Procter & Gamble Co PG (NYSE) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
81.79 USD	90.00 USD	72.00 USD	112.50 USD	Low	Wide	Stable	Standard	Consumer Packaged Goods

Wide-Moat P&G Launders Up Profit Gains, but Top Line Remains Tepid; Shares Strike Us as Attractive

See Page 2 for the full Analyst Note from 26 Apr 2016

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The primary analyst covering this company does not own its stock.

Research as of 26 Apr 2016
Estimates as of 05 Feb 2016
Pricing data through 01 Jun 2016
Rating updated as of 01 Jun 2016

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.

Contents

Investment Thesis 25 Nov 2015

Procter & Gamble is working to course-correct from entering too many new markets quickly and failing to bring new products to market that win with consumers (particularly emerging markets, where competitors already have a leg up). However, P&G efforts to shed around 100 brands--more than half of its brand portfolio, which in aggregate posted a 3% sales decline and a 16% profit reduction the prior three years--indicates it's parting ways with its former self to become a more nimble and responsive player in the global consumer products arena. We view this as important given the stagnant growth emanating from developed markets and the slowing prospects from emerging regions.

Given its leading brand portfolio and vast resources, we contend P&G is a critical partner for retailers. And we don't think this will change as the firm slims down--the 65 brands it will keep (including 21 that generate $1 billion-$10 billion in annual sales, and another 11 that account for $500 million-$1 billion in sales each year) already account for 90% of the firm's top line and 95% of its profits. By supplying products across multiple categories (such as fabric care, baby care, feminine care, and grooming among others), trusted manufacturers like P&G are critical to retailers, which are reluctant to risk costly out-of-stocks with unproven suppliers. As such, we doubt P&G will sacrifice its scale edge but will be able to better focus its resources (both personnel and financial) on its highest-return opportunities.

Further, P&G is driving efficiency gains with its $10 billion cost-saving initiative by reducing overhead, lowering material costs from product design and formulation efficiencies, and increasing manufacturing and marketing productivity. Overall, we think the combination of these efforts will enable P&G to up its core brand spending (behind product innovation and marketing), which is key given the ultra-competitive landscape in which it plays, while resulting in improved profitability. We forecast margin expansion at the gross (up around 200 basis points to 51% relative to the last five years) and operating income line (up 400 basis points to 24%) over our explicit forecast.

Vital Statistics

Market Cap (USD Mil)	217,713
52-Week High (USD)	83.87
52-Week Low (USD)	65.02
52-Week Total Return %	7.1
YTD Total Return %	4.7
Last Fiscal Year End	30 Jun 2015
5-Yr Forward Revenue CAGR %	1.4
5-Yr Forward EPS CAGR %	6.4
Price/Fair Value	0.91

Valuation Summary and Forecasts

Fiscal Year:	2014	2015	*2016(E)*	*2017(E)*
Price/Earnings	20.4	20.8	*22.5*	*20.0*
EV/EBITDA	13.5	13.7	*14.4*	*13.8*
EV/EBIT	16.3	16.8	*17.2*	*16.1*
Free Cash Flow Yield %	4.8	5.1	*4.2*	*3.0*
Dividend Yield %	3.2	3.4	*3.5*	*3.6*

Financial Summary and Forecasts (USD Mil)

Fiscal Year:	2014	2015	*2016(E)*	*2017(E)*
Revenue	80,510	70,749	*65,454*	*67,145*
Revenue YoY %	0.5	-12.1	*-7.5*	*2.6*
EBIT	14,740	13,864	*13,837*	*14,782*
EBIT YoY %	6.7	-5.9	*-0.2*	*6.8*
Net Income, Adjusted	11,225	10,840	*10,251*	*11,061*
Net Income YoY %	3.2	-3.4	*-5.4*	*7.9*
Diluted EPS	3.86	3.76	*3.63*	*4.09*
Diluted EPS YoY %	4.1	-2.7	*-3.6*	*12.9*
Free Cash Flow	10,509	13,641	*12,122*	*19,281*
Free Cash Flow YoY %	9.9	29.8	*-11.1*	*59.1*

Historical/forecast data sources are Morningstar Estimates and may reflect adjustments.

Profile

Since its founding in 1837, Procter & Gamble has become the world's largest consumer product manufacturer. It operates with a lineup of leading brands, including 21 that generate more than $1 billion in annual global sales such as Tide laundry detergent, Charmin toilet paper, Pantene shampoo, and Pampers diapers. P&G sold its last remaining food brand, Pringles, to Kellogg in 2012. Sales outside the U.S. represent more than 60% of the firm's consolidated total, including nearly 40% of which derive from emerging markets.

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Wide-Moat P&G Launders Up Profit Gains, but Top Line Remains Tepid; Shares Strike Us as Attractive 26 Apr 2016

We don’t expect to change our $90 fair value estimate for wide-moat Procter & Gamble after the firm’s third-quarter results. Excluding foreign exchange, organic sales edged up 1%, entirely due to higher prices. But despite the tepid sales performance, we perceive the profit improvement as impressive, with a 270-basis-point increase in adjusted gross margins to 50.9% and a 300-basis-point improvement in adjusted operating margins to 22.2%. Also, the firm targets extracting another $10 billion of costs from its operations over the next five years, but is unlikely to meaningfully boost margins as the bulk is slated to fuel product innovation (which includes improved packaging) and advertising (as well as increased sampling to prompt trial) to reignite its top-line prospects. Further, we’re encouraged by management’s commitment to "cleaning up the core business" and forgoing unprofitable sales across its business (such as its commoditized bathroom tissue lineup in Mexico). Despite hindering sales to the tune of around 1%, we believe these efforts illustrate P&G is focused on profitable growth longer term rather than just boosting its market share in declining or unprofitable categories.

Management maintained its top-line guidance for the full year (June year-end)--calling for a low-single-digit increase in organic sales--but narrowed its EPS range to down 3%-6% from down 3%-8% (and anticipates a negative 9% hit from unfavorable foreign exchange). We continue to believe that with its leading brand mix and vast resources, P&G is a critical partner for retailers, which are reluctant to risk costly out-of-stocks with unproven suppliers, supporting the firm's wide moat. In that vein, P&G strikes us as an attractive investment, as the market's confidence in its competitive edge and ability to drive accelerating sales growth (to a mid-single-digit level over the next several years) has yet to materialize, and we’d recommend investors consider building a position in the name.

Similar to its consumer product peers, its volume degradation was concentrated in emerging markets (down 5%) after actions to raise prices in response to the pronounced currency devaluation in select regions. This performance materially lagged the 3% volume growth the firm chalked up in developed markets, which we think reflects P&G's emphasis on winning with innovation and is a testament to recent rhetoric that it intends to be more laser-focused on driving profitable growth. In that light, management again articulated that core earnings within its emerging markets are growing 8 times faster than underlying regional sales. We continue to expect the firm to realize growth opportunities for its brands in many overseas markets, beyond the favorable demographic and disposable income trends we anticipate that will support emerging-market growth longer term. Further, we contend that the benefits from its more focused investments (following the completion of its product rationalization efforts over the next year), and subsequently the ability to more effectively tap into and respond to evolving consumer trends should bolster the brand intangible asset source of its wide moat. Overall, we forecast low-single-digit growth in the firm's developed-market regions and mid- to high-single-digit growth in its emerging markets.

