The Procter & Gamble Co. (PG): proxy contest with Trian Fund Management

Vote Recommendation: Vote FOR dissident nominee Peltz

Executive Summary

Trian Fund Management, a 1.5 percent shareholder, seeks to replace one of P&G’s 11 directors. The dissident criticizes the company’s bureaucratic corporate structure, insular culture, and lack of innovation, which it believes to be the root causes of P&G’s long-term underperformance. Seeking to demonstrate that this is a minimally-invasive campaign centered on the strength of its candidate’s potential contribution, Trian has proposed only one nominee, Nelson Peltz, who has stated that he would, if elected, seek to immediately reappoint the targeted incumbent, former Mexican President Ernesto Zedillo.

The company argues that Peltz would be a disruptive presence on the board, possibly derailing the execution of management’s turnaround plan under the leadership of CEO David Taylor (who was appointed in November 2015), which has begun to show results.

In analyzing proxy contests, ISS focuses on two central questions:

1. Have the dissidents made a compelling case that change is warranted?
2. If so, which nominees are most likely to drive that change?

Total Shareholder Return (TSR)

P&G is the largest consumer packaged goods (CPG) company in the world, with a market cap more than four times that of most companies in the peer group referenced by both the board and dissident in their investor presentations. Despite the large market cap gap, the identified peers are also P&G’s direct competitors. As such, they represent a valid peer group for our TSR analysis.

Our TSR analysis focuses on two different periods: A five-year period to evaluate how the board’s actions over the long term have impacted shareholder returns, and a short-term analysis which accounts for the tenure

Chart Focus

Special Situations Research delivers comprehensive, independent research on high-profile economic proposals including M&A and proxy contests, and on the implications for shareholders of evolving trends in corporate governance and shareholder rights.

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of the current CEO.

TSR over the five-year period ending Feb. 13, 2017 (the last trading day before the dissident made its position in the company public) was 58.9 percent, which was 54.5 percentage points below peer median and 27.3 percentage points below the S&P 500 Consumer Staples Index. Extending the analysis through Sept. 25, 2017, when this report was being prepared, the company's absolute performance improved to 69.4 percent. The company's relative underperformance improved slightly, to 54.0 percentage points worse than peer median and 23.2 percentage points worse than the index.

This negative picture changes when the current CEO tenure is analyzed. TSR from Nov. 1, 2015 (the date current CEO David Taylor started his tenure) through Feb. 13, 2017 was 20.0 percent, which was 13.7 percentage points above peer median and 9.5 percentage points above the S&P 500 Consumer Staples Index. Extending the analysis through Sept. 25, 2017, the company's absolute performance improved to 28.0 percent. The company's relative outperformance improved to 15.1 percentage points better than peer median, and 13.6 percentage points better than the index.

Two conclusions can be drawn from the TSR analysis. The first is that initiatives undertaken by CEO Taylor appear to have reversed a prolonged period of underperformance and are beginning to drive positive returns to shareholders. The second is that the announcement of the dissident campaign has had a limited impact on P&G's returns. The latter conclusion is perhaps unsurprising, considering that the dissident's small ask (one out of 11 seats) likely limits its ability to drive any meaningful short-term impact on stock price, particularly as the company is already in a positive TSR trend.

Operating Performance

Our analysis focuses on performance over two different periods: FY12-FY17 and FY15-FY17. We use the past five-year period to evaluate the board's actions and the past two-year period to evaluate the current CEO's performance (David Taylor's tenure started in November 2015).

From FY12 to FY17, revenues declined by a 4.9 percent compound annual rate, adjusted EBITDA declined by a 2.1 percent compound annual rate, and adjusted EPS was nearly flat, growing by only a 0.2 percent CAGR. A positive fact over this period was the improvement in ROIC from 9.5 percent in FY12 to 11.9 percent by FY17. Within this five-year stretch, the period from FY15 to FY17 accounts for most of the decline in revenues (-4.1 percent compound annual rate), adjusted EBITDA (-3.4 percent compound annual rate), and EPS (-2.3 percent compound annual rate); however, it also accounts for most of the company's improvement in ROIC, which increased 3.8 percentage points.

These negative numbers appear to have been driven by a series of ill-advised acquisitions as well as CEO turnover, after which P&G lost market share and saw sales decline in many segments, particularly in the grooming business, which offers the highest margins for the company. As the dissident points out, over the past five years P&G suffered market share losses in each individual category and in 68 percent of the of the top 20 country-categories. Although we believe that the pursuit of market share should be weighed against the negative effects it may bring to margins and profitability (measured by ROIC), market share gains, or the sustainability of current leadership position, are certainly key for CPG companies.

By FY15, P&G started addressing its problems through divestitures and a corporate reorganization. The decline in revenues from $83.6 billion in FY12 to $65.1 billion in FY17 was mainly a result of divestitures. P&G reduced its portfolio from 170 brands in 16 categories to 65 brands in 10 categories. Despite the 22.2 percent cumulative decline in revenues, adjusted EBITDA dropped over the period by only 10.1 percent. As a result, adjusted EBITDA margin improved by 356 bps to reach 26.4 percent, the third highest among its peers. P&G's 356 bps improvement in EBITDA margin over the past six reported fiscal years was also the third highest among its peers.

While the results of these efforts are still not completely visible in the income statement, the improvements in EBITDA margins and organic growth are encouraging. After delivering only 1 percent organic growth in FY16, P&G was able to deliver 2 percent organic growth in FY17 and is now guiding organic growth somewhat in line with the market in FY18, implying a stabilization of its market share position. Furthermore, the improvement in ROIC represents a positive sign that the company is taking the right steps toward a more sustainable and profitable growth path.

One data point which deserves additional scrutiny, however, is the company's ROIC. The 11.9 percent number reached in FY17 is certainly above the...
company’s cost of capital, but it seems unimpressive compared to the ROIC of P&G’s peers. These are smaller companies that are able to generate up to three times the ROIC delivered by P&G. P&G underperformed its peer group median on average by 5 percentage points over the past five fiscal years. This picture improves when we remove goodwill from the company’s invested capital. If we were to net goodwill from invested assets, P&G ROIC in FY17 would move from the low teens to the low twenties (goodwill represents approximately half of total invested capital). This analysis suggests that misguided acquisitions were the main culprit. These acquisitions initially helped sales growth, but, as pointed out by the dissident, as P&G integrated those businesses to its portfolio the company experienced a loss of key personnel and market share, along with a decline in sales and profitability.

Current management has taken appropriate steps to optimize the company to a core portfolio which it is able to profitably manage. This does not, however, absolve the board for its apparent lack of proper oversight over prior management’s M&A strategy and integration efforts, which still weighs negatively over the company’s numbers.

Management’s Cost Cutting Efforts
The dissident argues that cost cutting efforts over the FY12-FY16 period did not bear any results for the company. Management counters that most of its $10 billion in savings protected the company’s margins over a period of negative FX trends. As a result of the divestiture-driven decline in sales over this period and the negative FX impacts described by management, it is difficult to assess the real impact of those cost savings.

Management is implementing a new round of cost cuts, which targets another $10 billion in savings. However, the new initiative appears to be more of a reallocation of resources than a real cost-savings plan, as most of the savings will not flow to operational income. If P&G improves operating margin 50 bps per year over the FY16-FY21 period, which is in line with management’s guidance, the 250 bps improvement in operational margin would account for approximately $1.6 billion in cost savings (based on FY16 sales), or 16 percent of the company’s projected $10 billion in cost savings.

In that sense, the dissident makes a valid point in criticizing management’s cost-savings plan, as a relocation/optimization of resources should not be called cost-savings, no matter how critical the reallocation of resources is for the company. In other words, if a company is facing competitive pressures which will force it to spend more in marking, reducing G&A expenses to prevent a deterioration in operating margin should not be advertised by management as cost savings.

Governance Concerns/Board Effectiveness
Although P&G has adopted several positive governance practices, certain actions taken by the board since 2009 raise questions regarding the effectiveness of the company’s governance practices and structure in protecting shareholder interests.

The board’s handling of CEO succession prior to Taylor’s appointment, for instance, reflects a series of troubling decisions. When former CEO A.G. Lafley (2000-2009) retired, the board only considered internal candidates as potential replacements. The board’s eventual choice, then-COO Robert McDonald (2009-2013), proved to be a mistake and was let go after four years of unconvincing results (TSR was 68.0 percent over his tenure, representing an underperformance of 23.5 percentage points relative to the peer group median). By comparison, during Lafley’s earlier tenure, P&G outperformed its peer group median by 33.2 percentage points.

