BEHIND THE NUMBERS
Quality of Earnings Analysis
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The Coca Cola Company (KO) 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 KO with a 3- (Minor Concern) rating.

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

Summary

KO has been beating forecasts during 2020. It has significant liquidity too which makes it difficult to see enormous problems in the near-term. It was helped like many consumer products companies during Covid as it could trim marketing costs ($1 billion in 2020 or 300bp of margin) as well as release working capital. In the bigger picture, we think accounting techniques inflate both GAAP and non-GAAP earnings by more than 15%. The cash flow is not covering the routine acquisitions and the dividend. And KO lost a tax trial that could cost it $12 billion in back taxes and penalties. To appeal, KO may have to post $4.6 billion this year.

What is strong?

- Liquidity is high. There is just under $11 billion in cash and securities on hand. As business recovers, KO is well positioned to handle higher capital spending, marketing and rebuilding working capital.

- The spread between GAAP and non-GAAP EPS is not something one can drive a truck through. Both are positive, both are close to $2.00 per share.

What is weak?

- We believe EPS for both GAAP and non-GAAP are inflated due to recording the non-cash part of equity-method investment income that exceeds the cash dividends received. Neither adjusts for this and it adds about 9-cents to EPS.

- Both sets of EPS also benefit from not amortizing $28.1 billion in intangible assets. There are deals where KO adjusted later to put more assets into these areas and away from PP&E that would have been depreciated and others where 100% of purchase price was assigned to non-amortizing intangibles. We estimate this adding 15-19-cents to EPS both GAAP and non-GAAP.

- Both sets of EPS also are benefitting from tax incentives that will start to expire in 2023. These are currently contributing 7-8 cents in EPS now.

- The equity-method investments and the intangibles are often reporting impairments and other charges. In some cases, assets will be remeasured and marked-up in value, only to see impairments the next year. We think these charges indicate that there should be more amortization in earnings and cash equity investment earnings should carry more weight.

- Coke has been restructuring for decades with much of the same goals being touted as the reason for the next streamlining. What we can see is they spend about $500 million per year on average in this area and add it back as one-time nonrecurring items. Yet, comparing the last three years to 2008-10, we see revenues are up slightly, adjusted margins about 30-80bp, and it is probably gaining about $200-$250 million in operating earnings but ignoring the annual $500 million charge.

- Cash flow is tight when accounting for the frequent investments to equity-method entities. In the last five years, free cash flow after these investments has only covered the dividend in 2020 when capital spending fell by almost $900 million. We see little way for KO to cover its investments, dividend and stock repurchases without continuing to draw down its cash balance and essentially boost net borrowing. Net Debt to EBITDA has risen from 2x to 3x since 2016.

What to watch

- KO lost a case with IRS in tax court focused on changing its transfer pricing methods, which would move $9 billion in foreign earnings to the US. KO is planning to appeal this decision, but the court is waiting on the outcome of a similar case involving 3M to finalize the KO ruling for an aspect on Brazil. KO is warning it may have to post $4.6 billion to pursue an appeal.

- The tax case covers years 2007-09. If the new methodology from the IRS is adopted for years 2010-20 as well, KO estimates it could face a $12 billion tax bill. It could also see its effective tax rate rise by 350bp.

- KO is already stretching working capital. In 2019, it began paying its bottlers and suppliers more slowly and pulled $1.3 billion of cash out of working capital. In 2020, it started to factor receivables and pulled its first $185 million out there. The dividend coverage looks even worse without these items helping cash flow.

- We think investors may not see much in the way of share repurchases in the future. KO's cash flow does not support them. Already they have dropped considerably. And even after spending $10.5 billion since 2016, share count is basically flat due to the stock compensation causing more shares to be issued.

Supporting Detail

Both GAAP and Non-GAAP Earnings Are Inflated in Our View

On the surface, the spread between GAAP and non-GAAP EPS does not look that large.

	2020	2019	2018	2017	2016
GAAP EPS	$1.79	$2.07	$1.57	$0.27	$1.49
Non-GAAP EPS	$1.95	$2.11	$2.08	$1.91	$1.91

• 2017 GAAP's wide difference is the change in tax laws.

However, we think there are several items that already inflate both sets of earnings. The first is Coke has investments primarily in bottlers where it accounts for results on the equity method. It records its share of profits, which boosts the carrying value of the investment. It also deducts the dividends it receives, which reduces the carry value of the investment. The first thing we noticed is KO continually reports more non-cash income than dividends. This is helping EPS:

	2020	2019	2018	2017	2016
Equity Investment Income	$978	$1,049	$1,008	$1,071	$835
Dividends Received	$467	$628	$551	$443	$386
Non-cash Difference	$511	$421	$457	$628	$449
EPS Impact	$0.09	$0.08	$0.08	$0.09	$0.07

KO normally reports adjusted EPS of $1.90-$2.10 and GAAP of $1.50-$2.00 so this non-cash earnings is significant in our view. Both sets get a larger base to start from.

