BEHIND THE NUMBERS
Quality of Earnings Analysis
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Ecolab (ECL)
Earnings Quality Update- 12/21 Qtr.

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

We are downgrading our earnings quality rating of ECL to 3- (Minor Concern).

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

Summary

ECL reported non-GAAP EPS of $1.28 in the 12/21 quarter which was in line with expectations. A lower adjusted tax rate from “tax planning” strategies in the quarter added 1.7 cps. We also see other signs of temporary benefits for the quarter:

- Adjusted gross margin fell by 220 bps in the 12/21 quarter, an acceleration from the 80 bps decline in the 9/21 quarter as cost inflation worsened during the period. Costs were up 10% on the year but this accelerated to 20% in the fourth quarter. However, inventories adjusted for acquisitions fell sequentially, indicating a significant decline on a unit basis. Delay in replenishing could have boosted gross margin for inventories accounted for under the LIFO method and the Average Cost method. This benefit will fade as ECL must rebuild inventories at higher costs. (See detail below.)

- We discussed in our previous review of ECL that the company wrote off $50 million of excess sanitizer inventory in the 9/21 quarter and it could artificially benefit margins if that inventory was sold in a later quarter. We did not see discussion of that matter in the fourth quarter but note that ECL took another $10 million of similar write-downs in the 12/21 quarter which was added back to non-GAAP results. (See detail below.)

- In addition to the Covid-related inventory write-downs, the company took another $29 million of Covid-related charges it added back to non-GAAP earnings. We don't know the exact makeup of these charges for the fourth quarter, but in describing the charges for the full year, the company indicated they included amounts to "protect the wages" of employees, and for Covid testing. Interestingly, the non-inventory-related Covid charges for all of 2021 were on par with the amounts recorded in 2020 when the pandemic was in full-swing. Also notable is the fact that of the $47 million of charges taken in 2021, $29 million fell in the fourth quarter. This seems peculiar as we don't see what would cause the company to spend more on protecting wages or accelerating testing in the last quarter of 2021 versus the rest of the year. Note that every $5 million of charges added back amounts to 1.4 cps in earnings for a company that just met estimates in the quarter. (See detail below.)

Lack of Inventory Growth May Have Shielded the 12/21 Quarter from Full Brunt of Higher Costs

ECL's adjusted gross margin fell by 220 bps in the 12/21 quarter which was accelerated from the 80 bps decline in the 9/21 quarter as the rate of cost inflation jumped. However, we suspect that the company's inventory accounting methods shielded it from some of the impact of rising costs and this benefit is likely to wane going forward.

Like most companies, ECL's gross margins are under pressure from rising costs. Management stated in the call that over 2021, it saw its raw materials costs rise by 10%, but this accelerated to 20% in the fourth quarter. This increase in costs can be seen in the company's adjusted gross margins in the following table:

	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Adjusted Gross Profit Margin	39.8%	40.9%	41.8%	41.3%

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Adjusted Gross Profit Margin	42.0%	41.7%	40.1%	43.4%

The YOY decline in adjusted gross margin accelerated to negative 220 bps in the 12/21 quarter from negative 80 bps in the previous quarter. However, we suspect that the company's margins may have been shielded somewhat by its inventory accounting methods. ECL utilizes the LIFO method of inventory accounting for 27% of its inventory balances with the rest accounted for under either FIFO or Average Cost. Let's look at the components of the company's inventory balance for the last few quarters…

	12/31/2021	9/30/2021	6/30/2021	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Finished Goods	$1,010.6	$886.5	$879.9	$845.8	$789.6	$781.6	$750.0
Raw Materials and Parts	$596.1	$550.2	$578.6	$530.0	$511.2	$531.3	$503.9
FIFO cost to LIFO Cost Difference	-$114.9	-$58.5	-$40.0	-$28.8	-$15.6	-$25.1	-$25.2
Total Inventory	$1,491.8	$1,378.2	$1,418.5	$1,347.0	$1,285.2	$1,287.8	$1,228.7

… and the following table shows inventory components on a DSI basis.

	12/31/2021	9/30/2021	06/30/2021	03/31/2021
Finished Goods DSI	45.5	40.4	43.4	44.5
Raw Materials and Parts DSI	26.8	25.1	28.6	27.9
FIFO cost to LIFO Cost Difference DSI	-5.2	-2.7	-2.0	-1.5
DSI	67.2	62.9	70.0	70.8

	12/31/2020	09/30/2020	06/30/2020	03/31/2020
Finished Goods DSI	40.8	40.6	41.7	51.6
Raw Materials and Parts DSI	26.4	27.6	28.0	28.7
FIFO cost to LIFO Cost Difference DSI	-0.8	-1.3	-1.4	0.5
DSI	66.4	67.0	68.4	80.9

ECL acquired Purolite on 12/1/2021. According to the 10-K, the company booked $163 million of the purchase price as inventory. If we subtract that from the 12/21 inventory balance, we see that inventory declined to $1.32 billion from $1.34 billion in the 9/21 quarter. That is also up only 3% from the year-ago level. If costs were up 20%, that implies a significant decline in inventories on a unit basis. This could have helped lower the costs reported on the income statement in two ways:

- LIFO expenses the most recent, more expensive inventory on the income statement first. This is visible in the LIFO adjustment which jumped to $114.9 million in the 12/21 quarter from $58.9 million in the previous quarter and essentially represents how much more cost was recorded on the income statement under the LIFO method that would have been reported under the FIFO method. However, if the company delayed adding new inventories to its LIFO portion, it would have tapped into the older, less expensive layers. This would have benefitted reported gross margin as the company's revenues were fueled by charging higher prices. However, this benefit will run out as ECL is forced to add new LIFO inventory as higher costs.