Despite such significant underperformance relative to peers over a prolonged period, the eventual decision to terminate McDonald does not appear to have been internally driven. Only after an activist (Pershing Square) engaged with the company in 2012 and pushed for leadership change did the board decide it was time to replace the CEO. Given the underwhelming results of McDonald’s tenure, it would be reasonable to expect that the board would have subsequently conducted a more thorough succession plan by broadening the search for his replacement beyond the company’s own ranks. However, the board chose instead to bring Lafley out of retirement as a placeholder until another internal candidate could be selected – a process that took another 18 months. Though the eventual decision to appoint Taylor in late 2015 appears to have been a good one, the board’s handling of CEO succession during the better part of a decade left a lot to be desired, and subjected the company, and shareholders, to years of underperformance.

It is also worth noting that, excluding the CEO, only one of P&G’s 10 non-executive directors has prior CPG experience (Terry Lundgren was a director of Kraft Foods from 2012 to 2015). This may have
played a role in certain operational missteps over the past 10-15 years, such as the number of failed attempts to streamline decision making, misguided acquisitions (brands bought and subsequently sold), and missed trends. In terms of missed trends, the lack of investment in the direct to consumer (DTC) sales model appears to have brought negative results particularly in grooming, the company's most profitable segment. Considering Peltz' extensive background with consumer companies, particularly his directorships at Heinz and Mondelez, many shareholders might not readily agree with the board's dismissiveness of his potential contribution as a director.

While the board appears to lack direct CPG expertise, it has an abundance of C-suite experience. According to ISS data, P&G ranks among the top ten companies in the S&P 500 in terms of percentage of directors with CEO experience: 90.9 percent of P&G's directors are current or former CEOs (10 out of 11 directors), compared to a median of 61.5 percent for the S&P 500 and 67.9 percent for the S&P 500 consumer staples. The fact that P&G's board consists primarily of current and former CEOs may have played a role in shaping its resistance to the dissident's approach. Though at least one of the company's directors, Meg Whitman, seems to have had a positive interaction with an activist fund (Relational Advisors invested in Hewlett-Packard in 2011), more often than not CEOs see activists as a threat. Such sentiment may be particularly understandable in the wake of the most recent proxy season, which included several direct attacks on chief executives.

Circling back to the issue of succession, shareholders may find it ironic that a board comprised almost entirely of current and former CEOs seems to have failed to recognize, on more than one occasion over the years, the value of considering CEO candidates from outside of the company’s own ranks.

The Corporate Reorganization Argument

It is possible that certain views informed by the dissident's outside advisor for this campaign, former P&G CFO Clayton Daley, may be outdated, as the board claims, given that nearly nine years have passed since his retirement from the company. In the absence of a more current view from within the company, for instance, it is difficult for the dissident to argue that its proposed organizational structure is indeed optimal for the company. Moreover, in the years since Daley's departure, the company has made considerable progress towards streamlining the complex matrix that management refers to as "the thicket" and readily admits was an ineffectual structure.

During engagement with ISS, the board also presented reasonable arguments regarding potential shortcomings inherent in the dissident's proposed structure. It noted, for instance, that SMO leadership addresses specific needs of the organization in certain markets, such as government affairs and relationships with key accounts. In addition, the board pointed out that the company is working proactively to keep the decision power in the hands of the GBU heads. Moreover, the unintended consequences of moving corporate functions such as SMO and R&D into the three business units proposed by the dissident are unclear. In fact, the lack of centralized R&D was one of the main criticisms leveled by Pershing Square during its engagement with the company in 2012. In an interview with CNN in 2013, Pershing's Bill Ackman pointed out that P&G did not have "particularly innovative R&D" and that a "centralized R&D function allows people to think outside the box."

The fact that the dissident's plan to organize P&G under three units potentially primes the company for a split understandably did not endear Peltz to the board. Though the dissident has indicated that it is "not advocating for the break-up of the company," the word "ever" is conspicuously absent from that statement. For an activist, or management team, to narrowly qualify such a statement would be clearly disadvantageous, of course. Shareholders must therefore assess whether Peltz is essentially a wolf in sheep's clothing, as the board suggests, based on their view of the intentions and track record of the activist.

Management has begun to reduce organizational complexity, and portfolio optimization efforts are delivering positive results, such as the improvement in ROIC. It is possible that additional fine-tuning could further improve P&G's current structure. It is also possible that the optimal structure is much closer to P&G's current form than to Trian's proposed holding company with three global business units. What appears more likely than either scenario, however, is that more effective pruning through board oversight may have prevented "The Thicket" from becoming so dense in the first place.
What Matters Most: Trian's Case for Change or Track Record?

Trian's holding periods for its investments have generally been longer than those of most other activist hedge funds, which may be reassuring to some shareholders. And although the company has spent considerable time and effort downplaying Trian's performance, many of the dissident's investments have in fact yielded positive long-term results. Here, some of the company's tactics, such as comparing its returns from Nov. 1, 2015 (David Taylor's start date) through Sept. 6, 2017, to the returns of companies where Peltz serves as a director - and using a market-cap weighted average of Trian's investments - come across as disingenuous.

When even Wachtell, Lipton, Rosen & Katz's founding partner Martin Lipton, who has arguably spent more years defending companies from activists than any other active advisor, acknowledges Peltz's "impressive record of success with consumer products companies," it is perhaps a good indication that shareholders should focus on closely evaluating the dissident's case for the proposed change and on what Peltz could bring to the board, rather than on dissecting Trian’s track record.

ISS Conclusion: Is Change Warranted?

It is not unreasonable for a massive multinational corporation to need several years to shift course, particularly given the nature and extent of the structural, cultural, and operational changes pursued by CEO Taylor. It also seems clear that many of Taylor's initiatives are beginning to bear fruit, even against a weaker global consumer market and other challenges outside of management's control. In that sense, the optimal time for a typical activist intervention was perhaps a few years ago, during McDonald's tenure or right around the time of Taylor's appointment. However, P&G's recovery is still in its early stages, and has not been sufficiently sustained to give shareholders complete confidence regarding the path forward. In addition there are reasonable grounds to question the current composition of the board, particularly that it appears weak in specific experience of CPG.

While management undoubtedly deserves a longer runway to demonstrate durable results, there are several signs that the board could benefit from additional shareholder perspective and outside CPG experience. As competent and accomplished as each of its members may be individually, P&G's board is accountable for several missteps over the past several years, including its handling of previous CEO successions, its oversight of an M&A strategy that resulted in dozens of acquired brands subsequently being divested, and its failure to prevent the company's organizational structure from becoming overly complex in the first place. In a meeting with ISS, the board's longer tenured directors recognized some of these mistakes; the board certainly deserves credit for acknowledging its missteps and for the course corrections it has made, including the appointment of a stronger management team and the recent nomination of two seemingly appropriate directors (Francis Blake and Amy Chang). Nonetheless, as the board continues to consist primarily of former chief executives, it could benefit from additional diversity of thought and experience, and the presence of a shareholder voice. In light of these factors, the dissident has presented a compelling case that some degree of board change would be beneficial.

Although ISS' proxy contest framework does not require a dissident seeking minority board representation to present a detailed plan of action, a blatantly misguided plan would certainly dilute the strength of the dissident argument. In this case, the dissident's proposed solutions seem to ask the right questions, even if they lack the benefit of information available to the board. Thus, potential concerns regarding Peltz's addition to the board are tied less to the possibility that he will introduce wrong ideas, but to the possibility that he might derail the company's progress by disrupting the ongoing execution of management's strategy. Here, it is also worth noting that Trian's $3.5 billion stake represents 1.5 percent of P&G; more importantly, it represents nearly a quarter of Trian's own AUM. Also, that 1.5 percent eclipses the combined position of the entire board and management team. As such, it seems highly unlikely that Peltz, as a potential director, would be needlessly disruptive if his actions could negatively impact P&G's share price.

A small intervention, such as a one-seat ask, certainly limits risks; however, even a small intervention cannot be approached as a "it probably can't hurt" scenario. The better approach is considering the risk/reward balance presented to shareholders. Given the alignment of interest between Trian and unaffiliated shareholders, the fact that the dissident is asking the right questions, and the board's uneven performance over the course of the last decade, the potential reward of adding new perspective and experience from Peltz seems, on balance, to exceed the possible risks of disruption in the boardroom.
QUESTION 2: WHICH NOMINEES?