These equity assets also seem to have several impairments and write-downs that occur frequently. There are also gains recognized too that sometimes look odd such as KO booked a $1.3 billion gain in 2016 as it deconsolidated its German bottling company. From 2010-17, KO spent over $1.2 billion on integration charges for the German unit. Only non-GAAP adds back these recurring items:

- In 2016, there was a charge of $68 million related to equity-method investments and the $1.3 billion gain for German operations.

- In 2017, KO booked gains of $445 million in Japan, $88 million in China, $150 million in Africa, and $25 million in Mexico as it remeasured the valuations following external events. It also had impairments of equity-method investments of $142 million.

- In 2018, the African write-up was reversed with a $554 million charge. There were also charges in the Middle East of $591 million, Indonesia of $205 million, Latin America of $52 million, offset with gains of $47 million from refranchising in Latin America and the sale of Lindley for a gain of $296 million.

- In 2019, the Japan write-up from 2017 took a $406 million hit, the Middle East another $255 million, with North America $57 million more and Latin America $49 million. There was $100 million in gains booked in 2019 also.

- In 2020, Japan was hit again for $252 million, and other charges to equity-method investments were $303 million. They did enjoy a $902 million write-up of Fairlife as it bought the remaining shares at a higher price and thus marked up the value of prior purchases.

There are often the same assets. One year they are getting marked up as part of a merger or stock is sold/bought causing a repricing of the remaining shares. The next year they are impaired again. The continual string of gains/losses on many of the same assets seems to make the quality of adjusted earnings less valuable in our view.

The next issue KO is carrying $28.1 billion in goodwill and intangibles – considered to have indefinite lives. These were acquired via acquisition. There is only $0.5 billion in intangibles being amortized and that is over 8-20 years. Neither GAAP nor non-GAAP is expensing the $28.1 billion in intangibles.

- The indefinite lived assets add 9 cents to both EPS figures if it was expensed over 20-years or 5-cents if expensed over 40-years.

- The lack of goodwill amortization over 40-years is adding 10-cents to EPS figures.

- The Coca Cola Enterprises deal in 2010 was a large part of the intangibles. Adjustments to the purchase price in 2011 cut the value placed on PP&E by $0.7 billion, boosted the amount to franchise rights by $0.1 billion, and saw Goodwill rise by $0.3 billion so even more assets were assigned to an area where there is no expense.

- The Costa purchase in 2019 was $4.9 billion - $2.4 billion was assigned to trademarks with indefinite lives and $2.5 billion to goodwill as Coke starts to compete in the retail coffee market.

The problem we see is for indefinite lived assets – there seems to be considerable impairments happening on a regular basis. GAAP EPS would not add these back, but non-GAAP does:

- From 2013-15 – KO had $2 billion in charges for impairments and refranchising bottling assets.

- In 2016 – KO had $153 million in impairments of bottling assets, $415 million charge to refranchise bottlers, and a $2.46 billion hit to derecognize intangible assets.

- In 2017 – KO had $737 million in impairments of bottling assets, $313 million payment to bottlers, $422 million charge for refranchising, $2.14 billion charge to derecognize intangible assets (that is net of a $1.04 billion gain).

- In 2018 – KO had a $450 million impairment of bottling assets and $476 million more for refranchising.

- In 2019 – KO only had a refranchising charge of $105 million.

- In 2020 – a $55 million charge was taken on trademarks.

The final thing we would point out is both sets of EPS are benefiting from some expiring tax incentives from other countries where Coke has operations. These incentives expire between 2023-2036. So there is time for these to continue, but they may start to decline going forward and are helping EPS by 7-8 cents now:

	2020	2019	2018	2017	2016
Tax Incentives help to Net	$317	$335	$221	$221	$105
EPS Impact	$0.07	$0.08	$0.05	$0.05	$0.02

In conclusion, both GAAP and Non-GAAP EPS appear to be inflated by 9-cents from counting non-cash income from equity-method investments, 15-19-cents from non-amortization of intangibles, and 7-8-cents from tax incentives that will expire. Non-GAAP further ignores some frequent impairments and other recurring "one-time charges.

When Isn't Coke Restructuring?

