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Next to godliness

Evan Lorenz writes:

Covid-19 will eventually go away—either the scientists will defeat it or the infected herd will suppress it—but try telling that to the stock market. Not a few beneficiaries of the pandemic economy are trading as if the bug is permanent. Clorox Co. (CLX on the Big Board), the featured subject of this unfolding analysis, is one such lockdown darling. In preview, we're bearish on it.

Clorox is only one name among many in the Covid cohort. Campbell Soup Co., for instance, had struggled for years as consumers opted for uncanned eating options (*Grant's*, March 25, 2016), but sales leapt by 18% in the three months ended Aug. 2, a big jump from the 2% uptick in the same period a year ago. No doubt, this was partly owing to the shift from ordering professionally prepared meals in restaurants to making comfort food at home. In and around August, restaurant sales and grocery-store sales were, respectively, down and up by approximately 12% (that figure counts only the restaurants that remained open).

However, at least in the case of the venerable soup-maker, investors have chosen not to extrapolate plague-year prosperity. Campbell's price-to-earnings ratio has fallen to 16.2 times, from 21 times at the start of 2020, despite a 28% lurch higher in trailing 12-month adjusted earnings per share.

Exxon Mobil Corp. finds itself at the other extreme of the market's propensity to extrapolate (whether correctly or not, time will tell). The lockdown-induced collapse in energy demand, in no way mitigated by Calif. Gov. Gavin Newsom's recent order banning sales of internal-combustion-engine vehicles in the Golden State starting in 2035, has sawed the energy giant's market capitalization in half, to $144.9 billion.

Before last month's technology-stock pullback, Zoom Video Communications, Inc. had gained enough market cap to top Exxon's. Perhaps no product was better suited to a world of travel bans and office-shunning than this company's online chat suite. Professional users pay a mere $149.90 per year for a package of nine licenses, while amateurs pay nothing for personal meetings.

In the three months ended July 31, Zoom's revenues showed a year-to-year gain of 355%, though the share price has put even that figure in the shade. Up by 584% since the start of the year, Zoom commands a cool $132.4 billion in market cap, not much less than the once-regal Exxon. Yet, the former Standard Oil Co. generated sales of $213.9 billion over the past 12 months, while Zoom booked just $1.3 billion.

Zoom's stock-market stardom is all the more remarkable in view of the fact that this is a one-product company. It's not hard to imagine either a tech incumbent or a clever upstart inventing a chat program to knock Zoom out of the pole position in video conferencing.

For any who choose to refrain from betting against the hottest tech company of 2020, there are less-volatile stocks trading at large premiums on what may well prove to be peak earnings.

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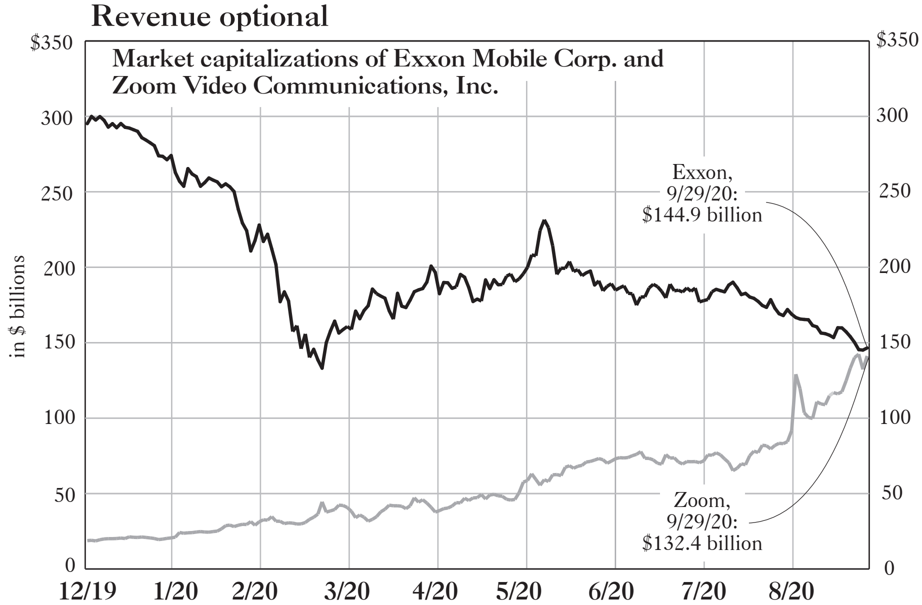
Revenue optional



source: The Bloomberg

Founded in 1913 as the Electro-Alkaline Co. and capitalized with all of $500, Clorox unsuccessfully tried to interest America in a compound of chlorine and sodium hydroxide. Fortune changed in 1916 when Annie Murray, wife of William Murray, the new financial angel and general manager, hit on a way to sell a less concentrated form of bleach for cleaning homes. The fruit of decades' worth of acquisitions is today a product lineup that includes such miscellaneous brands as Burt's Bees, Liquid Plmr, Fresh Step, S.O.S., Glad, Hidden Valley, Brita and Kingsford. In most categories, Clorox is the No. 1 or 2 brand by sales and 9 out of 10 American households use one or more of its products.