ISS Conclusion: Which Nominee?

Given his extensive CPG experience, and his firm's analytical capability and significant portfolio exposure to P&G, Peltz appears far more like a vested shareholder who could help the board look around the next corner and avoid future missteps than simply a "what's the harm" addition.

Although shareholders are recommended to support Peltz's election, we recognize that the removal of targeted incumbent Ernesto Zedillo is not a cost-free option. For a company with extensive global presence (operations in approximately 70 countries), a former Mexican president is obviously a significant asset to the board, especially considering recent developments such as the crisis in Venezuela. Peltz has prudently acknowledged this issue by promising to seek to re-nominate Zedillo to the board if he is elected.

Vote Recommendation

Trian presents a compelling case that a limited degree of boardroom change would be beneficial. The addition of one well-qualified nominee, who holds a large economic stake, appears likely to have benefits that outweigh the potential risks. Support for dissident nominee Peltz is recommended.
Total Shareholder Return Over Current CEO Tenure (Since Nov. 1, 2015)

Source: Bloomberg LP
5-Year Total Shareholder Return

Source: Bloomberg LP
### Historical Performance—Financial Metrics

#### Income Statement

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<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>$ 65,058</td>
<td>$ 65,299</td>
<td>$ 70,749</td>
<td>$ 80,510</td>
<td>$ 82,581</td>
<td>$ 83,680</td>
<td>(4.1)%</td>
<td>(4.9)%</td>
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<tr>
<td><strong>COGS</strong></td>
<td>$ 32,535</td>
<td>$ 32,909</td>
<td>$ 37,056</td>
<td>$ 41,010</td>
<td>$ 41,391</td>
<td>$ 42,391</td>
<td>(6.3)%</td>
<td>(5.2)%</td>
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<tr>
<td><strong>SG&amp;A</strong></td>
<td>$ 16,694</td>
<td>$ 17,049</td>
<td>$ 18,616</td>
<td>$ 22,760</td>
<td>$ 24,552</td>
<td>$ 24,421</td>
<td>(5.3)%</td>
<td>(7.3)%</td>
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<tr>
<td><strong>R&amp;D Expense</strong></td>
<td>$ 1,874</td>
<td>$ 1,900</td>
<td>$ 2,000</td>
<td>$ 2,000</td>
<td>$ 2,000</td>
<td>$ 2,000</td>
<td>(3.2)%</td>
<td>(1.3)%</td>
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<tr>
<td><strong>EBITDA</strong></td>
<td>$ 16,775</td>
<td>$ 16,519</td>
<td>$ 14,183</td>
<td>$ 17,881</td>
<td>$ 17,312</td>
<td>$ 16,496</td>
<td>8.8%</td>
<td>0.3%</td>
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<tr>
<td><strong>Adjusted EBITDA</strong></td>
<td>$ 17,174</td>
<td>$ 17,534</td>
<td>$ 18,406</td>
<td>$ 19,130</td>
<td>$ 18,215</td>
<td>$ 19,113</td>
<td>(3.4)%</td>
<td>(2.1)%</td>
</tr>
<tr>
<td><strong>Operating Income</strong></td>
<td>$ 13,955</td>
<td>$ 13,441</td>
<td>$ 11,049</td>
<td>$ 14,740</td>
<td>$ 14,330</td>
<td>$ 13,292</td>
<td>12.4%</td>
<td>1.0%</td>
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<tr>
<td><strong>Net Income</strong></td>
<td>$ 15,326</td>
<td>$ 10,508</td>
<td>$ 7,036</td>
<td>$ 11,643</td>
<td>$ 11,312</td>
<td>$ 10,756</td>
<td>47.6%</td>
<td>7.3%</td>
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<tr>
<td><strong>EPS (Adjusted)</strong></td>
<td>$ 3.89</td>
<td>$ 3.76</td>
<td>$ 4.08</td>
<td>$ 4.14</td>
<td>$ 4.03</td>
<td>$ 3.86</td>
<td>(2.3)%</td>
<td>0.2%</td>
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#### Balance Sheet

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<tr>
<td><strong>Cash &amp; ST Investments</strong></td>
<td>$ 15,137</td>
<td>$ 13,348</td>
<td>$ 11,612</td>
<td>$ 10,686</td>
<td>$ 5,947</td>
<td>$ 4,436</td>
<td>14.2%</td>
<td>27.8%</td>
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<tr>
<td><strong>Total Debt</strong></td>
<td>$ 31,592</td>
<td>$ 30,598</td>
<td>$ 30,350</td>
<td>$ 35,417</td>
<td>$ 31,543</td>
<td>$ 29,778</td>
<td>2.0%</td>
<td>1.2%</td>
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<tr>
<td><strong>Shareholder's Equity</strong></td>
<td>$ 55,778</td>
<td>$ 57,983</td>
<td>$ 63,050</td>
<td>$ 69,976</td>
<td>$ 68,709</td>
<td>$ 64,035</td>
<td>(5.9)%</td>
<td>(2.7)%</td>
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#### Cash Flow

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<tr>
<td><strong>Operating Cash Flow</strong></td>
<td>$ 12,753</td>
<td>$ 15,435</td>
<td>$ 14,608</td>
<td>$ 13,958</td>
<td>$ 14,873</td>
<td>$ 13,284</td>
<td>(6.6)%</td>
<td>(0.8)%</td>
</tr>
<tr>
<td><strong>Capex</strong></td>
<td>$ (3,384)</td>
<td>$ (3,314)</td>
<td>$ (3,736)</td>
<td>$ (3,848)</td>
<td>$ (4,008)</td>
<td>$ (3,964)</td>
<td>(4.8)%</td>
<td>(3.1)%</td>
</tr>
<tr>
<td><strong>Free Cash Flow</strong></td>
<td>$ 9,369</td>
<td>$ 12,121</td>
<td>$ 10,872</td>
<td>$ 10,110</td>
<td>$ 10,865</td>
<td>$ 9,320</td>
<td>(7.2)%</td>
<td>0.1%</td>
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#### Margins and Return Ratios

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<tr>
<td><strong>Gross Margin</strong></td>
<td>50.0 %</td>
<td>49.6 %</td>
<td>47.6 %</td>
<td>49.1 %</td>
<td>49.9 %</td>
<td>49.3 %</td>
<td>2.4</td>
<td>0.6</td>
</tr>
<tr>
<td><strong>EBITDA Margin</strong></td>
<td>25.8 %</td>
<td>25.3 %</td>
<td>20.0 %</td>
<td>22.2 %</td>
<td>21.0 %</td>
<td>19.7 %</td>
<td>5.7</td>
<td>6.1</td>
</tr>
<tr>
<td><strong>Adjusted EBITDA Margin</strong></td>
<td>26.4 %</td>
<td>26.9 %</td>
<td>26.0 %</td>
<td>23.8 %</td>
<td>22.1 %</td>
<td>22.8 %</td>
<td>0.4</td>
<td>3.6</td>
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<tr>
<td><strong>Operating Margin</strong></td>
<td>21.5 %</td>
<td>20.6 %</td>
<td>15.6 %</td>
<td>18.3 %</td>
<td>17.4 %</td>
<td>15.9 %</td>
<td>5.8</td>
<td>5.6</td>
</tr>
<tr>
<td><strong>Return on Assets</strong></td>
<td>12.4 %</td>
<td>8.2 %</td>
<td>5.1 %</td>
<td>8.2 %</td>
<td>8.3 %</td>
<td>7.9 %</td>
<td>7.2</td>
<td>4.4</td>
</tr>
<tr>
<td><strong>Return on Common Equity</strong></td>
<td>27.8 %</td>
<td>17.5 %</td>
<td>10.5 %</td>
<td>16.9 %</td>
<td>17.1 %</td>
<td>16.3 %</td>
<td>17.3</td>
<td>11.4</td>
</tr>
<tr>
<td><strong>Return on Invested Capital</strong></td>
<td>11.9 %</td>
<td>10.5 %</td>
<td>8.0 %</td>
<td>10.8 %</td>
<td>10.9 %</td>
<td>9.5 %</td>
<td>3.8</td>
<td>2.3</td>
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*Source: Bloomberg Finance LP*
## Shareholder Base

### Procter & Gamble Co/The

<table>
<thead>
<tr>
<th>Investor Type</th>
<th>Shares</th>
<th>Pct O/S</th>
<th>Filing</th>
<th>Date</th>
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<tbody>
<tr>
<td>1 Vanguard Group</td>
<td>180,730,770</td>
<td>7.1%</td>
<td>ULT-AGG</td>
<td>6/30/17</td>
</tr>
<tr>
<td>2 BlackRock</td>
<td>156,376,135</td>
<td>6.1%</td>
<td>ULT-AGG</td>
<td>9/22/17</td>
</tr>
<tr>
<td>3 State Street</td>
<td>114,947,577</td>
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<td>8 FMR</td>
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| Source: Bloomberg Financial LP    |

**Ownership Stake**

889,799,773 34.9%
Background

The Procter & Gamble Company (P&G) is the largest consumer packaged goods company in the world, with operations in approximately 70 countries and products sold in more than 180 countries and territories. The company provides products in the beauty, grooming, health care, fabric & home care, baby, feminine, and family care segments. P&G products are sold primarily through wholesale and retail channels, such as mass merchandisers, grocery stores, membership club stores, drug stores, distributors, and wholesalers. The company's largest client, Wal-Mart, accounted for approximately 16.0 percent of consolidated net sales in FY 2017. P&G was founded in 1837 and is based in Cincinnati, OH.

