Q3 2019 Earnings Release

Company Participants

- Jon Moeller, Vice Chairman & Chief Financial Officer

Other Participants

- Ali Dibadj, Analyst
- Andrea Faria Teixeira, Analyst
- Bill Chappell, Analyst
- Bonnie Herzog, Analyst
- Caroline Levy, Analyst
- Cody T. Ross, Analyst
- Jonathan Feeney, Analyst
- Joseph Nicholas Altobello, Analyst
- Mark Astrachan, Analyst
- Olivia Tong, Analyst
- Robert Ottenstein, Analyst
- Steve Powers, Analyst
- Steven A. Strycula, Analyst
- Sunil Harshad Modi, Analyst
- Wendy Nicholson, Analyst

Presentation

Operator

Good morning, and welcome to Procter & Gamble's Quarter End Conference Call. P&G would like to remind you that today's discussion will include a number of forward-looking statements. If you will refer to P&G's most recent 10-K, 10-Q, and-8 K reports, you will see a discussion of factors that could cause the Company's actual results to differ materially from these projections. Additionally, the Company has posted on its Investor Relations website, www.pginvestor.com, a full reconciliation of non-GAAP and other financial measures.

Now, I will turn the call over to P&G's Vice Chairman and Chief Financial Officer, Jon Moeller.

Jon Moeller {BIO 16200095 <GO>}

Good morning. We'll keep prepared remarks fairly brief today, reflecting a fairly straightforward quarter and the upcoming Deutsche Bank Conference in Paris. We'll provide result headlines, comment briefly on strategic focus areas and update guidance for the fiscal year, before turning to your questions.

January, marks top-line growth was strong, with organic sales growing 5%, driven by volume, pricing, and mix. Eight of 10 categories grew organic sales; Skin & Personal Care again grew in the teens, Feminine Care and Home Care, high singles; Fabric Care, Family Care, Hair Care, Oral Care and Personal Healthcare, each grew mid-single digits.

We delivered strong organic sales growth in our two largest markets: the US, up 4%; China up 11%. Organic growth was broad-based, equal to or ahead of year ago in 13 of our top 15 markets with all six geographic regions growing organic sales, five up mid-single-digits or more. E-commerce organic sales grew more than 20%.

Market share trends remained strong, 33 of our top 50 country category combinations holding or growing value share fiscal year-to-date, up from 26 last fiscal year, 23 in fiscal '17, and 17 in fiscal '16. Some challenges do remain with Grooming and Baby Care each down low-singles. In total though, consumption, volume, sales and shares, each progressing nicely.

In addition to very strong sales growth, we delivered strong constant-currency earnings growth. Core earnings per share was $1.06, up 6% versus the prior year. Foreign exchange was $245 million after-tax earnings headwind, about $0.09 per share. So on a constant-currency basis, core earnings per share were up 15%.

The effective tax rate for the quarter came in around 15.5%, due partly to favorable settlement of prior period audits. A portion of this benefit was initially expected in the April to June period. The tax rate also reflects benefits from higher actual tax deductions on stock option exercises versus deferred taxes booked through option vesting. Core gross margin improved sequentially to flat versus year-ago, despite FX and commodity cost headwinds. On a currency-neutral basis, core gross margin increased 60 basis points.

SG&A cost as a percentage of sales were up versus year-ago, driven in part by the addition of Merck, including temporary integration costs. For the balance of the Company, SG&A, as a percentage of sales increased modestly due to increased traditional digital and social media investments. On a constant-currency basis, core operating profit grew 7%.

On top of the sales and earnings growth, cash flow remained strong, with free cash flow productivity of 100%. $3.1 billion of cash was returned to share holders, approximately $1.3 billion of share repurchase, and $1.9 billion of dividends.

We announced a 4% increase in the dividend earlier this month, the 63rd consecutive annual increase, and a 129th consecutive year in which P&G has paid a dividend. P&G is one of only 10 US companies to pay a dividend for more than 120 consecutive years. Only three US companies have increased dividends more consecutive years than P&G. Over the last 10 years, the annual dividend has increased from $1.64 to $2.90 per share, returning $67 billion of cash dividends to shareholders over those 10 years .

In summary, a strong quarter, solid consumption, volume and organic sales growth, driving positive market share trends across categories and geographies, strong constant-currency core earnings per share growth, a continued best-in-class track record of cash return to shareowners.

All this delivered while working to address some significant category-specific challenges and against a difficult competitive and macro landscape. We continue to accelerate change, and our program of constructive disruption to meet the challenges we still face and to further improve results from here.

As you know, we've made several important strategic choices, which are enabling the progress we're making. One, was to focus and strengthen our portfolio, in daily use categories, were performance drives brand choice, and categories where we occupy a number one or two position, which have historically grown faster than the balance of the Company and are more profitable. This choice is clearly paying out.

Within these categories, again, the categories where performance drives brand choice, we've taken a deliberate step to invest in and advance the superiority of our products and packages, retail execution, marketing and value, growing the markets in which we compete and strengthening the long-term health and competitiveness of our brands. We've spent a lot of time together discussing these advances in the US and China, but they are global in nature.

Let's take a look at a few examples in Europe, where we have built P&G aggregate share by 20 basis points, 30 basis points, and 50 basis points over the last 12, six and three-month periods, respectively. In Europe, our growth in Fabric Care is driving category growth of 4%, led by the strength of consumer preferred products, such as Ariel PODS. Ariel's superiority has delivered nearly a point of share growth in Europe Fabric Care against very favorable local competition, offering consumers superior performance and convenience.