In the fiscal year ended June 30, Clorox generated $6.7 billion in sales across 100-plus countries and employed 8,800 people. Cleaning products account for 43% of total sales, but the company is nothing if not eclectic. Vitamins, minerals and supplements; plastic bags, cat litter, water filters, salad dressing and personal-care items round out the product array.

Atypically rapid growth is the opening argument of the bullish case. Sales climbed by 15% in the three months till March 31 and by 21.9% in the June 30 quarter. The only constraint on sales growth during the national handwashing and wipedown-fixation period was the capacity to produce. "While we've been able to add significant capacity, demand still far exceeds supply, leading to continued out-of-stock for many products," Lisah Burhan, head of investor relations, told the Aug. 3 earnings-call audience.

The bullish argument proceeds with an expression of hope that the new buyers of Clorox wipes, Kingsford charcoal and Brita water filters will keep on buying those, and other, Clorox products after the defeat of Covid-19. "So, our job right now is to make sure that we convert these newcomers or new users to ultimately loyal Clorox users," as Burhan tells me.

Eager to entice Covid-phobic customers to venture outside again, airlines, arenas and hotels are partnering with Clorox, Lysol (a Reckitt Benckiser Group plc brand) and others to secure a kind of antiviral seal of approval for their respective interiors. United Airline Holdings, Inc., for one, has adopted cleaning protocols drafted by Clorox and the Cleveland Clinic. Besides urging a wipedown of surfaces with a suitable disinfectant, the hygienic advisers suggest that the airline present passengers with a 2020 in-flight survival kit, containing two snacks, a drink and a disinfectant wipe. "The idea," as *The Los Angeles Times* reports, "is that the bag reduces the number of times flight attendants have to interact with fliers."

Before the bug bit, Clorox deployed its own self-help program. At its analyst day last fall, the company unveiled "Ignite," a strategy that targeted a 25–50 basis-point expansion in operating margins per year for the next five years. Clorox simultaneously climbed aboard the ESG bandwagon with a commitment to switch to 100% renewable energy sources and to make all its packaging recyclable, reusable or compostable by 2025.

A "dividend aristocrat," having raised its cash payout every year since 1977, Clorox delivers a 2.1% yield, slightly more than the 2.05% yield to maturity available on investment-grade corporate bonds. In fiscal 2020, the dividend absorbed $533 million, or 57% of net income.

Nor does it hurt the optimistic case that CLX is a heartthrob of passive investors. The Vanguard Group, Inc., BlackRock, Inc. and State Street Corp. hold 27.3% of shares outstanding. The stock features in the portfolios of the Vanguard Growth Index Fund, the iShares S&P 500 Value ETF, the SPDR S&P Dividend ETF and (in a nod to ESG bona fides) the SPDR S&P 500 Fossil Fuel Reserves Free ETF.

The company's lightly leveraged balance sheet further supports the bullish argument. As of June 30, Clorox had $2.8 billion in debt and $871 million in cash for net debt of $1.9 billion, or 1.3 times trailing earnings before interest, taxes, depreciation and amortization. In fiscal 2020, operating income covered interest expense by 13 times. Standard & Poor's rates Clorox single-A-minus, or solidly investment-grade.

Currently priced at 28.6 times trailing earnings and 18.8 times enterprise value to Ebitda, Clorox is no bargain, as even Wall Street is prepared to acknowledge (the analytical consensus breaks down to four buys, seven holds and four sells). Bears have begun to ogle the stock as short interest foots to 11% of the float.

Thank an ill wind

source: The Bloomberg

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Prior to the burst of pandemic prosperity, Clorox's sales and market share were weakening. In the June 2019 quarter, revenue contracted by 3.8% from the prior year; the September and December periods delivered declines of 3.6% and 1.6%, respectively.