Valuation, Growth and Profitability 05 Feb 2016

We're maintaining our $90 fair value estimate for P&G, which implies forward fiscal price/adjusted earnings of 23 times, enterprise value/adjusted EBITDA of 16 times, and a free cash flow yield of 3%. We've accounted for the drag unfavorable foreign exchange is expected to have on the top (negative 7%) this year, and forecast sales to slip 7.5% this year. We contend the decision to shed 100 brands over the next year stands to enhance its focus on the highest-return opportunities. Deteriorating economic conditions in the U.S. and Europe will constrain P&G's near-term growth prospects (which in combination accounts for around 65% of the firm's total sales), but our outlook for

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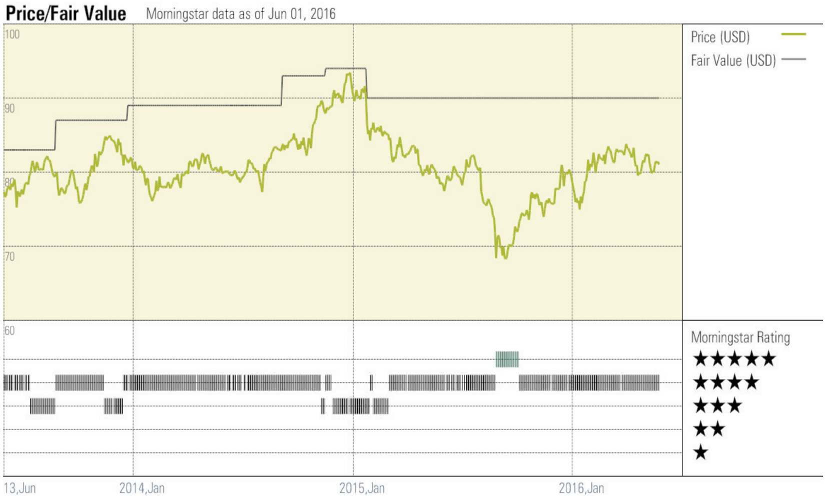
Price/Fair Value Morningstar data as of Jun 01, 2016



a top-line increase around 4% long term remains in place, with nearly two thirds of its annual growth from volume and the remainder resulting from higher prices and improved mix. Globally, P&G's categories grow roughly 3% annually, so to reach the 4% annual sales growth pace we've modeled, the firm would have to grow 1%-2% faster than the markets and categories in which it competes, which we view as achievable, particularly in light of recent strategic efforts. The firm has growth opportunities for its brands in many overseas markets, and in developed markets it remains the share leader in many of its categories.

We recognize that growth prospects in several emerging regions, which in the aggregate account for around 40% of annual sales, have also slowed over the past several quarters. However, we still believe that populations will grow exponentially, urbanization and private investment will create favorable disposable income tailwinds, and a younger consumer base will offer the potential for a lifetime of transactions ahead. We forecast low-single-digit growth in the firm's developed market regions and mid- to high-single-digit growth in its emerging markets.

Further, we're encouraged P&G is realizing some margin improvement from its ambitious initiative to shave $10 billion from its cost structure, but we ultimately think the firm will need to reinvest a portion of these savings to maintain its competitive positioning (which we peg at 3% of sales on R&D and 11.5% of sales for marketing, respectively, each year). However, we also think P&G's profitability will be boosted by the mix shift to focus on 65 brands, which already account for 95% of its profits. Our long-term forecast calls for operating margins to improve to nearly 24% by the end of our explicit forecast.

Scenario Analysis

Given the stability of its profitability and cash flows, we assign P&G a low uncertainty rating. However, the biggest risk to our valuation is whether the firm can offset intense competitive pressures and generate significant cost savings to enhance its competitive positioning. If new product launches win at the shelf with consumers, commodity costs abate, and cost savings come in quicker than we expect, our base-case forecast could prove too conservative. Under this scenario, sales would increase 4% on average over the next 10 years (compared with 3% in our base case) and operating margins would expand to 25.5% by fiscal 2025 (compared with 24% in our base case). This outlook results in around 20% upside to our fair value estimate, or roughly $110 per share.

On the other hand, if investments behind research and development as well as marketing support fail to resonate with consumers, sales growth could lag our base forecast. Further, if commodity cost pressures accelerate and competitive pressures intensify, P&G could be forced to invest even more resources behind its brands. Cost savings would fall short of management's--and our--expectations, and profitability could be constrained. Taking into account this set of assumptions, sales growth would amount to just 2% on average through fiscal 2025 while operating margins would approximate 22% at the end of our 10-year explicit

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forecast. The valuation for this downside scenario is $74.

Economic Moat

We assign a wide moat rating to Procter & Gamble resulting from its intangible assets and cost advantage. By operating as a leading household and personal care manufacturer (over 30% of baby care, 65% of blades and razors, more than 30% of feminine protection, and in excess of 30% of fabric care), we think that P&G is a valued-partner for retailers, supporting the firm’s intangible asset moat source. With resources to bring new products to market (spending nearly 3% of sales or $2 billion on research and development annually) and market that fare in front of consumers (spending almost 12% of sales or $8.3 billion annually) to drive customer traffic, P&G enhances the stickiness of its retailer relationships, in our view. Further, we believe trusted manufacturers, like P&G that maintain a product set that spans the grocery store (including baby care, hair care, fabric care, and grooming, among others) are critical to retailers that are reluctant to risk costly out-of-stocks with unproven suppliers. Despite the bargaining power garnered by a consolidating base of retailers, leading brands--like those in P&G's portfolio--still drive store traffic, supporting our contention surrounding the advantage resulting from the firm’s brand intangible asset. Further, the size and scale P&G has amassed over many years enable the firm to realize a lower unit cost than its smaller peers, resulting in a cost advantage.

P&G's announcement in 2014 that it intends to shed about 100 brands--more than half of its existing brand portfolio, which in aggregate posted a 3% sales decline and a 16% profit reduction the prior three years--indicates it is parting ways with its former self, looking to become a more nimble and responsive player in the global consumer products arena. Even a slimmed-down version of the leading global household and personal care firm will still carry significant clout with retailers, and we think these actions will support P&G's brand intangible asset and its cost advantage. The 65 brands it will keep already account for 90% of the firm’s top line and 95% of its profits. As such, we don't anticipate P&G will sacrifice its scale edge but will be able to better focus its resources (both personnel and financial) on its highest-return opportunities. Returns on invested capital (including goodwill) have averaged north of 11% annually over the past 10 years, exceeding our cost of capital estimate, and we think the firm can continue to outearn its cost of capital over the next 20 years, supporting our take that P&G maintains a wide moat.

Moat Trend

We believe recent investments are working to stabilize P&G's moat, and we view its moat trend as stable. While the firm’s pricing and brand power have come under pressure following a stream of lackluster innovation, we think the firm’s reignited focus on winning with innovation could be gaining some traction. For instance, P&G had operated as the number-two player in the U.S. diaper market for about 20 years. However, as a result of new product launches and efforts to get in front of new moms early on with increased sampling in hospitals, Pampers (P&G’s largest brand with $10 billion in annual sales) has overtaken Huggies (a Kimberly-Clark brand) and now controls more than 40% share of the U.S. diaper market, about 700 basis points above the level held by its leading competitor. The success of its recent innovation has been particularly evident in its Swaddlers’ product line (which now is sold in sizes 1 through 6, up from just 1 through 3), accounting for almost $800 million in annual sales (up from less than $200 million 10 years ago), equating to a 10% value share of the category.

The firm is also realizing an improved share position in the U.S. laundry category, now controlling about 62% of the market, up from less than 60% the past several years. Tide, P&G’s second-largest brand, has been a beneficiary,

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Morningstar Analysis

garnering 42% of the market, up from less than 40% during the past few years. We think this reflects the success of its single-dose laundry pod launch. As a segment, single-dose laundry now makes up about 12% of the overall U.S. laundry space, with P&G maintaining more than 80% of this niche (accounting for north of $750 million in annual sales). Management has called attention to the fact that single-dose laundry is even winning with dollar-store consumers, despite that it sells at a 20% premium to base Tide, given the convenience it affords. (It is easier to take a pod or two to the laundromat than a jug of liquid detergent.) We think this showcases that consumers are willing to pay up for a product when they perceive an added value.