Fairy auto-dishwashing is driving mid single-digit category growth, behind superior premium priced innovation, Fairy Platinum. Fairy is delivering double-digit organic sales growth, with share up more than 200 basis points. We just launched a new upgrade, Fairy Platinum Plus in the March quarter. Platinum Plus delivers the outstanding cleaning performance Fairy consumers expect, with added anti-dullness technology to keep the finish on dishes looking like new. Early results of Platinum Plus are strong and are further strengthening category growth.

In Feminine Care, our super premium innovation Always Infinity is driving Western European market growth in the pads segment. And Always Discrete continues to drive market growth in the adult incontinence category. In total, Always Feminine Care share is up over 0.5 point year-to-date as we continue to build and expand our advantages in each superiority vector.

European Oral Care is driving market growth and strong organic sales growth, led by high single-digit growth of Oral-B power brushes. We recently launched Gillette SkinGuard razors in Western Europe. SkinGuard is designed to delight the 70% of men who report skin sensitivity, which causes many of them to shave less frequently. By addressing this unmet consumer need with a superior performing product, we're creating the opportunity to increase usage, building the category and building share for P&G. After just a few months in market the razor systems category has accelerated to double-digit growth in France, Germany and the UK, with Gillette growing a few points ahead of the market.

We've talked a lot about products and packaging superiority, a little bit less about communication and value, and very little about retail execution superiority, a key driver of our accelerated growth results. In the recently published 2018 Global Advantage Monitor report which is an independent retailer assessment of manufacturers across seven key performance areas: strategic alignment, people, category development, consumer marketing, trade and shopper marketing, supply chain and customer service, P&G ranked number one globally. We are in the highest number of number one country ratings 12 in total, including China, Japan, Mexico, Russia and the US. And we were ranked number one in all seven performance areas.

Omnichannel results were tabulated for the first time in this past year. P&G was identified as the leading manufacturer overall, with the number one position in the US, China, France and Turkey. P&G was recently recognized by Walmart US as Supplier of the Year in consumables, the first-time we've earned this distinction in more than a decade, driven by innovation that growth markets and increases margin, and record service levels enabled by our supply chain transformation. We were also named Supplier of the Year by Walmart in Mexico, Japan and China. We've recently earned similar recognitions in the US at Target, CVS and Family Dollar. We appreciate this recognition, but what really matters as retailers improved view of P&G as a partner in joint value creation, which earns us stronger distribution, share of shelf, display and feature.

While we are making solid progress across these superiority drivers, we're working and investing to continue extending our margin of advantage, which will require additional investment. The need for this investment, the need to offset macro cost headwinds and the need to drive balanced top and bottom line growth, including margin expansion, underscores the importance of productivity. We're driving cost savings and efficiency improvement in all facets of our business as a part of our second five-year, $10 billion productivity program. We've consistently delivered $1.2 billion to $1.6 billion in annual cost of goods sold savings.

We're eliminating substantial waste in the media supply chain, delivering nearly $1 billion of savings in agency fees and add production costs over the last four years. We see more savings potential in these areas, along with more efficiency and effectiveness in media delivery. We're continuing to drive savings in organization cost. Our enrollment including contractor positions is down about 30% since the start of our first productivity program.

Through our productivity efforts, P&G has maintained and built its status as a highly profitable Company. Before tax operating margins are among the highest in the industry, behind only Reckitt and Colgate, whose margins reflect their concentrations in healthcare. We have significant below the line advantages, operating with one of the lowest interest expense percentages and one of the lowest tax rates, putting us near the top of the industry in after tax margin, already highly profitable and aggressively driving more savings.

We are driving cost productivity and cash productivity, with significant progress in all areas of working capital. Over the past five years, we've reduced receivables by three days, cut inventory by 10 days and increased payables by more than 30 days, enabling us to fund capital spending needed to transform our global supply chain while growing our dividend and maintaining an active share repurchase program.

Over the last seven fiscal years, we've averaged nearly a 100% adjusted free cash flow productivity, returning on an average of over 110% of reported net earnings to shareowners through a combination of dividend and share repurchase. We're making organizational structure and cultural changes to better position us to win. We're taking steps to simplify the organization structure, focused effort, clarify responsibility, increase accountability. We're supplementing internal talent development with experienced external hiring and are improving category dedication and mastery. We're strengthening compensation and incentive programs to align with the organization structure changes.

We are leading the constructive disruption of our industry. Lean innovation processes, improve speed to market, shots on goal and success rates of new products, monetizing internally developed technologies to build value and fund even more innovation investment, disrupting the brand building ecosystem with digitally enabled one to one mass marketing, supply chain transformation enabled by robotic process automation, and leveraging digitization and data analytics to drive greater efficiency and effectiveness of all facets of our operation.

These portfolio superiority, productivity, organization design and constructive disruption agendas are not independent strategies. They reinforce and importantly build on each other. Together, they position us well on a relative basis within our industry to deal with near-term challenges from macro headwinds, trade transformation and anticipated competitive response. And they are the foundation for stronger balanced growth and value creation over the short, mid and long term.

Moving to guidance, I know we'll all hate to see it go, but with three strong quarters on the books averaging over 4% organic sales growth, we must regretfully abandon the low 2% end of our organic sales guidance range, increasing our organic sales growth outlook for the year to a solid 4%. We now expect all-in sales growth in the range of in line to up 1% versus last year, reflecting 3 points to 4 points of -- negative points of foreign exchange. The net impact of acquisitions and divestitures should have a modest positive impact on all-in sales.

