BEHIND
THE NUMBERS
Quality of Earnings Analysis
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Ecolab Inc. (ECL) Earnings Quality Review

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

We are initiating earnings quality coverage of ECL with a 4- (Acceptable) rating

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

Summary

Overall, we do not have significant concerns with ECL's earnings quality. We do note that the company's 12/20 quarter non-GAAP EPS of $1.23 missed the consensus estimates by 2 cps. This would have been worse without a 4 cps benefit from a lower tax rate which appears unexpected. From a bigger picture perspective, we do not like the company's ongoing restructuring charges and the fact that the restructuring plan started in 2018 has continued to grow in size and duration. Nevertheless, we are not concerned enough to rate the company a 3 (Minor Concern) over that matter.

What is strong?

- The company has made several acquisitions in recent years which have resulted in sizeable goodwill and intangibles balances. Over half of the recent purchase prices have been allocated to goodwill and will not be amortized, but this is not a problem common to ECL. The bulk of the rest of the balances have been allocated to intangible categories, but the estimated amortizable lives are reasonable and we applaud the company for not adding back amortization to non-GAAP earnings.

What is weak?

- ECL's non-GAAP tax rate fell to 18.3% in the 12/20 quarter from 20.9% in the year-ago quarter. This added about 4 cps to EPS in the period. We saw no explanation for the decline and we do not believe this was largely anticipated by analysts. Therefore, we would view this as adding to the company's 2 cps earnings miss.

- ECL posts regular restructuring charges which it adds back to non-GAAP earnings. These amounts regularly exceed 5% of adjusted operating income. The most recent plan, Accelerate 2020, was started in 2018 and was originally expected to cost $260 million and be completed by the end of 2020. In 2020, the company expanded the scope of Accelerate 2020 and split part of it into a whole new plan. Together, these plans are now expected to cost over $350 million (when adjusted for discontinued operations) and run through 2023. On the bright side, the company has reportedly already realized $200 million of the total expected $365 million in annual cost savings to be achieved by these plans.

- The 2011 acquisition of Nalco resulted in a $1.2 billion indefinite-lived trademark intangible. This amount is not amortized which we believe is a negative for earnings quality. Amortizing this over 15 years- similar to timeframes used for recent deals- would add over 20 cps to costs on an annual basis which represents about 5% of trailing 12-month earnings. This intangible is reviewed for impairment annually and the most recent review showed the fair value to exceed carry value by "a significant margin" which implies at least 10%. The asset has never been impaired and we do not see a huge risk of this at the moment.

- ECL added back 9 cps of COVID-related charges to non-GAAP EPS in 2020. We have criticized some companies for doing this when these amounts included subjective costs such as incremental cleaning expense but ignore the one-time benefits such as lower travel costs. However, ECL's COVID charges appear to relate to its paycheck protection plan to ensure the pay of its employees during the pandemic net of government subsidies received. Given the specific nature of the expenditure, we do not consider this an unreasonable adjustment.

What to watch

- The company's institutional customers were hit hard by the pandemic which prompted the company to reduce inventories in that channel. Inventories have remained roughly flat sequentially during the year although they were higher on a DSI basis compared to the year-ago fourth quarter. Management expects rebuilding inventory will be a drain on cash flow in 2021 but not be significant. We will be watching inventory for signs of an

unexpected buildup keeping in mind that demand for cleaning products saw unusually strong demand during the pandemic which may wane as conditions normalize.