In addition, management's laser focus on removing excess costs from its operations and enhancing its cost advantage is also stabilizing its competitive positioning. For one, CFO Jon Moeller has expressed how the extension of common manufacturing platforms around the world is proving particularly advantageous for its diaper business, a product that had been manufactured in a disparate form but is a sizable opportunity. More specifically, the company was manufacturing diapers with different materials in multiple geographies around the world, which inherently limited the negotiating leverage it could garner over suppliers. However, as the firm has worked to streamline its manufacturing and production of diapers (using the same inputs on a global basis), we expect it to exploit its purchasing leverage and ultimately enhance its cost edge. Partly as a result of these efforts, we forecast gross margins will expand by around 200 basis points over the next 10 years to 51%, relative to its average gross margin over the past five years. While we ultimately think the firm will need to reinvest a portion of these savings to maintain its competitive positioning, we still expect operating margins to improve to nearly 24% by the end of our 10-year explicit forecast (about 400 basis points above the average margin between fiscal 2005 and fiscal 2015).

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Bulls Say/Bears Say

Bulls Say

- Despite rationalizing its brand mix, P&G will still operate with a portfolio of leading brands across the household and personal-care arena, making it a crucial partner for retailers looking to drive traffic in their stores.
- The firm's $10 billion cost-cutting initiative looks to trim its workforce, localize the sourcing of raw materials and product development, and reduce its manufacturing platforms.
- P&G increased core earnings at 4 times the level of sales in emerging markets in fiscal 2014 but 8 times sales in these regions in fiscal 2015, supporting the firm's cost edge.

Bears Say

- Although oil prices have declined, the firm and its industry peers are still battling increased transportation costs (primarily reflecting truck driver shortages), which will restrict potential profit gains.
- Volatile changes in foreign exchange can significantly weigh on P&G's bottom line, given that the firm makes and sells its wares in different locations.
- Management has noted that the competitive pressures resulting from local peers (rather than other multinationals) in emerging markets has intensified, highlighting the importance of understanding each region on a detailed level.

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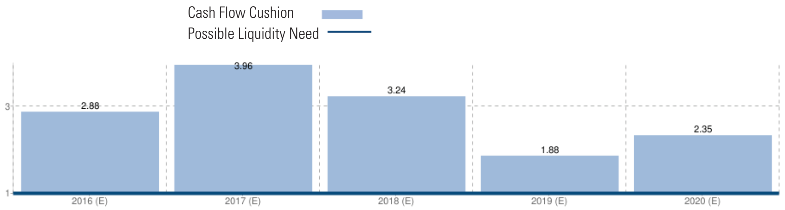
Five Year Adjusted Cash Flow Forecast (USD Mil)

	2016(E)	2017(E)	2018(E)	2019(E)	2020(E)
Cash and Equivalents (beginning of period)	6,845	1,937	5,141	2,888	3,633
Adjusted Available Cash Flow	5,338	12,278	4,222	4,495	4,647
Total Cash Available before Debt Service	12,183	14,215	9,363	7,383	8,281
Principal Payments	-2,772	-2,094	-1,330	-2,355	-1,929
Interest Payments	-669	-728	-791	-814	-837
Other Cash Obligations and Commitments	-782	-767	-770	-766	-764
Total Cash Obligations and Commitments	-4,223	-3,589	-2,891	-3,935	-3,530

Cumulative Annual Cash Flow Cushion



Adjusted Cash Flow Summary

	USD Millions	% of Commitments
Beginning Cash Balance	6,845	37.7
Sum of 5-Year Adjusted Free Cash Flow	30,981	170.5
Sum of Cash and 5-Year Cash Generation	37,826	208.2
Revolver Availability	11,000	60.6
Asset Adjusted Borrowings (Repayment)	—	—
Sum of Cash, 5-Year Cash Generation, Revolver and Adjustments	48,826	268.8
Sum of 5-Year Cash Commitments	-18,168	—

Financial Health

P&G takes a fairly conservative approach to its capital structure, keeping its focus on maintaining investment-grade credit to be able to cost-effectively deploy capital as it sees fit. We currently assign the company an issuer credit rating of AA, implying low default risk. Total debt/capital averaged 0.3 during the past five years, and debt/adjusted EBITDA averaged 1.8. We expect that upholding these levels or better will remain a priority for P&G. Free cash flow has averaged around 13% of sales over the past five years, and we anticipate the firm will generate a slightly higher amount (about 16% of sales) through fiscal 2025. Further, we don't think P&G will struggle to service its debt maturities, which average about $2.1 billion annually between fiscal 2016 and fiscal 2020. The firm maintains a healthy amount of cash on its balance sheet, but given management's commitment to step up investment in the business during the next several years, we doubt there is much appetite to raid the piggy bank for a large acquisition. Beyond reinvesting in the business, we expect that dividend payments will remain a top priority of cash (as the firm has paid a dividend to its shareholders consistently for more than 125 years), and we forecast mid- to high-single-digit dividend increases during the next 10 years. P&G's dividend yields north of 3% annually. On average, we also forecast that the company will buy back around 1% of shares each year over our 10-year explicit forecast.

Enterprise Risk

Like others, P&G has fallen victim to weak and volatile consumer spending combined with persistent cost inflation that has yet to fully abate. Promotional spending over the past several years has conditioned consumers to expect lower prices, and lackluster innovation has, in some instances, failed to prompt consumers to pay up for its new products. Further, with more than 60% of its sales derived outside the U.S., P&G is exposed to foreign exchange rate fluctuations, which could have a negative impact on its

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financial performance, with a more pronounced profit impact, as the firm isn't manufacturing in the locations its selling, a challenge that is unlikely to fully abate.Slowing growth rates around the world, competitive pricing, and unfavorable foreign exchange trends have played a part in P&G's woes, but we think the problems run deeper, as the firm might have overextended itself in its endeavors to build out its product portfolio and geographic footprint. While P&G was slow to react, management has responded with a massive $10 billion cost-saving initiative to dramatically reduce head count and ultimately free up funds to reinvest in its business. More recently, the firm has followed these cost cuts with plans to halve its brand portfolio to better focus its resources, which we view positively.From a category perspective, despite some of the gains the firm is realizing within the U.S. diaper and laundry categories, beauty remains a challenge, as organic sales growth has remained elusive. Management has noted that Olay in particular continues to struggle, although Pantene appears to be gaining some traction, posting mid-single-digit organic sales growth and expanding its share base over the past several months. And while this is a modest positive, we think P&G's performance in the beauty category could prove lumpy given the fierce competitive dynamics, particularly within U.S. hair care.

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Management & Ownership

Management Activity

Name	Position	Shares Held	Report Date*	InsiderActivity
ALAN G LAFLEY	Director	565,657	05 May 2016	257,775
JON R. MOELLER		105,526	29 Feb 2016	—
MARC S. PRITCHARD		104,169	29 Feb 2016	—
CAROLYN M. TASTAD		64,175	11 May 2016	—
W JAMES MCNERNEY JR	Director	62,272	08 Mar 2016	—
MR. SCOTT D. COOK	Director	62,262	08 Mar 2016	—
HATSUNORI KIRIYAMA		54,130	28 Aug 2015	—
DEBORAH P. MAJORAS		43,468	29 Feb 2016	—
GIOVANNI CISERANI		40,942	29 Feb 2016	—
DR. ERNESTO ZEDILLO	Director	40,162	08 Dec 2015	—

*Represents the date on which the owner's name, position, and common shares held were reported by the holder or issuer.