We're maintaining our core earnings per share guidance range of 3% to 8%, which translates to a range of 11% to 16% on a constant currency basis. This guidance is based on current market growth rates, commodity prices and foreign exchange rates. Significant additional currency weakness, commodity cost increases or additional geopolitical disruptions are not anticipated within this guidance range.

A little bit of perspective on the core EPS guidance. After three quarters, we are up 4.3%, more than 1 point below of the middle of the fiscal year range. Our outlook for foreign exchange, commodities, transportation and tariff impacts are unchanged, remaining at a combined $1.4 billion after-tax headwind for the year. We now expect an effective tax rate for the year of 17% to 18%. Factoring in higher option exercises, we now expect diluted shares outstanding to decrease by 1% for the fiscal year and Q4 diluted shares to be higher than last year by about 1%.

We are increasing our outlook for free cash flow productivity to at least 100%, well above our going-in target of 90%. We continue to expect within this, CapEx spending in the range of 5% to 5.5% of sales. This will be another year of strong cash return to shareholders. We expect to pay over $7 billion in dividends and repurchase approximately $5 billion of shares in fiscal 2018.

As I noted just a minute ago, this continues a long track record of significant cash generation and cash return to shareowners, ultimately, the most important and enduring measure of the successful enterprise. Over the last 10 years, P&G has generated more operating profit and cash than 98% of publicly listed companies around the world. Only three companies have returned a higher percentage of cash to shareowners.

We won't provide specific guidance for next fiscal year until our next earnings call on July 30th, but want to provide a few preview points for your consideration. We're pleased with the top line momentum we've created, but we expect a strong competitive response, and obviously, the comps will be more difficult next year. Some of the unusual bottom line help we've had this year from the land sale and in tax are unlikely to repeat next year, so these will create tough earnings comparisons. FX, commodities, and transportation markets remain volatile. Media markets and retail shopping are being transformed. I expect, as we sit here today, all of this will lead to fairly wide top and bottom line guidance ranges as we head into next year.

To sum up, we delivered our third strong quarter of the year, giving us confidence to raise sales and cash productivity targets, efforts to extend our margin of competitive superiority, to drive productivity savings to fund investments for growth, and enhance our industry-leading margins, to simplify our organizational structure and increase accountability, to constructively disrupt our industry, are driving improved results, but the external environment presents many challenges. To address these challenges and further strengthen results, we continue to accelerate the pace of change.

With that, I'm happy to take your questions.

Questions And Answers

Operator

Thank you, sir. (Operator Instructions) Your first question comes from the line of Bonnie Herzog with Wells Fargo.

Q - Bonnie Herzog {BIO 1840179 <GO>}

All right. Thank you. Good morning, Jon. So, clearly there's a lot going on in your business and the global markets. So in that context, I guess I have a two-part question on your forward outlook. First, on your FY '19 guidance, the momentum you see in your business did prompt you to raise your organic sales growth guidance, but not your EPS, and you did maintain the very wide range. You did touch on this, but could you drill down a little further for us on the key puts and takes of that? I guess that would help.

And then second, I was hoping to get your thoughts on the top-line looking forward. This has really been a key question, whether or not, you're going to be able to sustain the higher level of organic sales growth over the long-term, especially, as you're going to start to lap more difficult comps. So, I guess, I'm trying to get a sense of your confidence level in your ability to deliver, and then, realistically, if you expect share gains, to continue to accelerate or do you think a more moderate level of top-line growth going forward is more realistic? Thanks.

A - Jon Moeller {BIO 16200095 <GO>}

Thanks. Bonnie. On the current year bottom line, there's just a lot of -- well, let's just start with fiscal year-to-date. So, we've gone through three quarters, we're at 4.3%, as I mentioned in our prepared remarks. With only one quarter to go, that's relevant. Second, there's a lot of variability still in the environment, whether that's foreign exchange, commodities, transportation, geopolitical disruption, competitive response, et cetera. And we think it is, even with one quarter to go, a bit misleading to give you a view of a very narrow guidance range. We also have high degree of variability, as you've seen in the current quarter from things like tax and it's not certain at this point that we'll be able to close the land sale in Boston within the fiscal year. So that introduces variability. And last, but very importantly, we've talked about, and are committed to a level of investment that's needed to continue to advance our margin of superiority, and we're not going to let up on that.

So where does that put us, overall? I think, the most probable outcome is mid-single digits, consistent with what we've delivered fiscal year-to-date. We've said, the fourth quarter will be a little bit better, and we have, that land sale gain in the fourth quarter, so, maybe slightly above that. Everything goes right, and that opens up numbers closer to the top end of the range. A couple of problems and we're probably closer to the bottom end of the range. So I don't -- that's how I view the guidance and why I think it's appropriate that we provided the guidance that we have.

You raised -- your next question, gets really to the sustainability, not just of the top line, but of the bottom line, both for this year and as we go forward. And remember, in a constant -- a currency neutral environment, we're talking about core earnings per share numbers this year that are well into the double-digit range, high-double digits on the high-end of the range. And so the fundamental earnings power that exists behind the top-line growth that we've been delivering is significant and should remain significant.

And then, we'll just have to see what happens to things like currencies and commodities and tariffs.

In terms of sustainability of the top-line, obviously, we increased our guidance range or increased our guidance period to a strong 4%. We do that with confidence of sustainability of the numbers. One of the big questions we've all been wrestling with over the course of this fiscal year has been, what happens to pricing and can manufacturers successfully price in this environment. I think we're gaining collectively increased confidence that that should be available to us, done the right way, coupled with innovation in a way that builds the value equation for consumers and customers, and you're seeing that play through. You certainly saw that, for example, in Kimberley's results yesterday.