Trian Fund Management (Trian, or the dissident) holds 1.5 percent of PG shares.

Key Events

**Feb. 14, 2017:** Trian reports 0.6 percent position in the company as of EOY 2016.

On the same day, Wall Street Journal reports that Trian's position had since increased to 1.3 percent.

**July 17, 2017:** Company files preliminary proxy.

On the same day, dissident files preliminary proxy, launching contest for one board seat.

**July 27, 2017:** Dissident issues statement on P&G earnings report, says company must take action to change culture and organizational structure.

**July 31, 2017:** Dissident files definitive proxy; targeting director Ernesto Zedillo, though promising to immediately re-appoint Zedillo if dissident nominee (Nelson Peltz) is elected.

**Aug. 1, 2017:** Company files definitive proxy.

**Aug. 11, 2017:** Dissident reports 1.5 percent position as of Jun. 30, 2017.

**Sept. 14, 2017:** Yacktman Asset Management (0.6 percent shareholder) publicly announces support for the dissident.
Dissident Critique

The dissident argues that despite a decade of turnaround promises and portfolio changes, P&G is still experiencing market share losses and continues to be characterized by suffocating bureaucracy, aging brands, and lack of innovation. The dissident argues that this negative scenario is made worse by a complacent board that has failed to articulate a consistent and effective long-term strategy, and that has appeared content to reward management for sustained corporate underperformance relative to peers.

The dissident proposes a corporate restructuring plan designed to reduce red tape and streamline decision making, change the company's insular culture, align management compensation with market share gains, and focus on innovation to revitalize P&G brands.

In order to quell concerns, the dissident states that it is not advocating for a break-up of the company, nor suggesting that the CEO be replaced, nor suggesting cost cuts in R&D or marketing, nor proposing that the company take on excessive margin. The dissident also notes that it is not even attempting to replace a director, as it will seek to reappoint incumbent director Ernesto Zedillo to the board if Trian CEO Nelson Peltz is elected in his place.

Company Performance

The dissident reports that P&G underperformed the average return of a dissident-selected peer group by 4 percent over one year, 9 percent over two years, 25 percent over three years, 37 percent over four years, 51 percent over five years, and 117 percent over 10 years. P&G’s performance was among the bottom three over all periods other than one year. The dissident believes that this underperformance represents compelling evidence as to the ineffectiveness of the P&G organizational structure and the company’s lack of innovation.

Operational Performance

According to the dissident, P&G organic sales CAGR (compound annual growth rate) since 2011 has significantly underperformed peers. While the peer average was 3.7 percent, P&G posted the second worst organic sales growth of just 2.3 percent.

The dissident reports that P&G market share is down in 68 percent of the top 20 country-categories. The dissident also notes that P&G has lost market share in each individual category on a global basis over the past three- and five-year periods.

The dissident argues that this has resulted in core EPS growth below peer average. P&G core EPS declined by a 0.1 percent compound annual rate from 2011 to 2017 while peers grew on average at a 7.4 percent CAGR. The dissident also contests the idea that adverse currency exposure has been the main driver of P&G’s EPS underperformance, as peers such as Colgate-Palmolive and Kimberly-Clark grew EPS at a faster rate despite facing more significant currency headwinds. If cumulative EPS is analyzed over the same 2011-2017 period, P&G’s EPS declined 1 percent in the face of an 18 percent negative FX impact on sales. Over the same period, Colgate-Palmolive grew EPS 18 percent in the face of a 29 percent negative FX impact on sales, while Kimberly-Clark grew EPS 36 percent in the face of a 19 percent negative FX impact on sales.

The dissident also argues that a portion of the EPS growth in FY2017 was due to a $125 million cut in advertising spend. The dissident characterizes this cut as a benefit to near-term earnings at the expense of long-term growth.

According to the dissident, as revenue and earnings growth have stalled, the dividend per share growth has become unappealing and the payout ratio has become the highest in the industry. From 2011 to 2017, P&G grew dividends by 37 percent while the payout ratio moved from 50 percent to 69 percent. By comparison, peers grew
dividends an average of 98 percent while reporting an average payout ratio of 51 percent in their last fiscal year. The dissident explains that it is not advocating a dividend cut, but pointing out that P&G needs to regain its topline growth momentum in order to continue to support healthy earnings and dividend growth.

The dissident points out that despite investing approximately $96 billion since 2011 in R&D, marketing, and capex, volumes have increased less than 1 percent annually while market share has decreased. Although this cumulative investment is larger than the market cap of many peers, since 2011 P&G has faced market share losses, flat operating profit, and flat EPS. The dissident believes that this is symptomatic of P&G's lack of innovation, which represents a key driver of the company's topline growth underperformance.

**Organizational Concerns**

The dissident argues that the company's organizational structure limits accountability. The dissident reports that there is a three-tiered "matrix" structure, in that there are 10 Global Business Units (GBUs), divided into global, regional, and country divisions, six Selling & Market Operations units (SMOs), divided into regional and country divisions, and a Corporate Functions/Global Business Services unit (CF/GBS), divided into global, regional, and country divisions. The dissident notes that resources within the SMOs and CF/GBS often have dual-line reporting, and argues that the web of relationships 'obfuscates 'ownership' of decisions and reduces organizational agility...'

The dissident reports that, due to the organizational structure, GBU leaders are allocated costs from units outside of their control. The dissident argues that this diminishes morale, as it decreases the ability to optimize resource allocation, fund growth, and control costs, and can shift the focus from growing revenue and profit to managing the matrix structure. The dissident also argues that this leads to excessive costs, as the executives who are allocated costs do not report to the individuals best situated to grow revenue and optimize expenses.

The dissident argues that the organizational structure does not leverage the company's advantages. The dissident notes that the company is approximately four times larger than its average competitor and has a roughly 50 percent price premium, yet its operating margins are only 22.1 percent, compared to the peer average of 19.6 percent and the "best-in-class" of 27.2 percent. The dissident also reports that the company's international margins are lower than peer averages, which it suggests may be a byproduct of a "highly matrixed and globally-led GBU structure."

The dissident argues that the company has overstated improvements made to the organizational structure. The dissident states that the end-to-end improvement does not provide GBUs with full control over P&L, as sales resources are housed in the SMOs while GBU leaders are allocated costs outside of their control. The dissident also states that the "freedom within a framework" improvement is a "partial solution at best" to address a shift towards local preferences and the complexities of the organizational structure. The dissident argues that the company has been discussing structural improvements for over ten years, yet market share losses have continued.

The dissident discusses two case studies intended to highlight concerns with the company's organizational structure. In the first, the dissident suggests that multiple breakdowns across the entirety of the organizational structure resulted in Pampers, one of the company's largest brands, losing market share in China, the world's largest diaper market and the company's second largest market. In the second, the dissident suggests that the organizational structure hampered the success of Gillette following its acquisition by the company, in that it stifled Gillette's innovation and competitive edge, particularly with respect to upstart competitors such as Dollar Shave Club and Harry's.

**FY2017-2021 Productivity Plan**

The dissident argues that the company's FY2017-2021 productivity plan, which targets $12-13 billion in gross cost reductions, lacks credibility because it appears unrealistic. The dissident notes that the company projects aggregate cost savings under the 2012 and 2017 plans of up to $23 billion, which represents approximately 29 percent of 2017 gross sales and approximately 33 percent of net sales. According to the dissident, the company states that it overachieved against the 2012 goal of $10 billion, but that $7 billion was offset by foreign exchange. While the company states that it reinvested the remainder, the dissident contends that it did not drive sales or profit, and that if $3 billion had been dropped to the bottom line, operating profit would have been approximately 20 percent higher in 2016. The dissident also reports that there is a discrepancy between estimated savings under the productivity plan.
and management guidance. The dissident suggests that either the cost savings are not real or that management is reinvesting more than $11 billion back into the business.