Fund Ownership

Top Owners	% of Shares Held	% of Fund Assets	Change (k)	Portfolio Date
Vanguard Total Stock Mkt Idx	1.97	0.99	388	30 Apr 2016
Vanguard 500 Index Fund	1.26	1.17	112	30 Apr 2016
Vanguard Institutional Index Fund	1.10	1.18	58	30 Apr 2016
SPDR® S&P 500 ETF	1.02	1.18	-70	27 May 2016
SPDR® S&P 500® ETF Trust	0.94	1.25	—	31 Mar 2016
Concentrated Holders				
Fidelity® Select Consumer Staples Port	0.20	12.81	33	30 Apr 2016
AMG Yacktman Focused Fund	0.29	12.02	-1,100	31 Mar 2016
Consumer Staples Select Sector SPDR® Fd	0.52	11.48	15	27 May 2016
SPDR® S&P US Cnsmr Staples Sel Sect ETF	—	11.43	5	30 Apr 2016
Fidelity® MSCI Consumer Staples ETF	0.01	10.98	—	27 May 2016

Institutional Transactions

Top 5 Buyers	% of Shares Held	% of Fund Assets	Shares Bought/ Sold (k)	Portfolio Date
Procter & Gamble Company Profit Sharing Trust and Employee Stock Ownershi	3.11	37.12	94,377	30 Jun 2008
BlackRock Investment Management (UK) Ltd.	0.53	0.98	14,114	31 Mar 2016
BlackRock Fund Advisors	2.99	0.97	8,538	31 Mar 2016
Managed Account Advisors LLC	0.49	0.81	4,437	31 Mar 2016
New Jersey Division of Pensions and Benefits	0.14	0.38	3,930	30 Jun 2010
Top 5 Sellers				
Berkshire Hathaway Inc	0.01	0.02	-52,478	31 Mar 2016
Vanguard Group Inc	6.19	0.88	-7,325	31 Mar 2016
J.P. Morgan Investment Management Inc	0.33	0.33	-4,760	31 Mar 2016
Invesco Advisers, Inc	0.27	0.41	-3,085	31 Mar 2016
State of New Jersey Common Pension Fd D	0.10	1.00	-2,904	31 Mar 2016

Management 25 Nov 2015

After more than two years back at the helm, Procter & Gamble has tapped David Taylor--a 35-year company veteran, who most recently headed up the healthcare business since 2013 and brought beauty care and grooming into his fold--to succeed CEO A.G. Lafley, who continues to serve as executive chairman to ensure a smooth transition. We weren't surprised Lafley would look to step down from running the day-to-day operations as P&G closes the chapter on strategic efforts put in place in the summer of 2014 to shed more than half of its brand portfolio.

From an internal perspective, Taylor struck us as the heir apparent, given his grasp of P&G's vast product and geographic footprint. We also don't think this change in the management suite will shift the firm's standard stewardship of shareholder capital. We expect Taylor to continue implementing the playbook P&G has been operating under the past few years--maintaining a stringent eye on extracting costs from its operations, while fueling investments behind product innovation that resonates with consumers and marketing. From our view, these initiatives are likely to play out over the next few years rather than a couple of months. Beyond articulating and implementing the firm's strategic efforts, we think the onus will be on him to ensure P&G's large global employee base remains engaged in its strategic direction (unlike a few years ago).

From our view, the strategic decision to shed 100 brands will quell calls to split up the company (given past challenges to respond in a timely fashion to changing market dynamics) at least over the short term. However, we think that if results remain lackluster, calls for the firm to break up into its individual segments (likely beauty and home care) could increase, although we view such actions as a lower-probability event at this point.

Returns on invested capital (including goodwill) have historically exceeded our cost of capital estimate, and we expect this will remain the case going forward. In addition, we are encouraged by the stock-ownership requirements for senior management, which range from four to eight times base salary, as this tends to align management's interests with those of shareholders. In fiscal 2015, Lafley earned nearly $18 million in salary, bonus, and stock awards (including a $12 million stock award).

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Analyst Notes

Despite Muted Sales, Profit Gains Persist for Wide-Moat P&G in 2Q; Shares Still Offer Upside 26 Jan 2016

Procter & Gamble's second-quarter results support our contention that efforts to extract costs and rationalize the brand mix are gaining traction. Excluding foreign exchange, underlying sales ticked up 2%, reflecting higher prices. However, beyond shedding 100 of its brands, management emphasized its commitment to "cleaning up the core business" and forgoing unprofitable sales across its business. While these efforts hampered organic growth by about 1%, we believe this shows P&G is focused on driving long-term profitable growth. We viewed the firm's profit improvement as impressive, with a 290-basis-point increase in adjusted gross margins to 50.8% and a 390-basis-point improvement in adjusted operating margins to 23.5%. We expect these productivity savings will fuel further brand reinvestment.

Even after ratcheting back our current-year sales forecast to reflect a more pronounced hit from unfavorable foreign currency movements (which management now pegs at 7%, up from 5%-6%), the impact to our $90 fair value estimate is negligible. Longer term, our forecast for annual sales growth amounts to around 4%, with just less than two thirds of annual growth resulting from higher volume and the remainder from increased prices and improved mix. We expect operating margins of 23% (about 400 basis points above the average of the past five years) as the firm reinvests a portion of any savings realized to support the intangible asset source of its wide moat.

We haven't wavered from our stance that with its leading brand mix and vast resources, P&G is a critical partner for retailers, which are reluctant to risk costly out-of-stocks with unproven suppliers, supporting the firm's competitive edge. But we still don't believe the market shares our assertion regarding the firm's competitive prowess and ability to reignite its top line. Despite the recent runup in the share price, we still view P&G's valuation as attractive.

P&G's lackluster volume was concentrated in emerging markets (down 6%) following actions to raise prices in response to the pronounced currency devaluation that has ensued in select regions, with management calling out Russia. Conversely, volume in developed markets edged up 2%, reflecting P&G's reignited focus on winning with innovation. Despite recent pressure, we still believe the firm has growth opportunities for its brands in many overseas markets, beyond the favorable demographic and disposable income trends we anticipate that will support emerging-market growth longer term. As P&G wraps up its product rationalization efforts over the next year, we think the benefits of its more focused investments (and hence an ability to more effectively tap into and respond to evolving consumer trends) should yield improvements across its product mix, including in grooming, hair care, adult incontinence, and feminine care, driving accelerating sales and volume growth and subsequently aiding the brand intangible asset source of its wide moat.

While we continue to believe that P&G's efforts to focus on core brands will aid financial performance, beauty remains a particular challenge. Organic segment sales growth (up 1% in the second quarter) has yet to prove sustainable; the product set has failed to consistently win with consumers. Management has noted that Olay (which we estimate approximates 3%-4% of consolidated sales) has been a particular point of weakness, although Pantene (which we suspect contributes about the same to the firm's total sales base) appears to be gaining some traction, posting a mid-single-digit increase in organic sales and expanding its share base over the past several months. While this is a modest positive, we think P&G's performance in the beauty category could prove lumpy given the fierce competitive dynamics, especially in U.S. hair care. We hope to garner additional perspective on the firm's strategic efforts to

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81.79 USD	90.00 USD	72.00 USD	112.50 USD	Low	Wide	Stable	Standard	Consumer Packaged Goods

Analyst Notes

bolster its top line and competitive positioning when we attend the Consumer Analyst Group of New York conference next month.