- The Average Cost method of inventories calculates the average cost per unit in inventory during the period and uses that to calculate the expense associated with the sale of those units. When the company adds new units to the Average Cost inventories at higher costs, it immediately increases the average cost figure regardless of whether that inventory is sold during the quarter. Therefore, if the company delayed rebuilding Average Cost inventories it would also have deferred the impact of higher costs until later.

- The FIFO portion of inventories expense the older inventory levels first which results in strong reported profits as higher costs are delayed from hitting the income statement. A decline in inventories on a unit basis would not have increased this benefit.

Given the lack of growth in inventory despite higher prices coupled with the company's inventory accounting method, we suspect that a meaningful impact of higher costs was delayed from impacting the income statement in the 12/21 quarter. This could result in more pressure on gross margin in the next couple of quarters than some analysts are expecting.

More Inventory Write-Offs

We documented in our last review of ECL that the company took a $50 million charge in the 9/21 quarter to write down the value of excess sanitizer products. Consider the disclosure from the 9/21 10-Q:

“Customer demand for sanitizer products surged at the outset of COVID-19. The Company worked hard to meet the rapidly increasing demand and sold the vast majority of the sanitizer inventory. However, COVID-19 variant-related delays of customer reopenings and consumer activity resulted in a small portion of excess sanitizer inventory. The Company recorded inventory reserves of $50 million in the third quarter of 2021 for excess sanitizer inventory and estimated disposal costs.”

Disclosures indicate that the company took an additional $10 million write-off to excess sanitizer inventory in the 12/21 quarter. We pointed out in our previous review that if the company ended up selling this inventory, it could result in unusually high profits as there would be no associated cost. We saw no discussion on the matter in the disclosures or conference call for the 12/21 quarter.

Covid Charges Are Getting Bigger

In addition to the Covid-related inventory charges mentioned above, ECL has taken other Covid charges over the last two years which it has added back to non-GAAP results. The following table shows the total Covid charges by quarter with the inventory components broken out:

	12/31/2021	9/30/2021	6/30/2021	3/31/2021
Covid 19 Activities	$39.100	$52.200	$8.300	$7.500
Inventory Write-Downs	$10.00	$50.00	-	-
Non-Inventory-Related Covid 19 Charges	$29.10	$2.20	$8.30	$7.50

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
COVID 19 Activities	$20.200	-$1.200	$10.200	$0.000
Inventory Write-Downs				
Non-Inventory-related Covid 19 Charges	$20.20	-$1.20	$10.20	$0.00

The company disclosed the following regarding its Covid-19 activity charges in the 2021 10-K:

“Customer demand for sanitizer products surged at the outset of COVID-19. The Company worked hard to meet the rapidly increasing demand and sold the vast majority of the sanitizer inventory. However, COVID-19 variant-related delays of customer’s reopening and consumer activity resulted in a small portion of excess sanitizer inventory. The Company recorded inventory reserves of $60 million during 2021 for excess sanitizer inventory and estimated disposal costs. The Company recorded charges of $36.8 million and $57.1 million during 2021 and 2020, respectively, to protect the wages of certain

employees directly impacted by the COVID-19 pandemic. The Company recorded charges related to the COVID-19 pandemic of $16.5 million and $2.4 million related to employee COVID-19 testing and related expenses during 2021 and 2020, respectively. In addition, the Company received subsidies and government assistance, which were recorded as a special (gain) of ($6.2) million and ($23.4) million during 2021 and 2020, respectively. COVID-19 pandemic charges are recorded in product and equipment cost of sales, service and lease cost of sales, and special (gains) and charges on the Consolidated Statements of Income. Total after tax net charges (gains) related to COVID-19 pandemic were $81.3 million and $27.4 million during 2021 and 2020, respectively."

Here is a summary of the components of the charges for 2021 and 2020 adopted from the above disclosure:

	2021	2020
Inventory Write Offs	$60.0	
Protect Wages	$36.8	$57.1
Testing and Related Expenses	$16.5	$2.4
Government Subsidies	-$6.2	-$23.4
	$107.1	$36.1

We see that in addition to the inventory write-downs which were added back to the 9/21 and 12/21 quarters, the company took charges of $36.8 million in 2021 related to protecting the wages of employees and $16.5 million related to Covid testing. These amounts were added back to non-GAAP earnings. It is interesting that the non-inventory, non-subsidy portion of the charges for 2021 were on-par with the amounts spent in 2020 when the pandemic was in full swing.

Also notable was that $29.1 million of the $47.1 million in non-inventory-related charges taken in 2021 occurred in the fourth quarter. Most companies were testing employees throughout 2021 and we can't see how the company incurred meaningful amounts to "protect the wages" of its employees in 2021 when most companies were complaining they can't find enough people to fill open positions. All of this makes us question how much of these amounts can truly be characterized as "one-time" in nature.

Note that every $5 million in expenses added back amounts to 1.4 cps in earnings for a company that just met estimates in the 12/21 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 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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