BEHIND THE NUMBERS
Quality of Earnings Analysis

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July 26, 2021

Kimberly-Clark Corporation (KMB)
Earnings Quality Update- 6/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are reducing our earnings quality rating to 2- (Weak)

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

KMB reported non-GAAP EPS of $1.47 which missed consensus estimates by 24 cps. The company blamed this on higher-than-expected cost inflation and weaker-than-anticipated Consumer Tissue sales which were already going up against last year's incredibly strong Covid-driven second quarter.

The midpoint of full-year non-GAAP EPS guidance was dropped from $7.43 to $6.78, a 65-cps decrease, indicating the problems will continue. The company raised its outlook for full-year inflation to $1.20-$1.30 billion from the $0.90 to $1.05 billion forecasted just three months ago. The company also dropped its top-line organic growth forecast to 0% to -2% from the previous 0% to +1%.

The company cut discretionary spending more than expected in the quarter to help offset the higher raw materials costs and has increased its cost savings target for the year by $110 million. We have observed in past reviews that it seems unusual how KMB perpetually manages to find

hundreds of million of dollars in FORCE and restructuring savings every year. Accelerating cost cuts on top of that in response to a short-term problem makes us think it is likely these costs will simply wind up being shifted to upcoming quarters. We also identified approximately 7 cps in one-time items. These factors prompt us to maintain downgrade our earnings quality rating to a 2- (Weak).

What was weaker?

- After the first quarter, the company was projecting $340-$360 million in savings from its FORCE program for 2021. As a reminder, the FORCE program is an ongoing cost reduction effort that is in addition to savings from its 2018 Restructuring Plan. The company has claimed between $250-$500 million per year in FORCE savings for the last several years. KMB claimed it realized $145 million in both FORCE and restructuring savings in the 6/20 quarter and has raised its full-year target by $110 million and stated it "is increasing cost savings expectations for the year and reducing discretionary general and administrative spending." The company also remarked that adjusted between-the-lines spending was 17.5 percent of net sales compared to 20 basis points last year and admitted, "this was somewhat lower than we planned at the beginning of the quarter as we reduced discretionary spending and updated incentive compensation expectations." Some of this is likely related to advertising and other investments in the Consumer Tissue business. Regardless, we believe these costs cuts should be viewed as deferrals and the company will have to catch up its spending in later quarters to the detriment of future growth.

- Lower stock compensation expense added approximately 4.5 cps to earnings growth. Lower adjusted non-operating expenses added 1.6 cps and higher adjusted other (Income)/Expense added almost a penny.

What to Watch?

- The key factor in the company's underperformance in the quarter was the dramatically higher-than-expected raw materials inflation. While most raw materials costs are rising, this seems to be especially acute for pulp resin prices, a key ingredient in the company's tissue products. The company now projects resin costs will be up in the 100% range for the full year. This resulted in $345 million in higher costs, a 750 bps drag on gross margins in the quarter, and represented the highest level of inflation the company has experienced on record. The negative impact on the quarter was a 10 cps higher than expected going in.

- After the first quarter, KMB stated it was going to limit direct price increases and rely on lower promotional activity to control higher costs. Not anymore. The company has initiated significant price increase on products to combat the unexpectedly high raw materials inflation including “mid-to-high-single-digit” price increases across the majority of its consumer products business along with other price increases in both developed and developing markets. While retailers should understand the realities of the pricing environment, it is not a done deal that these higher prices can be pushed through without it impacting the company’s top-line growth and market share. Management stated on the call: “pricing actions globally are generally on track and I think broadly the retailer conversations though never easy, I would say have been largely constructive.”

- As a result of pressure on profits, the company has reduced its full-year share repurchase target to $400-$450 million from the previous $650-$750 million.

- We remind investors that the company received an approximate $100 million tailwind from favorable rebate accruals settlements in 4Q ’20 that will make for difficult comparisons at the end of the year.

- While higher costs and poor Consumer Tissue results have taken focus, the company’s Personal Care business (53% of sales) did report 6% organic growth in the quarter. Likewise, while KC Professional (16% of sales) sales growth lagged at 2%, this business could see a decent rebound in the second half if business reopenings continue to strengthen.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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