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Morningstar Analyst Forecasts

Financial Summary and Forecasts

Fiscal Year Ends in June

Growth (% YoY)	3-Year Hist. CAGR	2013	2014	2015	Forecast 2016	Forecast 2017	5-Year Proj. CAGR
Revenue	-5.4	-4.3	0.5	-12.1	-7.5	2.6	1.4
EBIT	-4.5	-13.2	6.7	-5.9	-0.2	6.8	4.7
EBITDA	-3.9	-12.2	6.4	-4.9	-2.6	3.8	3.4
Net Income	-1.2	-3.1	3.2	-3.4	-5.4	7.9	3.7
Diluted EPS	-0.5	-2.8	4.1	-2.7	-3.6	12.9	6.4
Earnings Before Interest, after Tax	-1.6	-1.4	15.0	-15.9	-10.3	19.1	5.1
Free Cash Flow	4.9	-19.2	9.9	29.8	-11.1	59.1	-1.0

Profitability	3-Year Hist. Avg	2013	2014	2015	2016	2017	5-Year Proj. Avg
Operating Margin %	18.4	17.3	18.3	19.6	21.1	22.0	22.3
EBITDA Margin %	22.4	21.0	22.2	24.0	25.3	25.6	25.9
Net Margin %	14.3	13.6	13.9	15.3	15.7	16.5	16.6
Free Cash Flow Margin %	14.8	11.9	13.1	19.3	18.5	28.7	19.5
ROIC %	9.6	9.4	10.1	9.5	11.5	12.8	13.8
Adjusted ROIC %	18.8	18.4	19.6	18.4	22.5	23.6	24.6
Return on Assets %	7.3	8.4	8.4	5.1	7.1	13.7	10.2
Return on Equity %	15.4	17.7	17.6	10.9	15.6	32.3	24.7

Leverage	3-Year Hist. Avg	2013	2014	2015	2016	2017	5-Year Proj. Avg
Debt/Capital	0.33	0.32	0.34	0.33	0.36	0.40	0.40
Total Debt/EBITDA	1.88	1.88	1.98	1.79	1.84	1.99	1.86
EBITDA/Interest Expense	25.85	25.19	25.22	27.15	24.74	23.60	23.75

Valuation Summary and Forecasts

	2014	2015	2016(E)	2017(E)
Price/Fair Value	0.88	0.87	—	—
Price/Earnings	20.4	20.8	22.5	20.0
EV/EBITDA	13.5	13.7	14.4	13.8
EV/EBIT	16.3	16.8	17.2	16.1
Free Cash Flow Yield %	4.8	5.1	4.2	3.0
Dividend Yield %	3.2	3.4	3.5	3.6

Key Valuation Drivers

Cost of Equity %	7.5
Pre-Tax Cost of Debt %	5.5
Weighted Average Cost of Capital %	7.1
Long-Run Tax Rate %	24.2
Stage II EBI Growth Rate %	4.7
Stage II Investment Rate %	3.9
Perpetuity Year	20

Additional estimates and scenarios available for download at http://select.morningstar.com.

Discounted Cash Flow Valuation

	USD Mil	Firm Value (%)	Per Share Value
Present Value Stage I	99,954	36.4	36.07
Present Value Stage II	73,478	26.7	26.51
Present Value Stage III	101,494	36.9	36.62
Total Firm Value	**274,926**	**100.0**	**99.21**
Cash and Equivalents	11,612	—	4.19
Debt	-30,350	—	-10.95
Preferred Stock	-1,077	—	-0.39
Other Adjustments	-13,171	—	-4.75
Equity Value	**241,939**	**—**	**87.30**
Projected Diluted Shares	2,771		
Fair Value per Share (USD)	—		

The data in the table above represent base-case forecasts in the company's reporting currency as of the beginning of the current year. Our fair value estimate may differ from the equity value per share shown above due to our time value of money adjustment and in cases where probability-weighted scenario analysis is performed.

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Morningstar Analyst Forecasts

Income Statement (USD Mil)

Fiscal Year Ends in June				*Forecast*	
	2013	2014	2015	*2016*	*2017*
Revenue	**80,116**	**80,510**	**70,749**	***65,454***	***67,145***
Cost of Goods Sold	39,991	41,010	36,538	*32,203*	*32,968*
Gross Profit	**40,125**	**39,500**	**34,211**	***33,251***	***34,177***
Selling, General & Administrative Expenses	11,574	10,419	7,251	*7,200*	*7,252*
Research & Development	2,023	2,000	2,047	*1,964*	*2,014*
Advertising & Marketing	9,729	9,200	8,290	*7,527*	*7,722*
Depreciation & Amortization (if reported separately)	2,982	3,141	2,759	*2,723*	*2,407*
Operating Income (ex charges)	**13,817**	**14,740**	**13,864**	***13,837***	***14,782***
Restructuring & Other Cash Charges	956	806	2,028	*700*	*400*
Impairment Charges (if reported separately)	308	—	787	*1,050*	—
Other Non-Cash (Income)/Charges	—	—	—	—	—
Operating Income (incl charges)	**12,553**	**13,934**	**11,049**	***12,087***	***14,382***
Interest Expense	667	709	626	*669*	*728*
Interest Income	1,029	306	589	*500*	*500*
Pre-Tax Income	**12,915**	**13,531**	**11,012**	***11,918***	***14,153***
Income Tax Expense	3,003	3,011	2,725	*2,979*	*3,397*
Other After-Tax Cash Gains (Losses)	—	78	-108	—	—
Other After-Tax Non-Cash Gains (Losses)	1,485	1,273	-1,143	—	*6,000*
(Minority Interest)	—	—	—	—	—
(Preferred Dividends)	—	—	—	—	—
Net Income	**11,397**	**11,871**	**7,036**	***8,938***	***16,757***
Weighted Average Diluted Shares Outstanding	2,931	2,905	2,884	*2,827*	*2,702*
Diluted Earnings Per Share	**3.89**	**4.09**	**2.44**	***3.16***	***6.20***
Adjusted Net Income	10,882	11,225	10,840	*10,251*	*11,061*
Diluted Earnings Per Share (Adjusted)	**3.71**	**3.86**	**3.76**	***3.63***	***4.09***
Dividends Per Common Share	2.22	2.38	2.53	*2.72*	*2.92*
EBITDA	**15,535**	**17,075**	**14,183**	***14,810***	***16,789***
Adjusted EBITDA	**16,799**	**17,881**	**16,998**	***16,560***	***17,189***

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Morningstar Analyst Forecasts

Balance Sheet (USD Mil)

