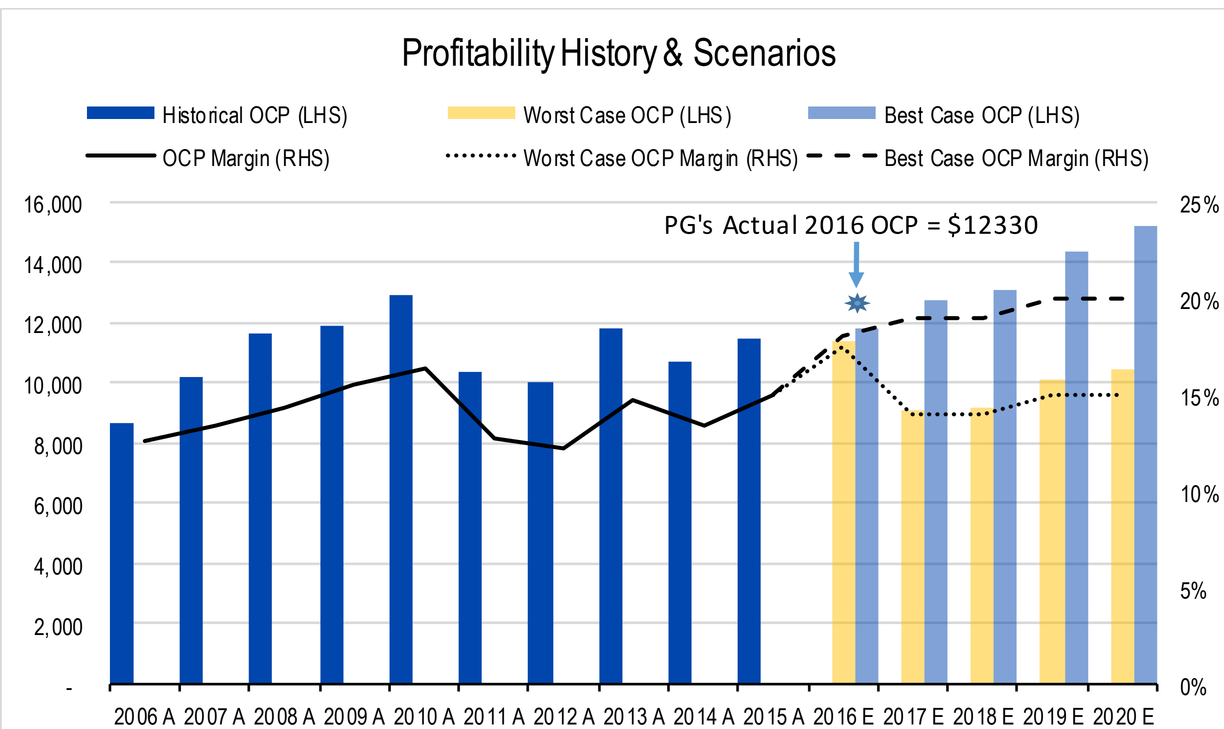
However, risks to the downside are significant and we have too little data to tell if the Company's new focus on investment and innovation will generate results that are sustainable. PG's current share price of ~$87-88/share leaves too little margin of safety to make it a good investment opportunity right now. But the strengthening business and strong shareholder return programs make it one to keep an eye on for any short term weakness.

Results vs. IOI Projections

P&G delivered results that were in line with IOI's projections for FY 2016 revenues (see chart below),



and a bit better than IOI's projections on profits as measured by owners cash profits (see chart below).



Net expansionary cash flows were right in line (Actual: 21% vs. Proj: 20%). None of this should be surprising as we had three quarters of the fiscal year complete when we did the May valuation project. The company did have a stronger 4th Quarter than we projected, even in our best case scenario – and this bodes well for the future.

Why is this quick check important, you ask? It helps us to prove to ourselves that our ability to both understand and project the explicit period of our model is at least in the right direction.

A key factor in being able to actually INVEST based on an analysis is to keep analyzing the quality of the analysis itself, such that when it comes time to ACT, we have the CONFIDENCE in our understanding of the Company in question to do so boldly.

Future Growth

You may recall we published a note about P&G's best potential paths to return to revenue growth and take utmost advantage of the Company's strong profitability (Two Paths to Growth for Procter & Gamble). The short version of that piece is that PG needed to effectively navigate the ongoing revolution in retailing while working to kick start revenue growth in both developed and developing markets. We projected that the net effect of successfully delivering on these objectives could be to add roughly $12Bn incremental to the revenue line.

So, what can we learn from the MD&A section of the 10-K and the Conference Call that helps us to better bound our upside and downside revenue, profit and net expansionary cash flow projections? Keep an eye out for the key growth drivers - things that provably impact revenues, profitability, investments and cash.