Supporting Details:

Significant Goodwill and Intangibles Balances- But Acquisition Accounting Seems Reasonable

ECL should not be labeled a "growth through acquisition story." Nevertheless, the company has made some sizeable deals over the years that have led to goodwill totaling more than 33% of total assets with other intangibles comprising more than 16%. The following table shows the acquisitions made over the last three years and the amount of the purchase prices allocated to intangible components:

	Price	Goodwill	Customer Relationships	Trademarks	Tech.	Non-Comp	Total Intangibles
2020							
CID Lines	$506.900	$275.700	$147.500	$58.600	$47.700		$529.500
2019							
Bioquell							
Lobster Ink							
Chemstar							
Gallay Medical & Scientific							
TOTAL	$415.50	$234.80	$115.70	$24.10	$48.90		$423.50
2018							
Unnamed water business							
Unnamed institutional business							
TOTAL	$226.50	$81.90	$101.50	$3.90	$6.50	$2.60	$196.40

We can see that in the last two years, virtually all of the purchase prices of acquired companies have been allocated to goodwill and intangible assets. Of that, more than 50% has been allocated to goodwill which will not be amortized. While we do not like that this ignores the cost of the acquisition, this is certainly not a problem specific to ECL.

The bulk of the remaining amount of the purchase prices was allocated to other intangibles which are amortized over the estimated useful life of the asset. The weighted average useful life for each category as of 12/20 was:

Customer Relationships	14 yrs
Trademarks	14 yrs
Patents	15 yrs
Other Technology	7 yrs

These are not outrageously long timeframes given the nature of the business. Also, we applaud the company for not adding back the amortization of intangibles to its non-GAAP results.

It is worth noting that the company also has a $1.2 billion indefinite-lived trade name intangible from its 2011 acquisition of Nalco. Like goodwill, this is not amortized. Also, note that the Nalco deal resulted in the addition of $4.5 billion in goodwill in addition to the indefinite-lived intangible. If the indefinite-lived trade name intangible was amortized over a 15-year timeframe (similar to recent deals) it would add about 20 cps to annual costs, or about 5% of trailing earnings so the decision to assign an infinite life to the trade name has been material to earnings. This intangible is subject to annual review for impairment. The company determined in its 2020 annual review that the fair value of the trademark exceeded its carrying value by "a significant margin."

Restructuring Program Expanding

ECL has a long history of taking restructuring charges which it adds back to non-GAAP earnings. The following table shows these charges relative to non-GAAP operating income for the last five years:

	2020	2019	2018	2017	2016	2015
Total Restructuring Charges	$78.8	$137.2	$101.5	$44.5	-$9.1	$100.3
Adjusted Operating Income (cont. ops in 2020)*	$1,623.5	$2,263.9	$2,083.0	$2,003.0	$1,882.8	$1,432.2
Charges as % of Adjusted Operating Income	4.9%	6.1%	4.9%	2.2%	-0.5%	7.0%

*Note that in 2020 the company began reporting its ChampionX results which were spun off in June and presented as discontinued operations. Restructuring charges associated with the discontinued operations were not included in the amounts shown above. However, 2019 and prior data include all charges and adjusted operating income including the discontinued operations. Therefore, these will not match historical data shown in the 2020 10-K.

ECL had restructuring plans in effect which were started before 2015 under which it incurred over $100 million in charges in 2015. These plans were largely wound down by 2016 and the company even incurred restructuring gains that year as spending came in below plan. Then in 2018, the company announced a new plan called *Accelerate 2020*. Below is an excerpt from the 2018 10-K describing the plan:

> *"During the third quarter of 2018, we formally commenced a restructuring plan Accelerate 2020 ("the Plan"), to leverage technology and systems investments and organizational changes. Subsequent to year-end, we raised our goals for the Plan to simplify and automate processes and tasks, reduce complexity and management layers, consolidate facilities and focus on key long-term growth areas by leveraging technology and structural improvements. We expect the expanded restructuring activities will be completed by the end of 2020, with anticipated costs of $260 million…The restructuring actions are expected to result in approximately $325 million of annual cost savings by 2021."*