Fiscal Year Ends in June

	2013	2014	2015	*Forecast 2016*	*Forecast 2017*
Cash and Equivalents	5,947	8,558	6,845	*1,937*	*5,141*
Investments	—	2,128	4,767	*4,767*	*4,767*
Accounts Receivable	6,508	6,386	4,861	*4,662*	*4,820*
Inventory	6,909	6,759	5,454	*5,117*	*5,230*
Deferred Tax Assets (Current)	948	1,092	1,356	*1,315*	*1,276*
Other Short Term Assets	3,678	3,845	2,853	*5,000*	*2,853*
Current Assets	**23,990**	**28,768**	**26,136**	***22,799***	***24,086***
Net Property Plant, and Equipment	21,666	22,304	20,268	*20,090*	*21,265*
Goodwill	55,188	53,704	47,316	*46,156*	*36,331*
Other Intangibles	31,572	30,843	26,829	*25,817*	*25,424*
Deferred Tax Assets (Long-Term)	—	—	—	—	—
Other Long-Term Operating Assets	6,847	5,798	5,436	*5,029*	*5,159*
Long-Term Non-Operating Assets	—	2,849	3,510	*3,510*	*9,510*
Total Assets	**139,263**	**144,266**	**129,495**	***123,401***	***121,775***
Accounts Payable	8,777	8,461	8,257	*7,588*	*7,741*
Short-Term Debt	12,432	15,606	12,021	*13,000*	*15,500*
Deferred Tax Liabilities (Current)	—	—	—	—	—
Other Short-Term Liabilities	8,828	8,999	8,325	*11,000*	*8,325*
Current Liabilities	**30,037**	**33,066**	**28,603**	***31,588***	***31,566***
Long-Term Debt	19,111	19,811	18,329	*17,500*	*18,750*
Deferred Tax Liabilities (Long-Term)	10,827	10,218	9,531	*9,531*	*9,531*
Other Long-Term Operating Liabilities	2,839	2,645	1,798	*1,663*	*1,706*
Long-Term Non-Operating Liabilities	7,740	8,550	8,184	*8,184*	*8,184*
Total Liabilities	**70,554**	**74,290**	**66,445**	***68,466***	***69,737***
Preferred Stock	1,137	1,111	1,077	*1,077*	*1,077*
Common Stock	4,009	4,009	4,009	*4,009*	*4,009*
Additional Paid-in Capital	63,538	63,911	63,852	*63,852*	*63,852*
Retained Earnings (Deficit)	80,197	84,990	84,807	*86,064*	*94,930*
(Treasury Stock)	-71,966	-75,805	-77,226	*-85,651*	*-97,429*
Other Equity	-8,851	-9,002	-14,100	*-15,000*	*-15,000*
Shareholder's Equity	**68,064**	**69,214**	**62,419**	***54,351***	***51,439***
Minority Interest	645	762	631	*584*	*599*
Total Equity	**68,709**	**69,976**	**63,050**	***54,935***	***52,038***

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Morningstar Analyst Forecasts

Cash Flow (USD Mil)

Fiscal Year Ends in June	2013	2014	2015	*Forecast 2016*	*Forecast 2017*
Net Income	11,402	11,785	7,144	*8,938*	*16,757*
Depreciation	2,454	2,627	2,677	*2,291*	*2,014*
Amortization	528	514	457	*432*	*393*
Stock-Based Compensation	346	360	337	*335*	*337*
Impairment of Goodwill	308	—	2,174	—	—
Impairment of Other Intangibles	—	—	—	—	—
Deferred Taxes	-307	-44	-803	*41*	*39*
Other Non-Cash Adjustments	-539	177	2,008	—	*-6,000*
(Increase) Decrease in Accounts Receivable	-415	87	349	*199*	*-157*
(Increase) Decrease in Inventory	-225	8	313	*337*	*-113*
Change in Other Short-Term Assets	—	—	—	*-2,147*	*-1,128*
Increase (Decrease) in Accounts Payable	1,253	1	928	*-669*	*153*
Change in Other Short-Term Liabilities	68	-1,557	-976	*2,675*	*-2,675*
Cash From Operations	**14,873**	**13,958**	**14,608**	***12,430***	***9,621***
(Capital Expenditures)	-4,008	-3,848	-3,736	*-3,273*	*-3,189*
Net (Acquisitions), Asset Sales, and Disposals	-561	546	4,360	*2,900*	*13,100*
Net Sales (Purchases) of Investments	-1,726	-805	-2,607	—	—
Other Investing Cash Flows	—	—	-908	*272*	*-87*
Cash From Investing	**-6,295**	**-4,107**	**-2,891**	***-100***	***9,824***
Common Stock Issuance (or Repurchase)	-2,537	-3,911	-1,778	*-8,425*	*-11,778*
Common Stock (Dividends)	-6,519	-6,911	-7,287	*-7,681*	*-7,891*
Short-Term Debt Issuance (or Retirement)	3,406	3,304	-2,580	*979*	*2,500*
Long-Term Debt Issuance (or Retirement)	-1,421	239	-1,374	*-829*	*1,250*
Other Financing Cash Flows	—	—	—	*-382*	*-322*
Cash From Financing	**-7,071**	**-7,279**	**-13,019**	***-16,338***	***-16,240***
Exchange Rates, Discontinued Ops, etc. (net)	4	39	-411	*-900*	—
Net Change in Cash	**1,511**	**2,611**	**-1,713**	***-4,908***	***3,204***

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Comparable Company Analysis

These companies are chosen by the analyst and the data are shown by nearest calendar year in descending market capitalization order.

Valuation Analysis

		Price/Earnings			EV/EBITDA			Price/Free Cash Flow			Price/Book			Price/Sales		
Company/Ticker	Price/Fair Value	2015	2016(E)	2017(E)	2015	2016(E)	2017(E)	2015	2016(E)	2017(E)	2015	2016(E)	2017(E)	2015	2016(E)	2017(E)
Unilever NV UNA NLD	1.01	23.6	*22.4*	*21.4*	13.2	*13.2*	*12.8*	22.1	*28.9*	*23.8*	7.9	*7.1*	*6.3*	2.3	*2.3*	*2.3*
L'Oreal SA OR FRA	1.07	25.5	*25.7*	*24.1*	16.6	*16.7*	*15.8*	28.7	*25.7*	*24.4*	3.7	*3.8*	*3.6*	3.4	*3.6*	*3.4*
Colgate-Palmolive Co CL USA	1.00	30.4	*26.1*	*24.0*	15.0	*16.3*	*15.3*	26.3	*26.4*	*25.2*	NM	*NM*	*NM*	3.7	*4.1*	*3.9*
Kimberly-Clark Corp KMB USA	1.17	22.3	*21.5*	*20.2*	13.5	*13.4*	*12.8*	36.8	*25.3*	*22.9*	NM	*NM*	*197.2*	2.5	*2.5*	*2.5*
Average		25.5	*23.9*	*22.4*	14.6	*14.9*	*14.2*	28.5	*26.6*	*24.1*	5.8	*5.5*	*69.0*	3.0	*3.1*	*3.0*
Procter & Gamble Co PG US	**0.91**	**20.8**	***22.5***	***20.0***	**13.7**	***14.4***	***13.8***	**19.5**	***23.8***	***33.9***	**3.4**	***4.0***	***4.2***	**3.0**	***3.3***	***3.2***

Returns Analysis

		ROIC %			Adjusted ROIC %			Return on Equity %			Return on Assets %			Dividend Yield %		
Company/Ticker	Last Historical Year Total Assets (Mil)	2015	2016(E)	2017(E)	2015	2016(E)	2017(E)	2015	2016(E)	2017(E)	2015	2016(E)	2017(E)	2015	2016(E)	2017(E)
Unilever NV UNA NLD	52,298 EUR	17.5	*16.6*	*16.7*	33.0	*29.5*	*29.2*	33.8	*31.6*	*29.5*	9.8	*10.0*	*10.4*	2.7	*2.7*	*2.8*
L'Oreal SA OR FRA	33,711 EUR	13.1	*12.6*	*13.3*	18.7	*17.9*	*18.8*	15.1	*15.1*	*15.2*	10.0	*10.6*	*10.7*	1.8	*1.5*	*1.9*
Colgate-Palmolive Co CL USA	11,958 USD	25.6	*28.1*	*30.0*	32.6	*36.0*	*38.4*	327.2	*-818.8*	*NM*	10.9	*19.2*	*20.3*	2.5	*2.2*	*2.3*
Kimberly-Clark Corp KMB USA	14,842 USD	17.2	*20.4*	*22.0*	19.8	*23.4*	*25.3*	365.1	*NM*	*NM*	6.7	*14.6*	*15.2*	2.8	*2.6*	*2.7*
Average		18.4	*19.4*	*20.5*	26.0	*26.7*	*27.9*	185.3	*-257.4*	*22.4*	9.3	*13.6*	*14.2*	2.5	*2.3*	*2.4*
Procter & Gamble Co PG US	— USD	**9.5**	***11.5***	***12.8***	**18.4**	***22.5***	***23.6***	**10.9**	***15.6***	***32.3***	**5.1**	***7.1***	***13.7***	**3.4**	***3.5***	***3.6***