One area where we think earnings also get inflated is when a company is constantly in restructuring mode. A huge number of cash costs get labeled as one-time and should be ignored for "adjusted earnings." Yet looking back over time, it seems these one-time items continually occur. Looking at some of these "one-time" items above with impairments on bottling assets and refranchising other bottlers – we picked up a few older annual reports and read:

- *"In January 2000, our Company initiated a major organizational Realignment intended to put more responsibility, accountability and resources in the hands of local business units of the Company so as to fully leverage the local capabilities of our system."*

- Also in 2000, KO was taking non-recurring impairments on bottling assets in Japan and Europe – does this sound familiar?

- In 2003, KO was taking actions and spending money to streamline operations

- In 2006-08, KO was taking impairments on Coca Cola Enterprises and announcing more streamlining.

One plan just becomes the next plan and often focused on the same issues. Since 2010, has recorded $5.3 billion in charges for restructuring and productivity, which is a full year's free cash flow in many years. What does KO have to show for all this?

Rev and adj. Margin	2020	2019	2018		2010	2009	2008
Rev in billions	$33.0	$37.3	$34.3		$35.1	$31.0	$31.9
Adj Op. Margin	29.6%	27.9%	28.8%		27.3%	27.6%	27.5%

- Revenues are basically flat to slightly up

- Margins are up 30-80bp.

- They are spending $500 million per year to pick up $200-$250 million in operating profit ($35b in revenue * 60-80bp of margin gain). But they get to exclude the $500 million as one-time nonrecurring expense in adjusted figures.

- We believe 2020's margin was heavily influenced by cutting marking costs by $1 billion (300bp), reduced shipping costs, and fewer incentives accrued to bottlers. Bottlers earn discounts and incentives that are recorded net of sales so in 2020, a smaller figure here boosted sales at the same time marketing fell.

We also think it is important to recognize that many of these constant restructurings consume cash. Sometimes it flows through the investing section of the cash flow statement as acquisitions/investments to equity-method businesses. That is why we view dealing with bottlers to be a routine expense for KO.

Cash Flow Is Tight to Maintain All Three Uses of Cash

We want to point out that KO has considerable liquidity. There is $11 billion in cash and securities. However, as is clear from the section above – KO is continually devoted to buying

new equity-method investments and working with bottlers as part of cash flow. While these investments can be lumpy, they are a constant use of cash at KO. Yet, there is still the dividend and share repurchases too.

	2020	2019	2018	2017	2016
Cash from Operations	$9,844	$10,471	$7,627	$6,930	$8,792
Capital Spending	$1,177	$2,054	$1,548	$1,675	$2,262
Free Cash Flow	$8,667	$8,417	$6,079	$5,255	$6,530
Acquisitions/Eq-Method Inv.	$1,052	$5,542	$1,263	$3,809	$838
Cash for Shareholders	$7,615	$2,875	$4,816	$1,446	$5,692
Dividends	$7,047	$6,845	$6,644	$6,320	$6,043
Repurchases	$118	$1,103	$1,912	$3,682	$3,681

- Note that only low capital spending and acquisitions allowed KO to cover its divided in 2020. In other years that is not the case.

- 2021 guidance calls for at least $1.5 billion in capital spending and free cash flow of about $8.5 billion.

Coke has been consuming its cash on hand to cover the shortfalls, which is boosting net debt. It has also not boosted its EBITDA in recent years:

	2020	2019	2018	2017	2016	2015
Borrowings	$42,793	$42,763	$43,555	$47,685	$45,709	$44,116
Cash and Securities	$10,914	$11,175	$15,964	$20,675	$22,201	$19,900
Net Debt	$31,879	$31,588	$27,591	$27,010	$23,508	$24,216
Adj. Oper Income	$9,770	$10,409	$9,886	$9,540	$9,958	$10,373
Depreciation/Amort.	$1,536	$1,365	$1,086	$1,260	$1,787	$1,970
Equity Div - Eq Income	-$511	-$421	-$457	-$628	-$449	-$122
Basic EBITDA	$10,795	$11,353	$10,515	$10,172	$11,296	$12,221
Net Debt/EBITDA	3.0	2.8	2.6	2.7	2.1	2.0

We want to emphasize that KO is not broke. It has $11 billion in cash, but that is down $9 billion from 2015. Debt to EBITDA has risen from 2x to 3x.

