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Clorox (CLX) EQ Update-12/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	4-

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

We lower our earnings quality rating to 3- (Minor Concern).

CLX's EPS of $1.40 in the 12/18 quarter beat consensus by 11 cps. However, a noticeable increase in inventory causes us to reduce our rating from a 4- (Acceptable) to a 3- (Minor Concern).

Inventory days (DSI) jumped by more than 7 days over the year-ago period as seen in the following table:

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
COGS	$830	$885	$947	$868
Inventory	$578	$519	$506	$508
COGS YOY growth	2.9%	7.0%	5.8%	5.0%
Inventory YOY growth	17.0%	12.3%	10.2%	-0.4%
Inventory DSIs	63.5	53.5	48.8	53.4

	12/31/2017	9/30/2017	6/30/2017	3/31/2017
COGS	$807	$827	$895	$827
Inventory	$494	$462	$459	$510
COGS YOY growth	3.9%	3.0%	2.5%	6.0%
Inventory YOY growth	-1.4%	-0.6%	3.6%	10.9%
Inventory DSIs	55.9	51.0	46.8	56.3

Management attributed the increase in inventory to the Nutranext acquisition and a buildup in product for pre-launch.

> *"I would say the bulk of that [inventory increase] is Nutranext. Keep in mind Q2 last year Nutranext not one of our portfolio. So that's the bulk of the increase in inventory. And then because we have such a strong innovation pipeline in the back half of this year, we did pre-build in preparation for launching in innovation, so that explains a bulk of the rest of it."*

However, the Nutranext deal closed on 4/2/18. This means that our calculation of quarterly DSI for that quarter would not have been artificially inflated by much given that it would have reflected almost a full quarter of Nutranext cost of sales to match against the acquired inventory. Therefore, the 6/18 and 9/18 quarters would have only been impacted to the degree that Nutranext's business model incorporates a higher level of inventory balances relative to cost of sales than the rest of CLX's business. The approximate 2-day year-over-year increases seen in the June and September quarters is not alarming. However, the sudden 7.6-day increase in the 12/18 quarter looks very much out of trend. Thus, we are skeptical that the acquisition could have driven half of the observed increase in inventory witnessed in the 12/18 quarter. This could be a sign of an unexpected buildup in product which could lead to higher markdowns in the upcoming quarters.

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 recent 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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