Commentary on the plan in the 2019 10-K indicated that the cost and scope of the plan remained unchanged. However, in 2020, the plan was expanded. A new plan was added called the *Institutional Advancement Program* which is expected to total $80 million in spending through 2023. Some of this $80 million includes spending on actions that were originally slated for the *Accelerate 2020 Plan*. Meanwhile, the *Accelerate 2020* plan was increased in scope during the year with total spending (now through 2022) to total $255 million adjusted for discontinued operations. From looking at the change in restructuring charge disclosure from 2019 to 2020, we deduce that discontinued operations included $18.5 million in restructuring charges. If we add that to the current forecast of $255 million in *Accelerate 2020* spending plus the $80 million in *Institutional Advancement Program* spending, we see that total restructuring spending on the original program grew to $353.5 million from the original cost of $260 million. Meanwhile, the forecast for total annual cost savings has risen to $315 million for *Accelerate 2020* plus another $50 million for the *Institutional Advancement Program* for total savings of $365 million versus the original *Accelerate 2020* goal of $325 million.

Conclusions about the charges:

On the positive side:

- Most of the charges appear specifically allocated to severance and closure costs rather than large components labeled as "other".
- According to management, the company has already realized $200 million in annual cost savings as of the end of 2020 as a result of these actions.

On the negative side:

- The company is regularly adding back charges exceeding 5% of non-GAAP operating profits. This is very material and despite the specific labeling of the charges, the size and

regularity leave open the possibility that expenses that should be considered ongoing are being dismissed with the charges by non-GAAP results.

- The increasing size of the plan is a concern, especially given its history of charges prior to 2018.

- The majority of all these charges are expected to result in cash expenditures.

These charges alone are not enough to prompt a 3 (Minor Concern) rating, but their size and ongoing nature are the main factor keeping us from rating ECL a 5 (Strong.)

Inventory Rebuilding

ECL's institutional customers (restaurants, hotels, schools, etc.) were hard hit by the pandemic which led to significant slowdowns. In response to the buildup in that channel, the company backed off on adding to its inventory. The analysis of inventory trends in 2020 is complicated by the spinoff of ECL's ChampionX operations to Apergy in the 6/20 quarter. ChampionX's operations were accounted for as discontinued operations so historical results include the ChampionX numbers. *Note that in the below table which shows the calculation of DSIs, the 3/20 quarterly results have not been adjusted for the discontinued operations:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020*	12/31/2019
Cost of Products Sold	$1,780.3	$1,769.6	$1,635.7	$2,116.8*	$1,809.1
Total Inventory	$1,285.2	$1,287.8	$1,228.7	$1,529.7*	$1,081.6
DSIs	66.4	67.0	68.4	65.8*	55.0

We can see that the company's inventories have remained essentially flat through the second quarter through the fourth quarter. However, 12/20 inventories are higher than the year-ago level on an absolute and DSI basis. Management has indicated that it expects inventory to grow during 2021 as conditions improve and it builds inventory to meet hopefully rising demand. This was addressed in the 12/20 conference call:

"Well, maybe to ground us in the very strong performance that we had in 2020. First of all, working capital was a net contributor to strong cash flow, because although we saw a little deterioration in collections and an increase in inventory on hand from a day's perspective, the very favorable to cash flow at least impact of declining volumes made working capital and net contributor. So 2021 will be somewhat the opposite of that.

> ***Meaning, as the business continues to rebound, we will invest more in receivables and inventory. So not significantly, but we will invest in working capital in 2021.***
>
> *Having said that, we'll remain very focused on collections. And I've said before, in earlier calls, we are very determined and have been sure to be paid for the value that we're creating for customers. And frankly on the inventory side, just a personal comment almost. My expectation, and I know Christophe shares this sort of vibrantly, is that* ***our goal on inventory in 2021 is to make sure that we're building the right stuff for the right customers and expectation of the rebound, and so the favorable inventory in '20 will reverse in 2021, but it won't be a big drag on overall cash flow performance."***

Building inventories to meet rising demand may consume some cash in the short-run, but it is not a bad problem to have. Therefore, we are not highlighting this as a risk but a point to watch over the year for signs of an unintended buildup of product. A material part of ECL's business has received a nice tailwind from the pandemic as customers added and beefed up existing disinfection protocols. A potential risk is that this demand wanes as conditions return to normal which could show up as a buildup of related products in inventory.

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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