It is also worth noting that KO has already started to stretch working capital too. At the end of 2020, it started to sell receivables and remove them from the balance sheet, that helped cash flow by $185 million in 2020. Covid also helped in 2020 as receivables and inventory declined by $883 million while payables and accruals fell by $860 million y/y. Total

working capital was a $700 million tailwind in 2020. Also, in 2019, it started to stretch the time to pay suppliers. Payables and Accrued Expenses rose $1.3 billion in 2019. So looking at cash from operations in the table above, it is clear where some of the increase in 2019 and 2020 came from:

Changes in Work Cap	2020	2019	2018	2017	2016
Accts Rec.	**$882**	-$158	$27	-$108	-$28
Inventory	$99	-$183	-$203	-$276	-$142
Prepaid Exp.	$78	-$87	-$221	$506	$279
Payables and Accr. Exp	-$860	**$1,318**	-$251	-$573	-$540
Accrued Income Taxes	-$16	$96	-$17	-$159	$750
Other liabilities	$507	-$620	-$575	$4,052	-$544
Working Capital on CFO	$690	$366	-$1,240	$3,442	-$225

- 2017 had the tax reform that drove the $4 billion change
- 2019 saw extending payables to suppliers boost cash flow
- 2020 saw receivables fall with Covid and sales of receivables. Payables and accruals dropped as incentive payments paid in arrears were higher than new incentives accrued with Covid.

We would expect results to bounce back from Covid issues in 2021, but we also believe working capital will likely be a cash drain on free cash flow this year. Our biggest conclusion is we think KO may stop buying shares beyond perhaps trying to prevent dilution from stock options. The company simply isn't getting much bang for the buck here. Since 2016, KO has purchased 228 million shares for $10.5 billion and the share count is flat! Coke has always been our poster child to illustrate that stock compensation is actually a cash expense:

Stock Issue/Repurchase	2020	2019	2018	2017	2016
Shares issued (mm's)	22	33	48	53	50
Shares bought (mm's	0	21	39	82	86
Share count	4323	4314	4299	4324	4367
Cash from Issue	$647	$1,012	$1,476	$1,595	$1,434
Cash spent on Repo	$118	$1,103	$1,912	$3,682	$3,681
Net Cash source/use	$529	-$91	-$436	-$2,087	-$2,247

Transfer Pricing – Tax Issue Risk

Coke is a multi-national company and it buys and sells products in most countries around the world. It pays taxes in many countries too. Part of its business accounting is determining where the costs and revenues were incurred when they cross national borders. So if it makes Coke concentrate in the US and ships it to a UK bottler who mixes it with carbonated water, packages it, ships and sells it in Ireland - Coke has revenue from Ireland to UK and UK to US. It has manufacturing and shipping costs in the US and UK but not Ireland. If it owns the UK bottler too, how does it split the transaction up?

It could argue that in the US – there is overhead costs of $2, concentrate cost of $1 and it was sold to UK for $3, giving the US operation zero profit. The UK bottler then pays $3 to the US and spends $2 bottling and sells it to Ireland for $7. There is a total cost of $5 and total revenue of $7 – it occurred in three countries.

Taxing authorities (especially those with higher tax rates) tend to watch where revenue and where costs are being recorded, because there is an incentive to record more costs in the higher tax areas to lower income and more revenues in lower tax areas to have income subject to the lowest tax rate. Here is where Coke has a problem with the IRS:

- The IRS had transfer pricing issues with Coke for years 1987-95. A methodology was agreed upon to determine how much US taxable income would be reported from foreign licensees.

- This method worked as Coke believed it should for the five audit cycles that covered years 1996-2006.

- The IRS changed the methodology in September 2015 and reallocated $9 billion in foreign profits to the US for years 2007-2009, which would be $3.3 billion in new taxes.

- The case was filed for trial in 2015 and the trail was held in 2018 and the Tax Court ruled in 2020 that it agreed with IRS for much of the dispute but did agree with Coke that dividends already paid by the foreign licensees should offset some of the difference.

After the ruling, Coke boosted its tax reserve by $438 million in December 2020. It will continue to seek to resolve this to the prior methodology with legal appeals. However, if the tax court is upheld, Coke determined that applying the new procedure to the years 2007-09 and subsequent years 2010-20, the cumulative tax and interest liability could be $12 billion. Coke further estimates that future tax rates could rise by 3.5%

There is a potential trigger here too. The tax court did not issue a full judgment on this case. The court set aside the issues regarding transfer pricing, royalties and dividends for Brazil pending the outcome of a similar case involving 3M. It is expected once that is resolved, the court will complete its full ruling on Coke.

In order to appeal, Coke expects it will need to post $4.6 billion as the potential liability. This payment could occur as soon as the 3M case is resolved and thus, Coke's initial case is finalized.

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:

Category	Useful Life
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.

Disclosure

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