

## Clorox (CLX) EQ Update- 12/19 Quarter

Current EQ Rating*	Previous EQ Rating
3+	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 maintaining our earnings quality rating of 3+ (Minor Concern)

- We have noted with multiple companies with a material presence in Latin America that non-GAAP organic sales growth figures are artificially benefitting from inflation-driven price increases while the related negative impact of FX devaluation is adjusted out of the non-GAAP growth figure. This phenomenon appears to have been a material benefit to CLX's 12/19 organic sales figure. Total organic revenue growth (ex. acquisitions/divestitures and FX) was flat with 6% organic growth reported in the international segment. However, that 6% organic growth was the product of only 1% volume growth and 7% pricing growth with the 8% negative currency impact being adjusted out. (Note that these amounts do not tie due to rounding). The 7% pricing boost was almost certainly driven by the inflationary environment in Latin America, namely Argentina. If we assign a more realistic 1% organic growth to the international segment, we get a total company organic sales growth *decline* of about 1.2% rather than the headline flat organic growth. International sales account for only 12% of total sales, yet the FX adjustment from that segment materially distorted the organic growth calculation.

- Inventory DSI fell by 5 days compared to the 12/18 quarter. We have observed in previous reviews that inventories have been rising which management blamed on the Nutranext acquisition. Our concern level was reduced by management’s acknowledgment of the issue and its plans to bring inventory down in the second half of 2019. In the conference call, management specifically addressed getting better at managing Nutranext inventories to meet demand, moving its supply chain for Brita water filters to the Dominican Republic from China which allows them to carry less inventory, and improvements in its Glad business. Overall, we view the decline in DSI as a positive. However, CLX utilizes the LIFO method of inventory accounting for over 30% of its inventories. Any time a company utilizing the LIFO method works down inventories, there is a possibility that gross margin artificially benefited from the company working its way into the older, lower-priced inventory balances to match against current sales. The LIFO reserve increased as a percentage of total inventory which does not indicate that there was a dramatic expensing of LIFO balances. Likewise, CLX carries less than 2 months of inventory on its balance sheet which would minimize the impact of a material boost from “LIFO liquidation.”
- Other (income)/expense was a positive \$5 million in the 12/19 quarter compared to a \$7 million expense in the year-ago quarter. This was largely due to the revaluation of trust assets related to its deferred compensation plans. This beneficial swing added about 7 cps to reported growth in the quarter but this accounted for only about half of the reported EPS upside.
- Lower pension cost added about 1.2 cps to EPS in the quarter.

# 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.

## Disclosure

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