The biggest measure though that we're focused on internally in terms of the sustainability of that top line is superiority, and being able to deliver that day-in, day-out across all five vectors that matter. But that is highly dependent on innovation, disruptive innovation that grows categories, that inflects market growth rates, and if we can continue to do that, and frankly expand that, successful effort across each of the categories, we should be in very good shape. And if we can't in categories where performance drive brand choice, we will have more difficulty. But our recent success, the progress in the markets even market growth itself, which is marginally up versus last time we talked, give us confidence that a higher level of sales growth is deliverable and sustainable.

Operator

Your next question comes from the line of Jason English with Goldman Sachs.

Q - Cody T. Ross {BIO 20114780 <GO>}

Hi. Good morning everyone, this is actually Cody on for Jason this morning. Two questions. One, at your current rate, it looks like you'll not hit the high-end of your $1.2 billion to $1.6 billion savings per year, which was your target. It seems to be one of the areas that has hold back your margin growth. What is causing the cost savings to come in below your target and how should we think about savings for 4Q '19?

A - Jon Moeller {BIO 16200095 <GO>}

It's largely timing. So, we expect to get close to our original communication on those savings. And for example, the Tabler Station plant in West Virginia is just coming online, with more categories being produced there, and the start-up costs and integration costs now being exceeded, hopefully, by savings. So we remain committed to a high level of cost of goods sold savings, we view it as deliverables over the next couple of years. We might be a little bit lower in some years, a little bit higher in other years, but we don't expect any delta from that representation to be a major driver for margin. And in fact, in the fourth quarter, we expect a positive comparison to year-ago on both gross and operating margin.

Q - Cody T. Ross {BIO 20114780 <GO>}

Great. Thank you. And just sticking on gross and operating margin, profitability rate has been a bit disappointing on such high organic sales growth. What's holding back your gross margin expansion in an environment where commodity inflation is easing, you're passing through the price, and as I said, organic sales growth has been the strongest it's been in years, and SG&A, as a percentage of sales grew much more than we anticipated this quarter? What drove that?

A - Jon Moeller {BIO 16200095 <GO>}

So, couple of questions within that. First of all, gross margin was flat versus year-ago, which is a sequential improvement. As we had indicated, and as I said, next quarter, I expect a positive gross margin comparison. Overall, the flow-through, through from sales to earnings, was dramatically impacted, as we've talked many times, by $1.4 billion of after-tax, of FX, commodity and transportation hits, as well as the tariffs, that have been imposed. And as I indicated, our currency-neutral, so just take out one of those headwinds, core earnings per share numbers are well into the double-digits. And as I mentioned on the call, core operating profit on a constant-currency basis will be up 7%.

So you just can't look past those big drivers of margin compression. And remember, when we're pricing to recover those costs, because you can say, well, yes, I understand that those costs are in there, but aren't you pricing to recover them, we're pricing to recover the cost, not to recover the margin. And so we typically see margin compression and that's just a function of the math behind that until we get through the cycle of market declines that typically occur with significant pricing and then back to growth. But I'm very confident that margin expansion, both gross and operating, will be a part of our algorithm going forward. It has to be, and we just delivered top third TSR, and we're committed to it.

Operator

Next, we'll go to Olivia Tong with Bank of America.

Q - Olivia Tong {BIO 7481692 <GO>}

Great. Thank you. Wanted to talk a little bit about the state of competition, because it seems like competitive battles are increasing, whether it's in toothpaste against Total SF, or diapers with Huggies launching something new this summer, laundry -- Henkel has obviously made a lot of noise we haven't seen in the marketplace. But through all of that, you have accelerated your sales growth. You are also spending more. So it seems or at least, it seems, you called out the 100 basis points of higher marketing spend. So can you talk about what you see going forward, because obviously those competitive battles seem to be continuing to brew up? Thanks.

A - Jon Moeller {BIO 16200095 <GO>}

Our industry is a competitive industry across markets, across decades and will continue to be. We have very strong and capable competition and we've indicated that we expect a strong response to our share gain. If we do our job and continue to increase the superiority advantage and if that translates into increased or sustained market growth, we'll be just fine. If we're unable to do that, as I said earlier, we will have some challenges.

We are -- it would be very unusual in an industry that's as competitive as ours, that we're going to be winning every day versus every competitor in every category in every country. That's not been our historical experience, it's not our current experience, and it won't be our future reality. But where we can win two-thirds of those encounters, we are likely to drive disproportional top and bottom line growth.

The other thing that's -- there are three kind of very positive developments in the market that are important to understand as we think about the role of competitiveness and competition. One is that, again, market growth is inflecting slightly positive, which is a very good thing. The second is that, pricing is occurring where it needs to occur. That's a very good thing. Third promotional levels. If you look at, certainly US results, are down. So, I am talking at a category level and are down meaningfully. They're down in the -- 5% below (inaudible) in terms of percentage of volume that's being sold on promotion. And marketing spending is up. So, you see that pattern in our results, you see it and others results. And that's a fairly -- on a very aggregate level, fairly constructive set of observations or dynamic. And each day is a new day, but as we sit here today, that all looks pretty good.

Operator

The next question comes from the line of Steve Powers with Deutsche Bank.

Q - Steve Powers {BIO 20734688 <GO>}

Yes. Hey, Jon. Good morning. I was wondering if you could -- if you would be able to maybe breakout growth in the quarter, enterprise versus focused markets, to the extent you're thinking about the business that way? And more generally, as you've been rolling out and communicating that new business structure over the last six months or so, I'm wondering, just to what extent it may be changing behavior, improving decision making efficiency or maybe just the way you're planning fiscal '20? Just some system thoughts and context around how that change is taking shape.