Growth Analysis

		Revenue Growth %			EBIT Growth %			EPS Growth %			Free Cash Flow Growth %			Dividend/Share Growth %		
Company/Ticker	Last Historical Year Revenue (Mil)	2015	2016(E)	2017(E)	2015	2016(E)	2017(E)	2015	2016(E)	2017(E)	2015	2016(E)	2017(E)	2015	2016(E)	2017(E)
Unilever NV UNA NLD	53,272 EUR	10.0	*-1.6*	*3.3*	-9.1	*5.8*	*3.4*	-8.9	*6.4*	*4.5*	-30.5	*9.4*	*20.1*	4.5	*-1.2*	*4.5*
L'Oreal SA OR FRA	25,257 EUR	12.1	*3.0*	*5.2*	12.8	*5.9*	*5.8*	19.4	*7.4*	*6.9*	37.5	*43.3*	*-7.6*	0.1	*-8.0*	*25.8*
Colgate-Palmolive Co CL USA	16,034 USD	-7.2	*-3.8*	*4.6*	-1.3	*0.6*	*7.1*	-16.5	*24.6*	*8.9*	-4.3	*2.5*	*5.8*	4.9	*-5.8*	*8.0*
Kimberly-Clark Corp KMB USA	18,591 USD	-5.7	*-1.9*	*3.1*	7.0	*2.1*	*4.8*	19.2	*4.3*	*6.6*	-31.1	*57.7*	*8.4*	4.3	*-5.8*	*6.6*
Average		2.3	*-1.1*	*4.1*	2.4	*3.6*	*5.3*	3.3	*10.7*	*6.7*	-7.1	*28.2*	*6.7*	3.5	*-5.2*	*11.2*
Procter & Gamble Co PG US	**70,749** USD	**-12.1**	***-7.5***	***2.6***	**-5.9**	***-0.2***	***6.8***	**-2.7**	***-3.6***	***12.9***	**29.8**	***-11.1***	***59.1***	**6.2**	***7.5***	***7.5***

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Profitability Analysis

		Gross Margin %			EBITDA Margin %			Operating Margin %			Net Margin %			Free Cash Flow Margin %		
Company/Ticker	Last Historical Year Net Income (Mil)	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*
Unilever NV UNA NLD	4,909 EUR	42.2	*42.1*	*42.1*	16.9	*17.7*	*17.7*	14.3	*15.4*	*15.4*	9.2	*9.9*	*10.0*	10.4	*8.1*	*9.5*
L'Oreal SA OR FRA	3,440 EUR	71.2	*71.3*	*71.4*	21.1	*21.6*	*21.7*	17.4	*17.9*	*18.0*	13.6	*14.1*	*14.2*	12.0	*14.1*	*14.1*
Colgate-Palmolive Co CL USA	1,991 USD	58.6	*58.8*	*59.0*	27.0	*27.5*	*28.1*	24.2	*25.3*	*25.9*	12.4	*16.0*	*16.4*	14.1	*15.6*	*15.7*
Kimberly-Clark Corp KMB USA	2,090 USD	35.6	*35.5*	*35.6*	21.1	*21.8*	*22.1*	17.1	*17.8*	*18.1*	11.2	*11.8*	*12.0*	6.7	*10.0*	*10.7*
Average		51.9	*51.9*	*52.0*	21.5	*22.2*	*22.4*	18.3	*19.1*	*19.4*	11.6	*13.0*	*13.2*	10.8	*12.0*	*12.5*
Procter & Gamble Co PG US	**10,840** USD	**48.4**	***50.8***	***50.9***	**24.0**	***25.3***	***25.6***	**19.6**	***21.1***	***22.0***	**15.3**	***15.7***	***16.5***	**15.4**	***14.0***	***9.6***

Leverage Analysis

		Debt/Equity %			Debt/Total Cap %			EBITDA/Interest Exp.			Total Debt/EBITDA			Assets/Equity		
Company/Ticker	Last Historical Year Total Debt (Mil)	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*
Unilever NV UNA NLD	14,236 EUR	92.2	*66.9*	*54.3*	48.0	*40.1*	*35.2*	16.5	*14.9*	*17.5*	1.6	*1.2*	*1.1*	3.4	*3.0*	*2.7*
L'Oreal SA OR FRA	782 EUR	3.3	*5.0*	*2.1*	3.2	*4.8*	*2.1*	385.6	*275.3*	*290.2*	0.1	*0.2*	*0.1*	1.4	*1.4*	*1.4*
Colgate-Palmolive Co CL USA	6,571 USD	-2,197.7	*-2,563.5*	*-4,458.8*	104.8	*104.1*	*102.3*	32.5	*30.0*	*31.9*	1.5	*1.6*	*1.5*	-40.0	*-45.8*	*-82.9*
Kimberly-Clark Corp KMB USA	7,775 USD	-4,468.4	*308,649.5*	*3,187.3*	102.3	*100.0*	*97.0*	13.3	*13.0*	*13.6*	2.0	*1.9*	*1.8*	-85.3	*NM*	*64.0*
Average		-1,642.7	*76,539.5*	*-303.8*	64.6	*62.3*	*59.2*	112.0	*83.3*	*88.3*	1.3	*1.2*	*1.1*	-30.1	*-13.8*	*-3.7*
Procter & Gamble Co PG US	**30,350** USD	**48.6**	***56.1***	***66.6***	**32.7**	***36.0***	***40.0***	**27.2**	***24.7***	***23.6***	**1.8**	***1.8***	***2.0***	**2.1**	***2.3***	***2.4***

Liquidity Analysis

		Cash per Share			Current Ratio			Quick Ratio			Cash/Short-Term Debt			Payout Ratio %		
Company/Ticker	Market Cap (Mil)	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*	2015	*2016(E)*	*2017(E)*
Unilever NV UNA NLD	122,462 EUR	0.80	*0.14*	*0.26*	0.63	*0.64*	*0.66*	0.42	*0.39*	*0.41*	0.53	*0.22*	*0.38*	67.9	*63.0*	*63.0*
L'Oreal SA OR FRA	94,218 EUR	2.48	*5.55*	*5.45*	1.13	*1.24*	*1.33*	0.83	*0.96*	*1.02*	1.89	*2.60*	*6.07*	46.5	*38.2*	*45.0*
Colgate-Palmolive Co CL USA	63,583 USD	1.07	*1.29*	*0.92*	1.24	*1.07*	*0.97*	0.91	*0.80*	*0.70*	3.21	*1.29*	*0.90*	107.9	*60.0*	*59.3*
Kimberly-Clark Corp KMB USA	46,089 USD	1.69	*0.64*	*0.57*	0.85	*0.81*	*0.82*	0.55	*0.51*	*0.51*	0.37	*0.15*	*0.14*	125.6	*55.3*	*55.0*
Average		1.51	*1.91*	*1.80*	0.96	*0.94*	*0.95*	0.68	*0.67*	*0.66*	1.50	*1.07*	*1.87*	87.0	*54.1*	*55.6*
Procter & Gamble Co PG US	**217,713** USD	**2.37**	***0.69***	***1.90***	**0.91**	***0.72***	***0.76***	**0.72**	***0.56***	***0.60***	**0.57**	***0.15***	***0.33***	**103.6**	***85.9***	***47.1***

Research Methodology for Valuing Companies

Components of Our Methodology

- Economic Moat™ Rating
- Moat Trend™ Rating
- Moat Valuation
- Three-Stage Discounted Cash Flow
- Weighted Average Cost of Capital
- Fair Value Estimate
- Scenario Analysis
- Uncertainty Ratings
- Margin of Safety
- Consider Buying/Selling
- Stewardship Rating

We believe that a company's intrinsic worth results from the future cash flows it can generate. The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic worth—or fair value estimate, in Morningstar terminology. Five-star stocks sell for the biggest risk-adjusted discount to their fair values, whereas 1-star stocks trade at premiums to their intrinsic worth. Four key components drive the Morningstar rating: our assessment of the firm's economic moat, our estimate of the stock's fair value, our uncertainty around that fair value estimate and the current market price. This process ultimately culminates in our single-point star rating. Underlying this rating is a fundamentally focused methodology and a robust, standardized set of procedures and core valuation tools used by Morningstar's equity analysts.