"Though it feels like a lifetime ago, at this time last year, we were most focused on trying to understand how difficult it would be and how much time and resources it would take for Clorox to improve its standing with retailers," a Barclays Capital, Inc. team of analysts led by Lauren Lieberman, who rates CLX a sell, wrote on Aug. 4. "Recall, Clorox was losing share across much of its portfolio and had lost considerable shelf space after taking too firm a stance on pricing (and promotion) even while innovation was lagging the marketplace in some categories."

And despite its 2020 growth spurt, Clorox is still losing market share in its core categories. Thus, in the June quarter, Reckitt Benckiser Group's North American hygiene division, which includes Lysol, grew by 38.8% year-over-year versus a 33% expansion in Clorox's health and wellness unit.

The Nielsen Co. tracks sales at grocery stores. Parsing through this data, Goldman Sachs Group, Inc. analyst Jason English sees problems for the bleach behemoth. "CLX's sales growth moderated to 2.3% this past quad week, with outright declines (-3.3%) over the past two weeks," wrote English, who rates Clorox a sell, on Sept. 16. "Growth moderated across each of its segments and market share losses accelerated. Although CLX's shipments are likely to exceed consumption growth as the company works to restore service levels [i.e., restock retailers], we are surprised by how quickly CLX's cleaning/disinfectant portfolio slowed down. Without robust growth in this segment, we believe the company is likely to miss investors' lofty expectations for earnings power in FY21."

Not surprisingly, the surge in demand for cleaning supplies is attracting competition. In February, Procter & Gamble Co. launched Microban 24 Sanitizing Spray, which not only kills bacteria and viruses but also warrants a 24-hour reprieve from any new bacterial visitation. "Today, the run rate is now in the couple of hundred million dollars range, which is more than we expected at the time we launched," CEO David Taylor said on the July 30 earnings call. While PG has yet to launch a Microban 24 wipe—a key product category for Clorox—it would be a logical product extension.

The Clorox Ignite strategy set the modest, almost humble, long-term growth target of 2%–4% per year—so Zoom, it isn't. "In the U.S., in the last five years," said CFO Kevin Jacobsen, elaborating to security analysts, "we've delivered about 3.5% growth. Now if I pull out M&A, that's closer to 2.5% growth." For reference, nominal GDP compounded by 4.1% over the same period.

The Clorox Co. at a glance
all figures in $ millions

	FY* 2020	2019	2018	2017	2016
sales	$6,721	$6,214	$6,124	$5,973	$5,761
operating profit	1,274	1,124	1,136	1,127	1,064
interest	99	97	85	88	88
net income	939	820	823	701	648
cash	871	111	131	418	401
debt	2,780	2,683	2,483	2,613	2,312
total assets	6,213	5,116	5,060	4,573	4,510
cash flow from operations	1,546	992	976	868	778
capital expenditures	254	206	194	231	172
free cash flow	1,292	786	782	637	606

* Fiscal year ends June 30.

source: company reports

Then, too, if history is any judge, Clorox will stretch to deliver even that margin expansion. The previous Clorox five-year plan, Strategy 2020, also targeted a 25–50 basis-point expansion in margins each year starting in fiscal 2015. And Clorox did manage to make its margins expand over that period—but at just five basis points per annum.

In the decade ended Dec. 31, 2019, Clorox traded at an average price-to-earnings ratio of 21.8 times, almost seven points below today's trailing p/e ratio. Perhaps, as the bulls seem to be betting, the pandemic will change American consumption patterns for keeps. If not, Mr. Market may be valuing Clorox on a fancy multiple of spurting, one-off earnings (EPS vaulted by 16.5% year-over-year in fiscal 2020.)

To judge by its actions, the Clorox C-suite is lining up with the bears. On Aug. 3, the company announced that Benno Dorer, age 56, would retire as CEO effective Sept. 14, although he will remain as executive chairman. Stepping into the top role is Linda Rendle, a former Clorox executive vice president. While this transition was no surprise, it happened one to two years ahead of the anticipated schedule.

Clorox executives who aren't voting with their feet are voting with their wallets. In the year to date, insiders have sold 430,686 shares for proceeds of $79.2 million, versus sales of 67,216 shares in 2019 for proceeds of $10.5 million. Not one insider has purchased shares in the past two years.

Even Clorox bulls may prove to be fair-weather friends. "I value the company on a p/e basis," Linda Bolton Weiser, who rates CLX a buy for D.A. Davidson & Co., told me. "And so currently, in the pandemic, I believe Clorox should garner a very high valuation because of its earnings momentum."

In reply to my question about how investors should react after the virus-turbocharged earnings come to an end, Bolton Weiser replied, "The valuation should come down."

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