And if I could squeeze in just a cleanup question. I think you had mentioned in SG&A this quarter 140 basis points of inflation and other impacts, just including Merck, and I'm just curious as to how much of that is transitory, was unique to the quarter, or is spending, inflation and elective spending that will persist over that over the future? Thanks.

A - Jon Moeller {BIO 16200095 <GO>}

Thanks, Steve. The majority of the SG&A increase, not all of it, but the majority is due to the addition of Merck to our consolidated results, and importantly, the reflection of the integration costs. So we're going to go through one-time costs to get to synergies going forward. And we will also annualize inclusion of Merck in our results after two more quarters. So I don't expect this to be an ongoing negative. I expect it to be ongoing positive once we get to the full integration and deliver the synergies that we expect to deliver.

There's also, just for clarity, within that SG&A number a reflection of the accrual that we make for compensation. And with the results we're delivering, that number is higher this year than it would have been in prior years. So that's also in there and John can help you tease out the relative components here in terms of magnitude, I think, excluding Merck, SG&A would have been up slightly, reflecting increases in investment, as we've talked about, across the vectors of superiority. But again, as we go forward, I would expect operating margin as soon as next quarter to, hopefully, be a positive comparison versus year ago and certainly in our construct next year, we'd be anticipating the same.

In terms of breaking out growth by enterprise markets and focused markets, I'm honestly not prepared to do that today. We're still going through the work of micro organization design and rewiring the Company's reporting mechanisms to accommodate exactly the question that you've asked and we will be prepared to answer that in the future. But the analog I can give you, though it's not precise or completely clean, I mentioned that growth was broad-based. In the quarter we just completed, we grew 3% in developed markets, 9% in developing market. I expect both sets of markets, focused and enterprise, to be sources of growth going forward. For perspective, again, if you just look at that developed market number, we grew 4% in the US in the last quarter, we grew 3% in Europe, we grew mid-single digits in Japan, so those are going to be -- and when you look at the absolute growth that those markets are delivering, it's the majority of our growth.

We want to maintain the growth upside that exists in some of the enterprise markets and we certainly want to maintain an optionality on future growth and profitability. So this isn't an either/or dynamic. We are set up differently now in those two different sets of markets to win in each. And we'll be prepared to talk more about how this is manifesting itself in terms of specific plans when we discuss our plans for next year, but generally, we're all pretty excited about the opportunities that this presents and are moving excitedly forward.

Operator

Your next question comes from the line of Andrea Teixeira with JPMorgan.

Q - Andrea Faria Teixeira {BIO 1941397 <GO>}

Hi. Thank you. Good morning. So, Jon, if you can, a little bit elaborate more on Merck. So you're saying like, excluding Merck, EBIT would have been slightly up. And I understand your commentary about the fact that once the synergies are coming through, you expect that to be less of a drag. But just on an apples-to-apples basis, I mean, the EBIT margin for that business is still probably going to cycle, the next two quarters being a drag. If you can give us like a little bit of a context there?

And on the category growth, on the - I'm sorry, on the commodity cost pressures, I understand some of the $1.4 billion is backward looking. So if you can give us like a State of the Union, how, on a sequential basis, you are seeing the puts and takes for pulp, resins and transportation? Thank you.

A - Jon Moeller {BIO 16200095 <GO>}

When you look at the quarter we just completed, from a bottom line standpoint, operating profit, operating margin, all the way through to EPS -- again, the biggest driver is FX. And as I mentioned, we'd have core operating growth on a constant currency basis of 7%. So I think it's important, as we talk about what exists going forward and what doesn't, to make sure that we have that in our mind's eye as well. The Merck dynamic is largely one of transition costs. And I'm not quite sure how those fall by quarter over the next couple of quarters, but I would expect us to continue to incur costs to integrate and transition that business. So, yes, for the next two quarters until it annualizes, and then, it will do more than annualize. It will not only annualize, it will improve as we deliver the synergies. From a -- and again, John can give you more detail there if you need that.

From a commodity cost standpoint, we've seen slight easing in parts of the commodity exposure that we have, but not in all. I don't see the commodity environment in terms of our exposures in aggregate being dramatically different than it was when we talked last quarter. Maybe a little bit better, but not necessarily a lot. And going forward, in terms of what we see, for example, in the pulp market and we certainly don't have a crystal ball in this regard, but if we just looked at the combination of demand and supply, there is no real reason to believe that that rolls over dramatically anytime soon. In terms of resins and the petro complex, your guess is as good as mine.

Operator

The next question comes from the line of Wendy Nicholson with Citi.

Q - Wendy Nicholson {BIO 2081269 <GO>}

Hi. Good morning. Can you talk more about Grooming from a high level perspective, because it just seems, outside of the big promotion, you had in the September quarter, that category just has been a weight on your overall results for several years now? And I get it that, as you say, hey, in a portfolio, sometimes things are going to work, sometimes aren't. I get that. But still, the consistency of the weakness in the business, despite what we hear about innovation, despite the pricing reset, it just seems so stubborn. So I guess, number one, how committed are you to the category? I mean you've made big decisions to get out of Duracell, to get out of fragrances. Is Grooming something that you really even need to be in over the long run? And number two, it's still, I think, your highest margin business, at least, on a pre-tax basis. So is there room to do another major reinvestment, another big price cut or some other reset there to get growth going? Thanks.