The concept of the Morningstar Economic Moat™ Rating plays a vital role not only in our qualitative assessment of a firm's investment potential, but also in our actual calculation of our fair value estimates. We assign three moat ratings—none, narrow, or wide—as well as the Morningstar Moat Trend™ Rating—positive, stable, or negative—to each company we cover. Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns on invested capital over at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. The assumptions that we make about a firm's economic moat play a vital role in determining the length of "economic outperformance" that we assume in the terminal sections of our valuation model. To assess the sustainability of excess profits, analysts perform ongoing assessments of what we call the moat trend. A firm's moat trend is positive in cases where we think its sources of competitive advantage are growing stronger; stable where we don't anticipate changes to competitive advantages over the next several years; or negative when we see signs of deterioration.

At the heart of our valuation system is a detailed projection of a company's future cash flows. The first stage of our three-stage discounted cash flow model can last from 5 to 10 years and contains numerous detailed assumptions about various financial and operating items. The second stage of our model—where a firm's return on new invested capital (RONIC) and earnings growth rate implicitly fade until the perpetuity year—can last anywhere from one year (for companies with no economic moat) to 10-15 years (for wide-moat companies). In our third stage, we assume the firm's RONIC equals its weighted average cost of capital, and we calculate a continuing value using a standard perpetuity formula. In deciding on the rate at which to discount future cash flows, we use a building block approach,

Morningstar Research Methodology for Valuing Companies

Economic Moat
Financial Health
Stewardship
Uncertainty
Moat Trend

→ **Morningstar Fair Value**

→ Margin of Safety
Market Pricing

→ **Morningstar Rating™ For Stocks**
★★★★★

Source: Morningstar, Inc.

Detailed Methodology Documents and Materials*

- Comprehensive Equity Research Methodology
- Uncertainty Methodology
- Cost of Equity Methodology
- Morningstar DCF Valuation Model
- Stewardship Rating Methodology

*Please contact a sales representative for more information.

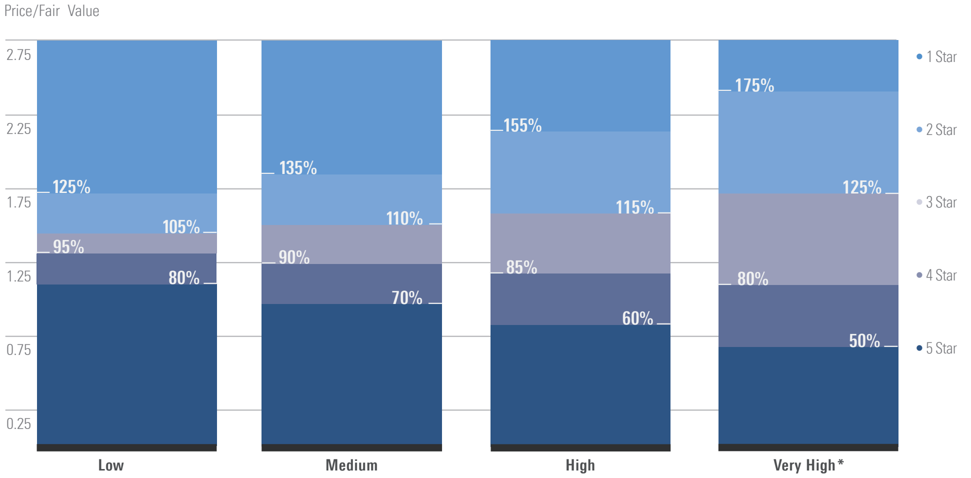
which takes into account expectations for market real return, inflation, country risk premia, corporate credit spread, and any additional systematic risk.

We also employ a number of other tools to augment our valuation process, including scenario analysis, where we assess the likelihood and performance of a business under different economic and firm-specific conditions. Our analysts model three scenarios for each company we cover, stress-testing the model and examining the distribution of resulting fair values.

The Morningstar Uncertainty Rating captures the range of likely potential fair values and uses it to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The Uncertainty Rating represents the analysts' ability to bound the estimated value of the shares in a company around the Fair Value Estimate, based on the characteristics of the business underlying the stock, including operating and financial leverage, sales sensitivity to the overall economy, product concentration, pricing power, and other company-specific factors.

Our corporate Stewardship Rating represents our assessment of management's stewardship of shareholder capital, with particular emphasis on capital allocation decisions. Analysts consider companies' investment strategy and valuation, financial leverage, dividend and share buyback policies, execution, compensation, related party transactions, and accounting practices. Corporate governance practices are only considered if they've had a demonstrated impact on shareholder value. Analysts assign one of three ratings: "Exemplary," "Standard," and "Poor." Analysts judge stewardship from an equity holder's perspective. Ratings are determined on an absolute basis. Most companies will receive a Standard rating, and this is the default rating in the absence of evidence that managers have made exceptionally strong or poor capital allocation decisions.

Morningstar Margin of Safety and Star Rating Bands

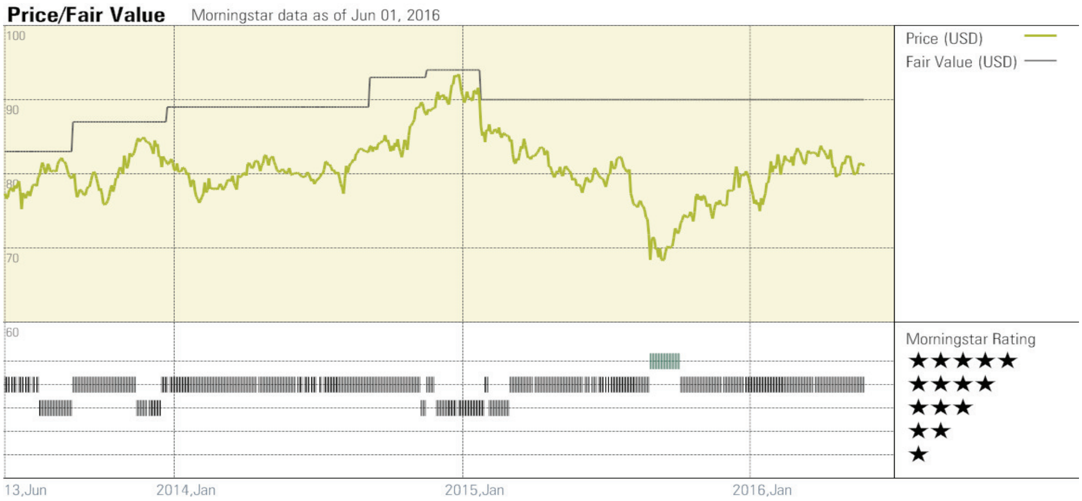


* Occasionally a stock's uncertainty will be too high for us to estimate, in which case we label it Extreme.

Source: Morningstar, Inc.

Procter & Gamble Co PG (NYSE) | ★★★★

Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Moat Trend™	Stewardship	Industry Group
81.79 USD	90.00 USD	72.00 USD	112.50 USD	Low	Wide	Stable	Standard	Consumer Packaged Goods



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Procter & Gamble Co PG (NYSE) | ★★★★

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