Here are the "Elite 8" things that caught our IOI eye – by growth driver.

Revenue / Demand Impacts

- The company explicitly set the following annual financial target – "organic sales growth above market growth rates in the categories and geographies in which we compete;" in the new 10-K. This is a direct commitment to delivering premium performing products that deliver premium revenues such that PG's revenue growth outstrips the market geography or segment growth. This is a tough ask given the global economic environment, but it is in line with our point about "empty share points" in our growth analysis. If P&G isn't aiming for this, one could begin to question the reality of the Company's economic moat.

- On the conference call, the Company projected "closer to 3% growth" in organic sales and at the end of the last FY organic volumes were ahead of 2015 in every segment. All this bodes well for revenue growth assuming no exchange rate effects and would be in line with our worst case projections for revenue growth at 5 years our and our best case at 3 years out.

- In a nod to the effects of global scale, despite all the press in North America about the growth of shave clubs and competition in this space over the last few years, P&G's share of the Global Shave Care market dropped half a point in 2016. The media can make a firestorm out of anything. Our challenge as analysts and business owners is to ask and answer questions about the real effects of the "story" on the actual business. While the changes occurring in retailing/e-commerce generally are material (more on that below), this specific one has had little impact to date.

- E-commerce retailing is changing the game for P&G, but they appear to have a handle on it and are making material strides to get out in front and lead it. In China, where online purchases of consumer goods are growing more rapidly than anywhere, P&G is growing share online and has more than 10% of its revenue coming online – well ahead of competition.

  P&G also appears to recognize that the barriers to entry for new competitors have come down dramatically by region and is focused on leveraging their core competencies - innovation and brand building - that are difficult to replicate and focused on quality repurchase rates. Repurchase or "turns" in CPG parlance are the lifeblood of a strong and growing consumer products business. These are predicated on understanding and providing a superior in-use experience.

Profitability Impacts

- The data shows that the Company is improving on its ability to control what it can control operationally leading to stronger profitability. This gives us some confidence in the strengthening Owners Cash Profit Margins we have projected. This is a big deal.

Comparisons as a % of Net Sales (FY ending June 30)	2016	Basis Point Change	2015	Basis Point Change	2014
Gross Margin	**49.6%**	200	47.6%	10	47.5%
Operating Margin	**20.6%**	500	15.6%	(310)	18.7%
Owners Cash Profit Margin	**16.0%**	200	14.0%	100	13.0%
Earnings from continuing operations before income tax.	**20.5%**	490	15.6%	(260)	18.2%

- P&G is executing to focus on profitability and simplify product line-ups (less cost and clearer consumer choice) in developing markets (Mexico, India and China were cited as examples). While this creates a near term drag on sales, eliminating products where P&G does not have a right to win ensures that the remaining share points in those markets are profitable ones and it focuses the Company on delivering products that are demonstrably better for consumers. This is consistent with IOI's vision to return to growth in developing markets.

Investment / Net Expansionary Cash Flow Effects

- Consistent with the Company's plans to return cash to shareholders, it expects to reduce average share counts by another 4% in FY 2017 (~$9.4Bn at current prices) as the Coty and Duracell asset sales finalize. For IOI's analysis, this was estimated by a ~$14Bn positive balance sheet impact inclusive of the cash involved in the transactions. The end result of all the asset sales will be in this ballpark leaving P&G with a sizable cash position.

- As we pointed out in the Two Path's piece, a smarter, more focused version of M&A activity remains on the table for P&G.

  "…am I am open to M&A bolt-on acquisitions that we think are strategic and would help accelerate the growth in any of our 10 core categories? The answer is clearly yes." - David Taylor, CEO

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Summing Up IOI's ReValuation of PG

There are a number of good bits of information in these two "releases" from P&G. Based on adding the above results to our model and holding our projections constant, P&G's valuation range ticked up less than 10% to between $62 and $102/share, largely for mechanical reasons. The Company's price as of the close on 25 August was $87 – so, relatively fairly valued.

It can be easy to get taken in by the "good news" flowing here, particularly if you are already a P&G investor or "sympathizer" ("hey, I should think about adding to this position!?"), but the important thing is to <u>check the effect of that news on the Company's ability to generate cash for its owners</u>. We have modeled ~$12Bn of incremental revenue growth on our best case scenario over the next 5 years. That growth is built into our price range already. It's certainly possible that all this wonderfulness will come to fruition and P&G's price reach over $100/share, but that is a stock priced for perfection on the execution side.

Risks remain to the downside if the initial bump to the businesses from the increases in investment and spending are not sustained. There are also looming demand risks from macroeconomic effects of Brexit and China or a broader global slowdown (John Moeller (CFO) highlighted these risks on the call). For us, there isn't enough margin of safety here to make the Company a good investment opportunity right now.

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