A - Jon Moeller {BIO 16200095 <GO>}

Thanks, Wendy. Let me just start with the math, if you will. So, the Grooming segment in the last quarter was down 1%, that's minus 3% in appliances, and flat in the wet shave part of the business. So not where we want to be in terms of growth, but not a disaster by any means. It also is very different, the results are very different by geography, with fairly strong results in Europe, fairly strong results in developing markets, and continued market growth challenges primarily, as well as some competitive challenges, in the US. We are investing more, right now, behind the launch of SkinGuard, which, as you know, addresses the 70% of men who feel that they have sensitive skin, and that the shaving experience provides irritation. To the extent that we can address that issue, which we feel SkinGuard does in a delightful way, we have the potential to increase usage, bring men back into the category, who have left or increase the shave frequency because it's no longer uncomfortable, and that's exactly what we're seeing right now in Europe. And I mentioned the systems part of that market inflecting to 10% market growth since we've introduced SkinGuard, and us growing slightly ahead of that.

We have more work to do in the US, and probably do need to invest more to get sufficient awareness and trial, which we're fully prepared to do. So that's how we're thinking about that business overall. The Female part of the business continues to do very, very nicely. We just introduced kind of an exciting exclusive brand with Walmart called Joy, which is off to a great start. This is a business that we not only want to keep, but that we like, and feel we can win in long-term.

Operator

Next question comes from the line of Mark Astrachan with Stifel.

Q - Mark Astrachan {BIO 15313233 <GO>}

Thanks. And good morning, everybody. Wanted to re-ask the question around pricing and volume-related impact. Maybe not specific to you, but overall, the level of pricing seems to be having some impact on volumes I guess from just an overall standpoint, more probably developed versus developing markets, probably, actually more almost entirely that way. I guess, I'm curious whether you're seeing things within your categories? And wanted to re-ask, also, the question on competitive response and think about it maybe in a different way. Have you seen anything that's changed on a category basis? We, obviously, see increasing threats, but so far it doesn't seem to be that the overall level of increase has gone higher.

And then, just lastly, kind of related to it, so if inputs have I don't know peaked or just are at a high level but maybe not going much higher, how have the discussions gone from a retailer standpoint, seeing that a lot of them are still eating these price increases? And what would your expectations be going forward, whether you can sustain or retain that level of pricing or do you have to do more from a promotional standpoint? You said that the level of promotional activity is low. So does that increase as we look out over the longer-term?

A - Jon Moeller {BIO 16200095 <GO>}

Again, as we look at the overall equation on an aggregate basis, as relates to pricing, we're relatively optimistic. I see the volume dynamics slightly different than you may see it. We have had significant volume declines in particularly developing markets, as we've made major increases in places like Argentina, in places like Turkey, where market size has been negatively impacted. If I look quarter-to-quarter, so when we talked last time to our conversation today, I feel more positive about the pricing environment, than I did when we talked last, and in part that's because of some moves that have been made by significant competitors, and you see that reflected in the results. I don't know, but I think what you're going to see broadly, and I'm just reflecting on the level of market growth, which has inflected ed a little bit, is pretty good top-line performance from the HPC industry in this quarter. And there will always be a small impact on volume as we adjust prices appropriately, but again, I feel fairly comfortable about where we stand currently.

Our conversations with our retail partners are primarily based on joint value-creation, on market growth, and on margin. The only way they make progress is through market growth. Our share growth is not that meaningful for them. They want the market to grow, and they want our items to generate an appropriate margin for them. And in that context, the pricing dynamic is actually a positive, not a negative. More importantly, we try to take pricing in very smart ways, specifically combining pricing with innovation, so that the value equation we're offering consumers increases, doesn't decrease, and ideally, the value equation that we're offering our retail partners increases, both in terms of the market growth potential, and in terms of the margin. And that's where we focus our conversations.

Operator

Next we'll go to Nik Modi with RBC.

Q - Sunil Harshad Modi {BIO 7557463 <GO>}

Yes. Good morning, everyone. Jon, I was hoping you can give an update on DS3? I know obviously it's a pretty small initiative at this point, but it does kind of align with the whole disruptive nature of how you're thinking about R&D. Is this one of the early learnings, are you going to put P&G brands on it, or if it's going to be its own brand, any kind of context you can give would be interesting?

A - Jon Moeller {BIO 16200095 <GO>}

We're very excited about DS3 and its potential across a number of our categories, from a consumer delight standpoint, from a product efficacy standpoint, from the degrees of innovation it opens up to us, in terms of how we can formulate that product, and what we can include with it or put in it. But it is very early days, and we are working in transactional environments with consumers today across several categories to understand how we can optimize the potential of this very exciting innovation. And that includes work to understand, how it can best be positioned from a branding standpoint. So all of that is work-underway, Nik, and we'll share more as we learn more and decide more, But this is just a wonderful opportunity that allows a superior form in multiple different categories, potentially the creation of some new jobs to do as well. So we're very, very excited about it and thanks for asking about it.

Operator

Next question comes from the line of Steve Strycula with UBS.

Q - Steven A. Strycula {BIO 18357963 <GO>}

Hi. Good morning. Super quick question on Merck as a follow-up. Just, Jon, just want to clarify that the integration costs were in fact part of the SG&A expense this quarter. Is that, in fact, the case?

A - Jon Moeller {BIO 16200095 <GO>}

Okay, it is, in fact, the case.

Q - Steven A. Strycula {BIO 18357963 <GO>}

Okay. And then switching over to Baby Care and Gillette, I noticed in the release this morning, it appears that Baby Care trends decelerated quarter-on-quarter slightly and you've called out competition. Just wanted to know whether this was primarily US versus China, and how you see both of those markets moving forward? And then, lastly, to an earlier question, how do you think about the inflection point for Gillette as SkinGuard gains traction, you ramp advertising? Thank you.

