BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Clorox (CLX) EQ Update- 3/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

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

We maintain our rating of 3- (Minor Concern).

- We remain concerned by the buildup in inventories which we pointed out in our review of the 12/18 quarter. In the conference call, management continues to blame the increase on its 4/2/18 acquisition of Nutranext:

  "Yes, no real change there. It's pretty consistent to what I mentioned last quarter, we were up about $48 million year-over-year at the end of Q3, $46 million was Nutranext, so the base business was essentially flat year-over-year and that was my commitment. Last quarter, we'd worked down the higher inventory as we launched our innovation. We had pre-built some innovation.

  And as I also mentioned, if you think about Nutranext, it's a relatively small business we've acquired, it was not particularly efficient when we bought it. Their days on hand probably operate in the 120 to 130 days. Clorox generally operates in the 50 to 60 days inventory on hand. So, there are some good work and some good opportunity for us to go through there and make that business more efficient.

  It will not be our first priority. We're focused on innovation. We're focused on extending distribution, but we will improve the overall turns of that business, but the other comment I'd say is I never expected to be consistent with other parts of our portfolio. They tend to be very high turn items. I think the VMS space in general will be a little bit higher in inventory levels and days on hand because of the complexity, but certainly expect it to be lower than where it is right now."

We remain puzzled by management's explanation of the increase. Remember that inventory days (DSI) of sales jumped over 7 days in the 12/18 quarter. However, the increases in DSIs in the 6/18 and 9/18 quarters (both post-Nutranext acquisition) were only about 2 days. DSIs rose by 4.4 days in the 3/19 quarter, which was still notably higher than the increases seen in the first two quarters after the acquisition. Management's admission that Nutranext had inefficient inventory management prior to the acquisition implies that improving the inventory situation should be relatively easy. Also. remember that sales fell short of expectations in the 3/19 quarter and the company lowered guidance partly due to increased competition in Glad bags and lower demand for sanitizing wipes. All of these factors continue to give us cause for concern that the increased inventory balances could have a negative impact on margins in upcoming quarters.

- CLX's buyback is now consuming more than free cash flow and adding about 1.2% to reported EPS growth. Organic growth is essentially non-existent. Debt to EBITDA is approximately 2x so this is not an immediate problem but warrants observation going forward.

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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