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BEHIND THE NUMBERS
Quality of Earnings Analysis

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Kimberly-Clark Corporation (KMB)
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 upgrading our earnings quality rating to of KMB to 2+ (Weak) from 2- (Weak) and removing from our Top Sell List.

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

Summary

KMB reported adjusted EPS of $1.30 for the 12/21 quarter which was 5 cps ahead of the consensus estimate. However, KMB shocked the market by releasing 2022 EPS guidance of $5.60-$6.00 with the midpoint representing a 6% decline from 2021 and falling far short of the pre-quarter consensus estimate of $6.70. Sales are expected to increase by 1-2% with 3-4% organic growth expected to be offset by a negative 2% impact from foreign currency. Continuing cost pressures from rising prices for certain raw materials, shipping, and labor are expected to be offset somewhat by higher pricing. We are raising our earnings quality rating to 2+ (Weak) as the company declared its 2018 Restructuring Plan is at an end, but we continued to see quality concerns with the quarter. The reduced guidance lowers the hurdle for the company, but the stock is still selling for almost 24 times forward earnings which in our minds is expensive for a company with declining earnings, multiple consecutive downward earnings revisions, and uncertainty regarding ongoing cost pressures.

We will need the 10-K to complete our review of the quarter but would point out the following updates from our previous points of concern based on the press release and call:

- Stock compensation expense was a credit of $4 million in the quarter versus an expense of $46 million a year ago. This $50 million beneficial swing alone added almost 100 bps to operating margin and 12 cps to EPS. Remember that in the 9/21 quarter, the company discussed a similar benefit from a $12 million credit which it attributed to a change in the outlook for incentive compensation prompting a true-up adjustment to the accrual. Management said in the call there would not be a true-up in the 12/21 quarter. We suspect this benefit was largely unexpected and earnings would have missed by a material margin had it not occurred. The company noted in its outlook that 2022 margins will be pressured by higher variable incentive expenses indicating this benefit will reverse.

- We upgraded our earnings quality rating based on the fact that the company's 2018 Restructuring Plan has now come to an end. Throughout the plan, the company added back $1.6 billon in after-tax charges which amounted to over 17% of adjusted net income over the period. We would also note that the scope of the plan was also expanded multiple times. This, coupled with KMB's long history of taking such charges reduces our faith in the quality of the adjusted profit figures. We take it as a positive that the plan was not extended, yet we would not be surprised to see another plan pop up later this year or next.

- We had previously warned that the 12/20 quarter represented a tough comp given the company's $100 million reduction of its promotional accrual a year ago. This was confirmed by the company pointing out in the press release that North America pricing fell by 4% as "pricing actions were more than offset with lower promotion expense in the base period."

- Management noted that while some raw materials such as eucalyptus, softwoods, and polypropylene are expected to be down, this will be offset by higher prices for other materials such as fluff pulp and recycled fiber as well as higher energy, shipping, and labor costs. KMB experienced $1.5 billion in inflation in all of 2021 with $1 billion of that falling in the second half. Therefore, comps will remain tough for the first half of 2022.

- Marketing and R&D are also expected to increase which will likely be necessary to maintain unit sales growth in the wake of the mid-single-digit price increases the company is planning to push through.

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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