**Strategy Concerns**

The dissident argues that the company has failed to adapt its strategy to changing market dynamics. The dissident states that the company went long on "proven brands" just as the market shifted towards small and local players. According to the dissident, consumer preferences, e-commerce, and digital marketing have allowed small, mid-size, and local brands to gain market share, while the internet and social media are eliminating barriers to entry. The dissident states that the small, mid-size, and local P&G brands failed due to the company's structure and culture, and that instead of addressing these systemic factors, the company divested. The dissident argues that the company's focus places it at an increasing risk of commoditization.

The dissident argues that the company appears to be dismissing the long-term opportunities and threats presented by e-commerce. The dissident states that the company's online presence is bolstered by its penetration in China, but that the company primarily relies on third-parties such as Amazon. The dissident notes that the company has lost market share to competitors with direct-to-consumer models, that subscription services are appearing across the company's product categories, and that competitors are beginning to aggregate data on customers, yet the company cut digital spending in Q4 2017. The dissident argues that the internet neutralizes the power of large brands, and that smaller companies appear to be better at using online platforms. The dissident also reports that as small and mid-size brands develop through online platforms, they are making a push to enter the company's traditional retail channels. The dissident argues that the company has been dismissive of this threat.

**M&A and Organic Growth Concerns**

The dissident argues that the company's culture and structure have inhibited successful M&A integration in the past. The dissident states that the company must make M&A a core competency due to the growing importance of small, mid-size, and local brands. With respect to organic growth, the dissident argues that despite spending $1.9 billion on R&D per year, the company has not created a new leading brand in decades and has not driven consistent growth through breakthrough products or brand innovation/renovation.

**Governance Concerns**

The dissident argues that the company not only has a complex organizational structure, as discussed above, but that the company has an insular culture and suffers from corporate governance shortcomings. The dissident believes that the company's underperformance relates in part to a culture that rejects outsiders and new ways of thinking. The dissident points to CEO David Taylor's statement that, "[P&G] cannot bring in outside people at too senior a level or they will fail." The dissident suggests that the skills required to be successful in the company's complex organizational structure have diverged from the skills required to grow sales and profits. The dissident also believes that the company's commitment to hire more external managers is half-hearted, and reports that only three of the company's top 33 executives have more than three years of external work experience.

The dissident argues that the very existence of this proxy contest speaks to the state of the company's corporate governance given that the dissident is requesting only one seat and has committed to recommend the reappointment of the nominee who is not re-elected; that the dissident holds approximately $3.5 billion in company stock, while other independent directors own less than $100 million in company stock; and that the dissident has direct consumer packaged goods (CPG) experience, something that appears to be lacking among the incumbent directors.

The dissident also argues that the board has failed to effectively manage CEO succession planning, long-term strategy decisions, and executive compensation. There have been three CEO changes in the past eight years, all internal candidates with no external experience, and half of current directors were on the board for all three CEO transitions.

The dissident also states that management has received generous bonuses despite poor results. According to the dissident, management has received approximately 100 percent of annual target bonuses over the past five and ten years as a result of steadily declining financial targets. To highlight the disconnect between pay and performance, the dissident notes that organic sales growth under the 2016-2019 performance stock program is targeted below expected market growth.
Dissident’s Plan

The dissident argues that P&G should organize into a holding company with three semi-autonomous GBUs: (1) Beauty, Grooming, & Health Care; (2) Fabric & Home Care; and (3) Baby, Feminine & Family Care. Each GBU would have regional leaders with full P&L ownership, though there would be oversight at the GBU level that includes global brand management and R&D. GBU leaders would be incentivized to fund growth investments, optimize costs, and maximize profits. The CEO would oversee the three GBU presidents, while the holding company would control public company functions/costs and provide back office/shared services to the GBUs. The dissident argues that this structure would lead to faster growth by creating accountability at the GBU level, reducing operational complexity, allowing for faster decision making, creating a leaner cost structure, and providing a more locally adept perspective and competitive position.

The dissident identifies several secondary areas in which it would seek to make less invasive improvements. The dissident states that it will seek to ensure the company delivers on the productivity plan, and that related savings are reinvested into volume generating investments that translate into operating profit growth. The dissident would seek to develop small, mid-size, and local brands, while overhauling the company’s approach to e-commerce. The dissident states that it would recruit talent with modern marketing expertise while aggressively dedicating more resources to an e-commerce offensive. The dissident would also propose a study on the lack of innovation breakthroughs generated via R&D, and would seek to capitalize on acquiring small, mid-size, and local brands.

The dissident also states that it would address the company’s insular culture and corporate governance shortcomings. The dissident argues that the company should set a goal that approximately 25 of its top 100 executives have significant outside experience. The dissident would also seek to ensure that succession planning gives proper consideration to outside candidates, and that executive compensation has a stronger alignment with company performance.
Management Response

The company states that it has taken steps to address the legacy operational and organizational concerns identified by the dissident. The company indicates that these measures have translated into improved performance, noting that the company has delivered TSR of 28 percent since the most recent CEO transition in November 2015. Although Peltz has a vested economic interest in the company’s success, the board argues that his perspective is outdated and misinformed, and that his addition to the board would unnecessarily risk a derailment from the current strategy.

Company Performance

The company states that TSR was 28 percent from Nov. 1, 2015 through Sept. 6, 2017. According to the company, over the same period, peers returned 13 percent, the S&P Consumer Staples Index returned 16 percent, the S&P 500 Index returned 23 percent, and companies with Nelson Peltz serving on the board returned 4 percent. The company notes that the TSR for peers reflects a simple average, while the TSR for companies with Nelson Peltz serving on the board reflects a weighted average based on market cap.

Operational Performance

The company argues that it delivered strong results in FY17, as it met or exceeded all objectives. The company reports that organic sales growth was 2 percent (on a target of 2 percent), core EPS was up 7 percent (on a target of mid-single digits), adjusted FCF productivity was 94 percent (on a target of 90 percent), and capital returned to shareholders was $22 billion (on a target of $22 billion). The company’s initial FY18 guidance projects 2-3 percent organic sales growth, which is in line with a market growth rate of approximately 2.5 percent, and 5-7 percent core EPS growth.

The company highlights its constant currency core EPS growth and margin expansion. According to the company, constant currency core EPS grew 10 percent in FY13, 14 percent in FY14, 11 percent in FY15, 7 percent in FY16, and 11 percent in FY17, while constant currency core gross margin increased 2.0 percentage points to 50.8 percent and constant currency core operating margin increased 2.7 percentage points to 22.1 percent over the same period.

The company states that it has the third highest core operating margin among peers, the second most favorable interest rates, and the second highest after-tax profit margin. The company also contests the dissident’s claim that advertising spend was cut by $125 million in order to improve near-term earnings. The company states that working advertising spend remained steady, and that the reduction focused on inefficient and ineffective spending, such as content served by bots or displayed next to objectionable content.

The company argues that it is accelerating market share progress. The company reports that it holds the top global share position in seven of 10 categories, and the second global share position in the remaining three categories. The company states that it is growing or holding market share in 11 of the top 20 countries and 14 of the top 20 brands. The company notes that this is an improvement from April-June 2015, when it was growing or holding market share in just two of the top 20 countries and 10 of the top 20 brands.

The company argues that it is a leader in returning capital to shareholders. The board reports that it has returned $138 billion to shareholders over the last 10 years, $76 billion via share repurchases and $62 billion via dividends. The company notes that this represents 59 percent of market cap. The company also notes that it has had 127 consecutive years of dividend payments and 61 consecutive years of dividend increases.

The company argues that it has been negatively impacted by FX conditions to a greater extent than peers. According to the company, over the last five years, FX impacts have reduced reported sales by a cumulative $14.0 billion – almost 20 percent – and after-tax profit by $4.4 billion. The company states that Euro, Pound Sterling, and Yen functional currency competitors experienced less than half of the FX headwinds faced by the company, while primarily domestic competitors experienced almost no FX headwinds.