A - Jon Moeller {BIO 16200095 <GO>}

I'll focus on Baby, since we haven't discussed that much during the call so far. Market share trends in Baby are actually improving sequentially, past 12, past six, past three months on a global basis. So that's very encouraging. We did see a slight -- we did see a reduction in the rate of growth in China, but still growing share overall and that's really the story on baby with a lot of innovation to come through importantly -- and I want to be a little bit careful here from a competitive sensitivity standpoint, but to ensure that our -- as much as possible, our entire portfolio offers a superior experience for consumers, again, across the pricing ladder and form offerings.

Operator

Your next question comes from the line of Ali Dibadj with Bernstein.

Q - Ali Dibadj {BIO 15328592 <GO>}

Hi, guys. So, to help answer the sustainability of top-line question, would it be possible to dis-aggregate the drivers of the 5% top line growth a little bit differently than you typically do? And I get that precise numbers might be hard, but in terms of list price change, lower trade spend or promo, same-store sales, like all-else-equal same-store sales, and then, shelf space, understanding those dynamics might be helpful for all of us to then be able to think about which one of those dynamics are sustainable going forward. And if you can in that talk a little bit about the Argentina price help that you and all your peers -- it's not just you but all your peers are getting as well and how that figures into your numbers would be helpful? Thanks.

A - Jon Moeller {BIO 16200095 <GO>}

Argentina pricing I think had about 20 basis points to 30 basis point impact on our overall aggregate top-line so a positive, but not a huge driver. As you can appreciate, Ali, sitting here right now, I don't have the ability to break down the numbers in the way that you've been asking for. But let me make some couple of comments, one is, if you look at our traditional break down, all components are driving top-line growth, volume, pricing, mix. That's a much more sustainable equation, as I think, you'll readily appreciate than when you have only one of those or only two of those driving the top line. So that itself speaks to sustainability of the model, and within that, price was 2 points in the quarter, volume was a positive impact, price was a positive impact.

The second thing, you mentioned shelf space, and we spent some time this quarter intentionally talking about our go-to-market execution and its importance in this turnaround and in the sustainability of the top-line going forward. And it's very important and we are seeing increased distribution, both in terms of accounts, but also in terms of shelf space. We are seeing significant cooperation from our retail partners, again, in the spirit of joint value creation and are seeing them viewing us as a source of that potentially more potently than has been the case in recent history. So we're very positive about the progress we're making with the retail trade, be that online or offline, and that speaks to the sustainability of results. I will try to get you more perspective over time along the lines you've asked, but as I said, you can appreciate, I don't have that readily available here.

Operator

The next question comes from the line of Jonathan Feeney with Consumer Edge Research.

Q - Jonathan Feeney {BIO 2268157 <GO>}

Good morning, Jon. Thanks very much. I wanted to understand maybe bigger picture about how discretionary marketing investments work. It seems to me both from the 100 basis points relative increase in marketing, you called out, the over performance on tax rate and coincident with that, that there is up a level of discretionary investment here. And I can understand why that would be. What I'm trying to understand is, how practically that works? So there is like list of spending people want to do and when the environment so justifies, you or people in your suite are able to approve that on a rolling basis? I'm trying to understand what the marginal -- how you think about margin ROI when opportunities to invest come up like this? And clearly, they are driving some top line right now, should we expect that to continue to be the case going forward? Just that kind of discipline and process, I'd love some insight on. Thank you.

A - Jon Moeller {BIO 16200095 <GO>}

The majority of those decisions are made by individual category presidents and group presidents who have the clearest view to the opportunities that exist and the return that can be generated on those opportunities. And typically, only if they find themselves in a bind as relates to delivering their bottom line objectives, would they come to David and I and ask for, in essence, a view of the corporate degrees of flexibility that would facilitate investment. That's point one. Point two, where we find smart opportunities to invest, we're going to invest. And I tried to make that clear even in articulating the maintenance of our guidance range, bottom line for the fiscal year. We really believe that in these categories where performance drives brand choice, we need to be superior across all five vectors of superiority. And we're very determined to deliver that.

And that doesn't mean that we're going to do super things. We're very focused on return, but we know that superiority delivers return in these categories. And in the categories where we have truly been able to bring that to market across the portfolio, the results have been really terrific, not just in terms of our own business, but in terms of the inflection of market growth rates and the acceleration of market growth rates. So I'm not sure that gives you the granularity that you're looking for, but again, the vast, vast majority of decisions on where and how to invest are made by individual categories and individual markets and they are held within that to deliver a bottom line objective and an overall value creation objective.

Operator

All right. Your next question comes from the line of Bill Chappell with SunTrust.

Q - Bill Chappell {BIO 1737315 <GO>}

Yeah. Good morning. Thank you. Hey, Jon, just going back to Baby, how comfortable are you that Baby can turn in light of unfavorable demographics for the foreseeable future? And I'm just trying to understand if the birth rate continues to decline, both in US and around the world, I mean, how do you grow that business and is that reasonable to expect it to grow in the next couple of years?

A - Jon Moeller {BIO 16200095 <GO>}

On a global basis, we expect population to increase, the number of babies born each year to increase. So again on a global basis, as is witnessed by current market growth rates, this should be a very attractive category. The other encouraging aspect, Bill, is that, what is growing the fastest within the Baby Care category are the pants form, particularly premium pants and premium type diapers. So, I don't want to make an absolute statement or an over-generalization, but generally the category is mixing up, not in every case, but in aggregate, China is a clear example of that.

