BEHIND THE NUMBERS
Quality of Earnings Analysis

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Ecolab (ECL)

Update after 3/22 Quarter Results and 10-Q Review

We maintain our earnings quality rating of ECL at 3- (Minor Concern) but move from Top Sell given the improvement in the inventory situation.

Summary

ECL reported non-GAAP EPS of $0.82 in the 3/22 quarter which missed consensus estimates by a penny while revenue came in above targets. The company forecast for 2Q22 earnings to approximate last year's figure of $1.22, but is calling for accelerating earnings growth in the back half with "low teens" earnings growth for the full year, consistent with its outlook at the end of the year.

Management cautioned that much would depend on the timing of the energy surcharge it plans to implement. These charges are intended to offset the higher cost of energy resulting from the Russian invasion of Ukraine, will range from 8-12%, and will be levied on the whole customer base. The company raised prices by 3% in 4Q21, 5% in 1Q22, and expects pricing to increase 6-7% for the balance of the year. Management indicated it is pleased with how pricing is being received by customers but the timing and success of the surcharges and price increases will be key to the company meeting expectations over the next couple of quarters.

We continue to see a risk for higher than expected costs to lead to disappointment in upcoming quarters.

- Raw materials inventory balances rose by almost 30% year-over-year. However, the company stated that cost inflation was running at 25% in the quarter. While the situation has improved somewhat from the end of the 12/21 quarter, there still was not much rebuilding on a unit basis. Inflation is expected to jump to 30% in 2Q22 which will put the company replenishing inventory at elevated levels. With almost 30% of inventory accounting for under LIFO, these higher-cost units will hit the income statement as soon as sold which increases the risk of disappointment if the company is delayed implementing its planned energy surcharges or gets pushback from its price increases.

- The company took almost $18 million in charges to write down the value of excess Covid sanitizer products which it added back to non-GAAP earnings. These charges continue to roll in and it is not known if the company is selling some of this inventory which would result in an artificial boost to margins from the reduced cost basis.

- Also added back to non-GAAP results was $27 million in amortization of the inventory step-up related to the acquired Purolite inventory. Many companies add these amounts back to non-GAAP earnings but we have always believed that it distorts the economic picture in terms of inflation, especially for a company that normally utilizes LIFO accounting for approximately 30% of its inventories.

Inventory Unit Growth Appears to Still Be Lagging

We noted our concern in our last review that the company's inventory was lagging unit sales growth. Our concern was that profits could have been helped temporarily if the company ate into lower-cost LIFO layers in the 27% of inventories that were accounting for under LIFO. The declining raw materials balances also put the company in a position of replenishing inventories at much higher prices. The below table shows the components of inventory for the last eight quarters:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Finished Goods	$1,039.5	$1,010.6	$886.5	$879.9
Raw Materials and Parts	$687.5	$596.1	$550.2	$578.6
FIFO cost to LIFO Cost Difference	-$137.1	-$114.9	-$58.5	-$40.0
Total Inventory	$1,589.9	$1,491.8	$1,378.2	$1,418.5

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Finished Goods	$845.8	$789.6	$781.6	$750.0
Raw Materials and Parts	$530.0	$511.2	$531.3	$503.9
FIFO cost to LIFO Cost Difference	-$28.8	-$15.6	-$25.1	-$25.2
Total Inventory	$1,347.0	$1,285.2	$1,287.8	$1,228.7

And here are the inventory components on a DSI basis:

	3/31/2022	12/31/2021	9/30/2021	6/30/2021
Finished Goods DSI	45.1	45.5	40.4	43.4
Raw Materials and Parts DSI	29.8	26.8	25.1	28.6
FIFO cost to LIFO Cost Difference DSI	-6.0	-5.2	-2.7	-2.0
DSI	69.0	67.2	62.9	70.0

	3/31/2021	12/31/2020	9/30/2020	6/30/2020
Finished Goods DSI	44.5	40.8	40.6	41.7
Raw Materials and Parts DSI	27.9	26.4	27.6	28.0
FIFO cost to LIFO Cost Difference DSI	-1.5	-0.8	-1.3	-1.4
DSI	70.8	66.4	67.0	68.4

We see that raw materials did increase both sequentially and year-over-year in the 3/22 quarter. Also, raw materials DSIs increased by almost 2 days which puts the company in a better position than it was at the end of the year. However, we still note that the 30% YOY increase in raw materials inventory was not significantly higher than the 25% YOY increase in costs the company cited in the quarter implying that the inventory build may not have been as high on a unit basis as the figure above indicate. As noted above, management expects YOY inflation to hit 30% in Q2, meaning the company will be buying new inventories at very high levels. Also, with over a quarter of inventories accounted for under LIFO, much of the impact of these higher costs will be felt immediately. We see this adding a degree of risk of more disappointment on the cost side in 2Q22 if the company is delayed in pushing through the surcharges or gets more pushback than expected from its price increases.

More Covid Charges

ECL took another $17.8 million in Covid charges in the quarter which it added back to non-GAAP results. The bulk of these charges related to writedowns of Covid sanitation product inventories. It is not known if these products will be sold in the future but if so, it could result in an artificial boost to profits due to a lower cost basis.

Inventory Step-Up Charge

Also added back to non-GAAP results was $27.4 million in integration charges which the company attributed to the recognition of the fair value step-up in the Purolite inventory acquired in the previous quarter. At the time of the Purolite acquisition, ECL would have marked up the value of Purolite's inventory to reflect the cost of the inventory at the time the deal closed. The higher value was largely the result of cost inflation. Accounting rules require ECL to amortize this increase in value over the estimated time that the inventory is sold. The inventory step-up ECL added back was the amortization charge associated with the increase in the value of the inventory. While this is very common to see inventory step-ups added back, we believe this distorts the economic picture. It essentially has the effect of converting the accounting for that inventory from LIFO (current cost) to FIFO (historical cost.) However, ECL uses LIFO for almost 30% of its inventories on a regular basis. Also, in times of inflation, this benefit increases in size.

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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