Organization

The company states that it is dismantling the complex matrix structure, termed "The Thicket" by P&G employees. The former structure had 16 business units, each divided into six regions, with heavily staffed function organizations and people frequently moving between businesses, markets, and functions. The company now has 10 "end-to-end" product categories. Product categories are responsible for innovation, manufacturing, and marketing. According to the
company, category leaders have full P&L responsibilities, along with ownership and accountability. Product categories account for 70 percent of sales, while a "freedom within a framework" approach accounts for the remaining 30 percent. Under the freedom within a framework system, which has been introduced in markets where the product category framework does not make economic sense, a market has freedom to make real-time changes without the need for engagement with regional or global resources so long as the market is executing within predefined strategies and is delivering on financial targets. The company argues that these changes have driven efficiency and accountability.

The company also discusses its supply chain transformation. The company indicates that it is transforming the supply chain in North America, followed by Europe and Latin America, with plans for India, the Middle-East, and Africa. The company expects savings to increase over the next two years.

**FY2017-2021 Productivity Plan**

The company states that it delivered on its first $10 billion productivity plan, which ended in 2016, and that it is pursuing another $10 billion plan. The company indicates that it could save up to $7 billion in COGS, $2 billion in marketing efficiencies, $1.5 billion in trade spending, and $1-2 billion in overhead spending under the second plan. The company reports that it is on track after the first year.

**Strategy**

The company argues that it has streamlined and strengthened its portfolio. The company states that it has focused on faster-growing, higher-margin businesses, and businesses where the company is a market competitor. The company has pared back from 170 brands across 16 categories to 65 brands across 10 categories. The company indicates that these categories leverage its core strengths, including consumer understanding, branding, product and package innovation, and go-to-market capabilities. The company also indicates that it has focused on five superiority criteria: products, packaging, brand communication, in-store & online execution, and consumer & customer value equations. The company states that Dawn and Bounty are examples of products that meet all five superiority criteria. Dawn's value share has grown from 40 to 50 percent in the U.S. over the past ten years, while the value share of its sister brand in the U.K. has grown from 55 to over 70 percent. Over the past 15 years, Bounty has consistently maintained over 40 percent value share in the U.S. despite challenges from branded and private label competition.

In addition to decreasing categories and brands, the company has also decreased manufacturing platforms by 50 percent, total roles by 32 percent, advertising and PR agencies by 65 percent, office buildings by 60 percent, R&D centers by 25 percent, and legal entities by 50 percent.

**Innovation**

The company states that it has been an innovation leader throughout its history. The company reports that it accounted for five of the top 10 and seven of the top 25 innovations in the 2016 IRI new product pacesetters report for the most successful non-food product launches. According to the company, since the first pacesetters report in 1995, P&G has had more than 170 products make the top 25 list in non-food categories, more than its six largest competitors combined. The company states that it has a cumulative R&D spend 1.6 times that of its largest competitor, which it argues is driving new brands and sub-brands. The company also states that its online presence is growing. The company indicates that online sales totaled $3 billion in FY2017, which represented 30 percent YOY growth and was larger than the company's top two peer competitors combined.

**Governance**

The company argues that the director selection process has resulted in a board that is diverse, qualified, and engaged, with the right mix of skills and experiences to oversee the company's continuing transformation. The company notes that the current directors are established leaders from a variety of fields, and have experience in key executive roles and proven track records. The company also discusses what it considers to be other best in class governance practices, as well as initiatives focused on diversity and inclusion, gender equality, environmental sustainability, and company's community impact.

The company also argues that it has strong compensation practices aligned with shareholder interests. The company states that incentive compensation targets are balanced across top and bottom line results, that compensation emphasizes pay for performance and focuses on long-term success, and that the company has recently realigned compensation incentives to increase...
category accountability. The company notes that the five-year combined NEO performance awards have paid out at an average of 61 percent of target. The company also indicates that current performance stock program targets are based on above-market growth rates.

Company Critique of Dissident’s Plan

The company reports that it has interacted with the dissident 16 times. The company states that the dissident was initially supportive of the ongoing transformation and plan, but that the dissident never asked to further understand the transformation or plan and never asked about the organization or employees. The company states that the dissident first asked for a board seat on March 7, and that his request was first declined on March 17. The company argues that adding an activist investor like Nelson Peltz to the board would not assist the board or management team in executing the plan that has the company on the right track.

The company also argues that the dissident has not produced new ideas that make sense for the company, and that the dissident’s ideas are confirmation of an outdated and misinformed view. The company states that the dissident’s proposed initiative to reorganize into a holding company was considered, along with numerous other ideas, prior to implementation of the current transformation plan. The company argues that this additional layer would add costs and complexity, dilute accountability, and compromise delivery of the current plan, and could act as a precursor to a push for a breakup. The company states that the dissident’s proposed initiative to ensure the productivity plan delivers results does not offer a new approach to achieve greater savings or a means to achieve savings faster. The company notes that the first plan exceeded the $10 billion commitment on an accelerated timeframe, which demonstrates management's ability to achieve the targets.

The company states that the dissident’s proposed initiatives to improve innovation through a board-led study, to develop small, mid-size, and local brands, and to focus on growth via M&A do not offer new ideas. The company states that rather than studying innovation, it is delivering superior innovation that meets consumer needs and grows share. Many of the company's new brands and sub-brands, which owe their existence to the innovation factor, are leading growth in the company's categories. The company believes that M&A cannot supplant this organic growth. The company also indicates that serial M&A would impact cash available for dividends while complicating a portfolio that has recently been simplified.

The company states that the dissident’s proposed initiative to focus on digital is already being initiated, as the company is #1 in e-commerce sales among peers, recently added a "digitally native" director, and has ongoing talent exchanges with top digital media and e-commerce companies. The company states that the dissident's proposals to address the insular culture and governance concerns are similarly misguided. The company states that its strategy is to hire and promote the best people, whether from inside or outside, and reports that external management level hiring has quadrupled.
Analytic Framework

In analyzing proxy contests, ISS focuses on two central questions:

1. Have the dissidents made a compelling case that change is warranted?
2. If so, which nominees are most likely to drive that change?

When the dissidents are seeking a minority position on the board, ISS does not require a detailed plan of action, nor that the dissidents prove their plan is preferable to the incumbent plan. Instead, ISS will require that dissidents prove that change is preferable to the status quo and that the dissident slate will add value to board deliberations of the issues at hand.

1. Is Change Warranted?

**Total Shareholder Return (TSR)**

P&G is the largest consumer packaged goods (CPG) company in the world, with a market cap more than four times that of most companies in the peer group referenced by both the board and dissident in their investor presentations. Despite the large market cap gap, the identified peers are also P&G’s direct competitors. As such, they represent a valid peer group for our TSR analysis.

Our TSR analysis focuses on two different periods: A five-year period to evaluate how the board’s actions over the long term have impacted shareholder returns, and a short-term analysis which accounts for the tenure of the current CEO.

TSR over the five-year period ending Feb. 13, 2017 (the last trading day before the dissident made its position in the company public) was 58.9 percent, which was 54.5 percentage points below peer median and 27.3 percentage points below the S&P 500 Consumer Staples Index. Extending the analysis through Sept. 25, 2017, when this report was being prepared, the company’s absolute performance improved to 69.4 percent. The company’s relative underperformance improved slightly, to 54.0 percentage points worse than peer median and 23.2 percentage points worse than the index.

<table>
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<th>Total Shareholder Return</th>
<th>Five-Year Through Unaff. Date Through Extended Through</th>
<th>CEO Tenure Through Unaff. Date Through Extended Through</th>
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<tbody>
<tr>
<td>Procter &amp; Gamble</td>
<td>58.9% 69.4%</td>
<td>20.0% 28.0%</td>
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<tr>
<td>Peer Median</td>
<td>113.4% 123.5%</td>
<td>6.3% 12.9%</td>
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<td>S&amp;P 500 Cons Staples Idx</td>
<td>(27.3) (23.2)</td>
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Source: Bloomberg Financial L.P. Peers include Beiersdorf Ag, Church & Dwight Co Inc, Clorox Company, Colgate-Palmolive Co, Edgewell Personal Care Co, Henkel Ag & Co Kgaa, Kimberly-Clark Corp, L’Oreal, Reckitt Benckiser Group Plc, Unilever Plc.

This negative picture changes when the current CEO tenure is analyzed. TSR from Nov. 1, 2015 (the date current CEO David Taylor started his tenure) through Feb. 13, 2017 was 20.0 percent, which was 13.7 percentage points above peer median and 9.5 percentage points above the S&P 500 Consumer Staples Index. Extending the analysis through Sept. 25, 2017, the company’s absolute performance improved to 28.0...
The company’s relative outperformance improved to 15.1 percentage points better than peer median, and 13.6 percentage points better than the index.