And generally, smaller families contribute to that dynamic. The preciousness of one child versus the family I grew up in of eight children, generates a very different purchase dynamic. So there is nothing that we see that causes us concern that this is a category that's going to be declining. There are certain markets that will present challenges and we need to make sure, as I said earlier, that we're superior across each points of the pricing ladder that people choose to enter the category in or move too. And if we do that, this should be a very, very attractive business.

Operator

The next question comes from the line of Caroline Levy with Macquarie.

Q - Caroline Levy {BIO 1494597 <GO>}

Thanks so much, and good morning. Just wanted to ask within Beauty, your top line looked strong and I would have expected stronger EBIT growth driving that. And then, in contrast, in Fabric Care, you had really, really strong profit growth. Can you just talk to some of the drivers of what happened to margins in each of those respective businesses Beauty and Fabric?

A - Jon Moeller {BIO 16200095 <GO>}

Once we get below the top and bottom lines on an individual category basis, I'm a little bit ill-equipped to give you the quality of answer that I think you deserve. So I'm going to ask you to follow up with John on that. Clearly, in Fabric Care, we dialed back significantly on promotion levels, which has had a big impact on profitability. In both categories, we have productivity savings coming into effect. We're investing pretty heavily in the Beauty business to drive that top-line, and it's responding very nicely. I'm comfortable overall with the combination of top and bottom line growth rates in both of those businesses, but John can provide you a little bit more granularity.

Operator

Our next question comes from the line of Joe Altobello with Raymond James.

Q - Joseph Nicholas Altobello {BIO 5113646 <GO>}

Thanks. HI, guys. Good morning. So, first a quick housekeeping item, the gain on the sale of the Gillette site in Boston that you expect in the fourth quarter, that's about $0.04 to $0.05 a share, if my notes are correct, and I think that's going to be in the SG&A line item, not on other income?

A - Jon Moeller {BIO 16200095 <GO>}

I would call the range $0.04 to $0.06, and the asset will be in SG&A.

Q - Joseph Nicholas Altobello {BIO 5113646 <GO>}

Okay. And then, shifting gears to the after-tax headwinds from FX to commodities, currencies, it still look about $1.4 billion this year. And I know this is a big assumption, but if we assume nothing changes, what would that number look like for fiscal '20, with commodities getting better, and transport rates at least on the spot market down dramatically year-over-year?

A - Jon Moeller {BIO 16200095 <GO>}

Yes. It's a hard question to answer, believe it or not. I realize, it would seem relatively simple, but nothing is in this space. If you just look at it ceteris paribus, so nothing else changes, you've seen the constant-currency earnings per share growth numbers I have provided, so you see significant leverage. As we hopefully, continually, sustainably grow the top line, that should lead to improved margins. And that constant-currency number, which is well into double-digits, still assumes the commodity hit and the tariff yet. So if all of that goes away, we're in a much better place.

Now the second question, as you rightly move to is, what do -- that doesn't just affect P&G, it effects other competitors and what do they do with that savings, and do they spend that back, do they take it to the bottom line, how is it spent back? All of that will have an impact on what actually happens from a bottom line standpoint in the scenario that you described. But clearly, it would be more -- it's hard to imagine, it wouldn't be a more positive scenario, and we are hopeful that's the case.

Having said that, as we went into last year, and this is why I'm kind of anchored to fairly wide ranges, because I think it reflects reality, we went into last year and within months, had an additional $400 million after-tax in currency impacts alone, then we had the introduction of the tariffs, as we went through the year. So I would encourage you to think in ranges.

Operator

Next question comes from the line of Robert Ottenstein with Evercore ISI.

Q - Robert Ottenstein {BIO 1498660 <GO>}

Great. Thank you very much. Two questions if I may. First, just wanted to go back to the operating leverage or lack of leverage in the results, and wondering if you could just talk a little bit more about the FX impact? And why, given the significant weight of the US, the impact is so much higher on earnings than it is on sales, and if there's anything you could do about that over time? So that would be the first question. And then, second, just a little bit more detail on e-commerce, great overall results, up 20% globally, could you give us a little bit more detail in terms of how the US did, how China did, and whether you're gaining share or not on e-commerce? Thank you.

A - Jon Moeller {BIO 16200095 <GO>}

In terms of currency, on margin, the impact, if you look at gross margin, as we said in our prepared remarks, was flat, all-in on a core basis versus year-ago, constant-currency was plus 60 basis points, so you get an idea of the impact on gross margin. On operating margin, we were 60 basis points down versus year-ago, all-in core, and ex-currency, we were 40 basis points up. So again, with that top-line result, as hopefully currency annualizes, and doesn't -- in a scenario, where it doesn't continue to devalue, there should be a significant leverage within the income statement that hasn't existed this year as we've tried to work our way through that.

E-commerce, we're doing well on a geographic basis pretty broadly. There are a lot of dynamics within individual retail accounts, which drive a fairly high degree of volatility within the result. But if you trend it out beyond one quarter, we continue to make really significant progress. We still have a share opportunity. We're growing share in China, but our shares in e-commerce are still lower than offline. So that continues to present an opportunity that we're closing that gap quarter-on-quarter. In the US, our shares are more representative on the online business of our offline position.

Operator

And ladies and gentlemen, that concludes today's conference. Thank you for your participation. You may now disconnect. Have a great day.

A - Jon Moeller {BIO 16200095 <GO>}

Thanks, everybody. Again, I think a very, very strong quarter. I do believe these kind of results or a proximity of them should be sustainable going forward, and we should be able to drive more leverage to the income statement in a more benign FX environment, but very, very positive development, sequentially. So, thanks for participating.
