BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Kimberly Clark (KMB) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are raising our earnings quality rating to 3+ (Minor Concern) from 3- (Minor Concern)

KMB's stock price took a beating after missing EPS targets in the 9/20 quarter by a penny. Strength continues in demand for at-home paper and personal care products, but the weakness in business spending was felt in the KC Professional segment.

Items that Deteriorated

- Our main issue with KMB is the ongoing restructuring charges that the company adds back to non-GAAP results. Charges increased to $0.31 cps in the quarter compared to non-GAAP EPS of $1.72- almost 20%. The 2018 restructuring plan is expected to run through 2021. In our mind, these regular charges erode the quality of adjusted earnings given the possibility of ongoing expenses being included in the charges and dismissed by those only watching non-GAAP results. The October acquisition of Softex could become an excuse for charges to expand. We note that the company already added back 3 cps of acquisition charges in the 9/20 quarter despite the deal not closing until October 1.
(Concern level: MEDIUM)

- Higher advertising was a drag on margins in the quarter. We have cited the company's low level of advertising in the past as a concern. This could continue to pose a problem in the future as the company combats the commodity-like nature of many of its products.
  (Concern level: LOW)

Items that Improved

- Stock-based compensation increased by about 6 cps which was a material headwind and possibly a factor in the company falling short of EPS targets.

Items to Monitor

- KMB has not cut back capital spending as much as some companies have done during COVID. Nevertheless, free cash flow saw a massive boost from the infamous first-half rush on toilet paper. When conditions normalize, we expect free cash flow will again be insufficient to cover the dividend and the buyback.

- With the above point in mind, we are skeptical of the recently announced Softex acquisition for $1.6 billion. In normal conditions, KMB struggles to post positive organic growth. ***IF*** Softex represents the first step in a growth-through-acquisition binge which consumes cash, drives up debt, and brings the associated massive charge-offs and one-time charges, then quality could deteriorate rapidly.

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 Concerns"	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 may 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 the next quarter. 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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