Two conclusions can be drawn from the TSR analysis. The first is that initiatives undertaken by CEO Taylor appear to have reversed a prolonged period of underperformance and are beginning to drive positive returns to shareholders. The second is that the announcement of the dissident campaign has had a limited impact on P&G’s returns. The latter conclusion is perhaps unsurprising, considering that the dissident’s small ask (one out of 11 seats) likely limits its ability to drive any meaningful short-term impact on stock price, particularly as the company is already in a positive TSR trend.

Operating Performance

Our analysis focuses on performance over two different periods: FY12-FY17 and FY15-FY17. We use the past five-year period to evaluate the board’s actions and the past two-year period to evaluate the current CEO’s performance (David Taylor’s tenure started in November 2015).

From FY12 to FY17, revenues declined by a 4.9 percent compound annual rate, adjusted EBITDA declined by a 2.1 percent compound annual rate, and adjusted EPS was nearly flat, growing by only a 0.2 percent CAGR. A positive fact over this period was the improvement in ROIC from 9.5 percent in FY12 to 11.9 percent by FY17. Within this five-year stretch, the period from FY15 to FY17 accounts for most of the decline in revenues (-4.1 percent compound annual rate), adjusted EBITDA (-3.4 percent compound annual rate), and EPS (-2.3 percent compound annual rate); however, it also accounts for most of the company’s improvement in ROIC, which increased 3.8 percentage points.

These negative numbers appear to have been driven by a series of ill-advised acquisitions as well as CEO turnover, after which P&G lost market share and saw sales decline in many segments, particularly in the grooming business, which offers the highest margins for the company. As the dissident points out, over the past five years P&G suffered market share losses in each individual category and in 68 percent of the of the top 20 country-categories. Although we believe that the pursuit of market share should be weighed against the negative effects it may bring to margins and profitability (measured by ROIC), market share gains, or the sustainability of current leadership position, are certainly key for CPG companies.

By FY15, P&G started addressing its problems through divestitures and a corporate reorganization. The decline in revenues from $83.6 billion in FY12 to $65.1 billion in FY17 was mainly a result of divestitures. P&G reduced its portfolio from 170 brands in 16 categories to 65 brands in 10 categories. Despite the 22.2 percent cumulative decline in revenues, adjusted EBITDA dropped over the period by only 10.1 percent. As a result, adjusted EBITDA margin improved by 356 bps to reach 26.4 percent, the third highest among its peers. P&G’s 356 bps improvement in EBITDA margin over the past six reported fiscal years was also the third highest among its peers.

While the results of these efforts are still not completely visible in the income statement, the improvements in EBITDA margins and organic growth are encouraging. After delivering only 1 percent organic growth in FY16, P&G was able to deliver 2 percent organic growth in FY17 and is now guiding organic growth somewhat in line with the market in FY18, implying a stabilization of its market share position. Furthermore, the improvement in ROIC represents a positive sign that the company is taking the right steps toward a more sustainable and profitable growth path.

One data point which deserves additional scrutiny, however, is the company’s ROIC. The 11.9 percent number reached in...
FY17 is certainly above the company’s cost of capital, but it seems unimpressive compared to the ROIC of P&G’s peers. These are smaller companies that are able to generate up to three times the ROIC delivered by P&G. P&G underperformed its peer group median on average by 5 percentage points over the past five fiscal years. This picture improves when we remove goodwill from the company’s invested capital. If we were to net goodwill from invested assets, P&G ROIC in FY17 would move from the low teens to the low twenties (goodwill represents approximately half of total invested capital). This analysis suggests that misguided acquisitions were the main culprit. These acquisitions initially helped sales growth, but, as pointed out by the dissident, as P&G integrated those businesses to its portfolio the company experienced a loss of key personnel and market share, along with a decline in sales and profitability.

Current management has taken appropriate steps to optimize the company to a core portfolio which it is able to profitably manage. This does not, however, absolve the board for its apparent lack of proper oversight over prior management’s M&A strategy and integration efforts, which still weighs negatively over the company’s numbers.

Management’s Cost Cutting Efforts
The dissident argues that cost cutting efforts over the FY12-FY16 period did not bear any results for the company. Management counters that most of its $10 billion in savings protected the company’s margins over a period of negative FX trends. As a result of the divestiture-driven decline in sales over this period and the negative FX impacts described by management, it is difficult to assess the real impact of those cost savings.

Management is implementing a new round of cost cuts, which targets another $10 billion in savings. However, the new initiative appears to be more of a reallocation of resources than a real cost-savings plan, as most of the savings will not flow to operational income. If P&G improves operating margin 50 bps per year over the FY16-FY21 period, which is in line with management’s guidance, the 250 bps improvement in operational margin would account for approximately $1.6 billion in cost-savings (based on FY16 sales), or 16 percent of the company’s projected $10 billion in cost savings.

In that sense, the dissident makes a valid point in criticizing management’s cost-savings plan, as a relocation/optimization of resources should not be called cost-savings, no matter how critical the reallocation of resources is for the company. In other words, if a company is facing competitive pressures which will force it to spend more in marketing, reducing G&A expenses to prevent a deterioration in operating margin should not be advertised by management as cost savings.

Governance Concerns/Board Effectiveness
Although P&G has adopted several positive governance practices, certain actions taken by the board since 2009 raise questions regarding the effectiveness of the company’s governance practices and structure in protecting shareholder interests.

The board’s handling of CEO succession prior to Taylor’s appointment, for instance, reflects a series of troubling decisions. When former CEO A.G. Lafley (2000-2009) retired, the board only considered internal candidates as potential replacements. The board’s eventual choice, then-COO Robert McDonald (2009-2013), proved to be a mistake and was let go after four years of unconvincing results (TSR was 68.0 percent over his tenure, representing an underperformance of 23.5 percentage points relative to the peer group median). By comparison, during Lafley’s earlier tenure, P&G outperformed its peer group median by 33.2 percentage points.

Despite such significant underperformance relative to peers over a prolonged period, the eventual decision to terminate McDonald does not appear to have been internally driven. Only after an activist (Pershing Square) engaged with the company in 2012 and pushed for leadership change did the board decide it was time to replace the CEO. Given the overwhelming results of McDonald’s tenure, it would be reasonable to expect that the board would have subsequently conducted a more thorough succession plan by broadening the search for his replacement beyond the company’s own ranks. However, the board chose instead to bring Lafley out of retirement as a placeholder until another internal candidate could be selected – a process that took another 18 months.

Though the eventual decision to appoint Taylor in late 2015 appears to have been a good one, the board’s handling of CEO succession during the better part of a decade left a lot to be desired, and subjected the company, and shareholder-
ers, to years of underperformance.

It is also worth noting that, excluding the CEO, only one of P&G’s 10 non-executive directors has prior CPG experience (Terry Lundgren was a director of Kraft Foods from 2012 to 2015). This may have played a role in certain operational missteps over the past 10-15 years, such as the number of failed attempts to streamline decision making, misguided acquisitions (brands bought and subsequently sold), and missed trends. In terms of missed trends, the lack of investment in the direct to consumer (DTC) sales model appears to have brought negative results particularly in grooming, the company’s most profitable segment. Considering Peltz’ extensive background with consumer companies, particularly his directorships at Heinz and Mondelez, many shareholders might not readily agree with the board’s dismissiveness of his potential contribution as a director.

While the board appears to lack direct CPG expertise, it has an abundance of C-suite experience. According to ISS data, P&G ranks among the top ten companies in the S&P 500 in terms of percentage of directors with CEO experience: 90.9 percent of P&G’s directors are current or former CEOs (10 out of 11 directors), compared to a median of 61.5 percent for the S&P 500 and 67.9 percent for the S&P 500 consumer staples. The fact that P&G’s board consists primarily of current and former CEOs may have played a role in shaping its resistance to the dissident’s approach. Though at least one of the company’s directors, Meg Whitman, seems to have had a positive interaction with an activist fund (Relational Advisors invested in Hewlett-Packard in 2011), more often than not CEOs see activists as a threat. Such sentiment may be particularly understandable in the wake of the most recent proxy season, which included several direct attacks on chief executives.

Circling back to the issue of succession, shareholders may find it ironic that a board comprised almost entirely of current and former CEOs seems to have failed to recognize, on more than one occasion over the years, the value of considering CEO candidates from outside of the company’s own ranks.

