BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Clorox (CLX) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4+	3+

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are raising our earnings quality rating to 4+ (Acceptable).

CLX reported non-GAAP EPS of $3.22 in the 9/20 quarter which was 97 cps ahead of estimates. We did not see any significant earning quality issues in the quarter. Unlike most companies, CLX does not regularly report non-GAAP earnings figures with an endless array of one-time charges added back. In most quarters, the EPS figure at the bottom of the income statement is what is compared to the consensus target which we find refreshing. This quarter did contain a non-operating gain of about 52 cps, but the earnings beat was well intact after adjustment for that.

We also remind clients that our earnings quality review score reflects the reliability of the reported earnings and cash flows and does not take fundamental macro and market demand factors into consideration. Virtually all of CLX's products are receiving a huge boost from COVID- cleaning products, kitty litter, trash bags, and grilling products. When the COVID impact laps, the organic growth rate will fall from its current near-30% rate, and when conditions return to normal, organic YOY declines are quite likely. When that happens and how far the decline will be are questions beyond the scope of this report.

What deteriorated?

- During the quarter, CLX increased its investment in its joint venture in Saudi Arabia from 30% to 51% resulting in the company consolidating the operations on its financial statements. This resulted in a remeasurement of its existing ownership which generated a one-time non-cash gain of $85 million or about 52 cps. This accounts for just over half of the 97 cps earnings beat in the quarter, so we consider this a non-issue for earnings quality.

What to watch

- We have identified several companies with a large presence in Latin American that are receiving an artificial boost in their organic sales growth figures which have the negative impact of FX rates adjusted out but continue to benefit from unsustainable, inflation-driven price increase in those markets. We have noted in the past that CLX has received a meaningful benefit from this phenomenon in the past. International organic sales did receive a benefit in the quarter from 8% pricing growth while the 8% negative FX impact was adjusted out. This did artificially boost total company organic sales growth by about a point and a half, but with COVID driving 27% organic growth, the impact is less meaningful now.

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 Concerns"	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 may 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 the next quarter. 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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