The Corporate Reorganization Argument

It is possible that certain views informed by the dissident’s outside advisor for this campaign, former P&G CFO Clayton Daley, may be outdated, as the board claims, given that nearly nine years have passed since his retirement from the company. In the absence of a more current view from within the company, for instance, it is difficult for the dissident to argue that its proposed organizational structure is indeed optimal for the company. Moreover, in the years since Daley’s departure, the company has made considerable progress towards streamlining the complex matrix that management refers to as "the thicket" and readily admits was an ineffective structure.

During engagement with ISS, the board also presented reasonable arguments regarding potential shortcomings inherent in the dissident’s proposed structure. It noted, for instance, that SMO leadership addresses specific needs of the organization in certain markets, such as government affairs and relationships with key accounts. In addition, the board pointed out that the company is working proactively to keep the decision power in the hands of the GBU heads. Moreover, the unintended consequences of moving corporate functions such as SMO and R&D into the three business units proposed by the dissident are unclear. In fact, the lack of centralized R&D was one of the main criticisms leveled by Pershing Square during its engagement with the company in 2012. In an interview with CNN in 2013, Pershing’s Bill Ackman pointed out that P&G did not have "particularly innovative R&D" and that a "centralized R&D function allows people to think outside the box."

The fact that the dissident’s plan to organize P&G under three units potentially primes the company for a split understandably did not endear Peltz to the board. Though the dissident has indicated that it is "not advocating for the break-up of the company," the word "ever" is conspicuously absent from that statement. For an activist, or management team, to narrowly qualify such a statement would be clearly disadvantageous, of course. Shareholders must therefore assess whether Peltz is essentially a wolf in sheep’s clothing, as the board suggests, based on their view of the intentions and track record of the activist.

Management has begun to reduce organizational complexity, and portfolio optimization efforts are delivering positive results, such as the improvement in ROIC. It is possible that additional fine-tuning could further improve P&G’s current structure. It is also possible that the optimal structure is much closer to P&G’s current form than to Trian’s proposed holding company with three global business units. What appears more likely than either scenario, however, is
that more effective pruning through board oversight may have prevented "The Thicket" from becoming so dense in the first place.

What Matters Most: Trian's Case for Change or Track Record?
Trian's holding periods for its investments have generally been longer than those of most other activist hedge funds, which may be reassuring to some shareholders. And although the company has spent considerable time and effort downplaying Trian's performance, many of the dissident's investments have in fact yielded positive long-term results. Here, some of the company's tactics, such as comparing its returns from Nov. 1, 2015 (David Taylor's start date) through Sept. 6, 2017, to the returns of companies where Peltz serves as a director - and using a market-cap weighted average of Trian's investments - come across as disingenuous.

When even Wachtell, Lipton, Rosen & Katz's founding partner Martin Lipton, who has arguably spent more years defending companies from activists than any other active advisor, acknowledges Peltz's "impressive record of success with consumer products companies," it is perhaps a good indication that shareholders should focus on closely evaluating the dissident's case for the proposed change and on what Peltz could bring to the board, rather than on dissecting Trian's track record.

ISS Conclusion: Is Change Warranted?
It is not unreasonable for a massive multinational corporation to need several years to shift course, particularly given the nature and extent of the structural, cultural, and operational changes pursued by CEO Taylor. It also seems clear that many of Taylor's initiatives are beginning to bear fruit, even against a weaker global consumer market and other challenges outside of management's control. In that sense, the optimal time for a typical activist intervention was perhaps a few years ago, during McDonald's tenure or right around the time of Taylor's appointment. However, P&G's recovery is still in its early stages, and has not been sufficiently sustained to give shareholders complete confidence regarding the path forward. In addition there are reasonable grounds to question the current composition of the board, particularly that it appears weak in specific experience of CPG.

While management undoubtedly deserves a longer runway to demonstrate durable results, there are several signs that the board could benefit from additional shareholder perspective and outside CPG experience. As competent and accomplished as each of its members may be individually, P&G's board is accountable for several missteps over the past several years, including its handling of previous CEO successions, its oversight of an M&A strategy that resulted in dozens of acquired brands subsequently being divested, and its failure to prevent the company's organizational structure from becoming overly complex in the first place. In a meeting with ISS, the board's longer tenured directors recognized some of these mistakes; the board certainly deserves credit for acknowledging its missteps and for the course corrections it has made, including the appointment of a stronger management team and the recent nomination of two seemingly appropriate directors (Francis Blake and Amy Chang).

Nonetheless, as the board continues to consist primarily of former chief executives, it could benefit from additional diversity of thought and experience, and the presence of a shareholder voice. In light of these factors, the dissident has presented a compelling case that some degree of board change would be beneficial.

Although ISS' proxy contest framework does not require a dissident seeking minority board representation to present a detailed plan of action, a blatantly misguided plan would certainly dilute the strength of the dissident argument. In this case, the dissident's proposed solutions seem to ask the right questions, even if they lack the benefit of information available to the board. Thus, potential concerns regarding Peltz's addition to the board are tied less to the possibility that he will introduce wrong ideas, but to the possibility that he might derail the company's progress by disrupting the ongoing execution of management's strategy. Here, it is also worth noting that Trian's $3.5 billion stake represents 1.5 percent of P&G; more importantly, it represents nearly a quarter of Trian's own AUM. Also, that 1.5 percent eclipses the combined position of the entire board and management team. As such, it seems highly unlikely that Peltz, as a potential director, would be needlessly disruptive if his actions could negatively impact P&G's share price.

A small intervention, such as a one-seat ask, certainly limits risks; however, even a small intervention cannot be approached as a "it probably can't hurt" scenario. The better approach is considering the risk/reward balance presented to shareholders. Given the alignment of interest between Trian and unaffiliated shareholders, the fact that the dissident is asking the right questions, and the
board's uneven performance over the course of the last decade, the potential reward of adding new perspective and experience from Peltz seems, on balance, to exceed the possible risks of disruption in the boardroom.

2. Which Nominees?

Director nominees

The dissident has nominated the following candidate:

Nelson Peltz, 75, is the CEO and a founding partner of Trian (2005). Previously, from April 1993 through June 2007, Peltz served as Chairman and CEO of Triarc Companies, Inc. which during that period of time owned Arby's Restaurant Group, Inc. and the Snapple Beverage Group. From 1983 to 1988, he was Chairman and CEO of Triangle Industries, Inc. Peltz serves as the non-executive Chairman of The Wendy’s Company and is a director of Mondelez International, Inc., Sysco Corporation, and The Madison Square Garden Company. He previously served as a director of H. J. Heinz Company from 2006 to 2013, Legg Mason, Inc. from 2009 to 2014 and Ingersoll-Rand plc from 2012 to 2014.

The dissident has targeted the following incumbent for removal (although has also committed to seek to re-nominate Zedillo to the board if the dissident is elected):

Ernesto Zedillo, 65, has served as a member of the board since 2001. He was the President of Mexico from 1994 to 2000 and currently serves as Director of the Center for the Study of Globalization and Professor of International Economics and Politics at Yale University. He has been a Director of Alcoa, Corp. since 2002 and Citigroup, Inc. and Promotora de Informaciones S.A. since 2010. Previously, Zedillo served on the audit committee of Union Pacific and as the Secretary of Economic Programming and the Budget for Mexico, as well as having held various positions at the Banco de Mexico.

According to the dissident’s proxy, if elected as a director of P&G, Peltz intends to resign from at least one of the four boards on which he currently serves.

ISS Conclusion: Which Nominee?

Given his extensive CPG experience, and his firm’s analytical capability and significant portfolio exposure to P&G, Peltz appears far more like a vested shareholder who could help the board look around the next corner and avoid future missteps than simply a "what's the harm" addition.

Although shareholders are recommended to support Peltz's election, we recognize that the removal of targeted incumbent Ernesto Zedillo is not a cost-free option. For a company with extensive global presence (operations in approximately 70 countries), a former Mexican president is obviously a significant asset to the board, especially considering recent developments such as the crisis in Venezuela. Peltz has prudently acknowledged this issue by promising to seek to re-nominate Zedillo to the board if he is elected.

Vote Recommendation

Trian presents a compelling case that a limited degree of boardroom change would be beneficial. The addition of one well-qualified nominee, who holds a large economic stake, appears likely to have benefits that outweigh the potential risks. Support for dissident nominee Peltz is recommended.
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