Ecolab Inc ECL ★★★

Rating as of Dec 6, 2019

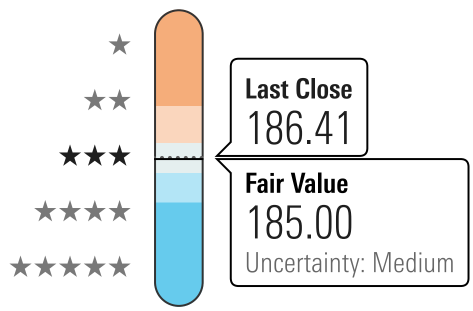
Quote | Stock Analysis | News | Price vs Fair Value | Trailing Returns | Financials | Valuation | Operating Performance

Morningstar's Analysis

Summary | Competitors | Bulls Say/Bears Say

Valuation Jul 31, 2019 Currency in USD

ECL is trading within a range we consider fairly valued.



1-Star Price
> 249.75

Economic Moat
Wide
Trend: Stable

5-Star Price
< 129.50

Stewardship
Exemplary

Ecolab Reports Decent Third-Quarter Results; Maintaining Outlook and $185 Fair Value Estimate

Seth Goldstein
Equity Analyst

Analyst Note | by Seth Goldstein Updated Oct 29, 2019

Ecolab reported decent third-quarter results, as operating income grew 12% year on year to nearly $670 million when adjusting for acquisitions and currency. Higher profits were driven primarily by higher pricing.

In its earnings update, management slightly reduced the midpoint of its 2019 adjusted earnings per share guidance to $5.85 from $5.90. Having updated our model to incorporate Ecolab's third-quarter results, we maintain our $185 fair value estimate. Our wide moat rating is also unchanged. At current prices, Ecolab appears fairly valued to us, trading slightly above our fair value estimate but still in 3-star territory.

The industrial business, which includes water, continued to generate solid 2019 results. Operating income grew 14% year on year to $240 million after adjusting for currency and acquisitions, due largely to higher prices. Revenue for the water business grew 5% year on year as higher pricing and new business was partially offset by slower auto and steel markets. These results were in line with our long-term outlook. As fresh water prices continue to rise globally, we expect Ecolab will continue to realize revenue and profit growth from new business. This is because Ecolab's water management systems will allow a growing number of manufacturing plants to reduce water and energy costs by a greater magnitude than the cost of installing Ecolab's water management system.

In the energy business, operating income grew 16% year on year to $104 million when adjusting for currency and acquisitions, as higher prices and lower costs were partially offset by lower volume. Ecolab still aims to spin off the upstream portion of the energy business in mid-2020. We remain in favor of the move as the upstream business is closely tied to oil prices and would probably run better as a stand-alone operation, allowing for greater management focus and optimization.

Business Strategy and Outlook | by Seth Goldstein Updated May 01, 2019

As the global leader in the cleaning and sanitation industry, Ecolab provides products that help its hospitality, food-service, and healthcare customers do laundry, wash dishes, and fix appliances when they break. With unmatched scale and a solid razor-and-blade business model Ecolab's competitive advantages are firmly in place.

The company's cleaning and sanitation scale dwarfs the competition. Ecolab generates over twice the revenue of Diversey, its largest rival. The industry is very fragmented, with much of the market made up of regional and local companies. Ecolab controls roughly 11% of the $125 billion-plus global market. With its unrivaled scale and breadth of product offerings, the company is an attractive partner to global hospitality and food-service firms. We think it will continue to gain share from smaller players.

The firm uses a razor-and-blade business model by providing cleaning equipment to customers that solely uses Ecolab's proprietary consumables. This model creates a steady stream of consumables revenue. The installed base and consumables model also leads to high customer switching costs, as clients are generally reluctant to switch out equipment and retrain staff. The company sells directly to customers in most cases and focuses on improving cost efficiencies for its clients in areas such as water, energy, labor, and turnaround time. This strategy provides Ecolab with pricing power and builds customer loyalty.

Ecolab's water treatment business also benefits from switching costs. We expect fresh water costs to double in the U.S. by 2030 and increase around the world. This will make Ecolab's water management systems that reduce a customer's water usage more valuable, as the systems will reduce customer operating expenses. Therefore, we expect the industrial water business to generate the majority of incremental profit growth for Ecolab.

Ecolab plans to spin off its upstream energy business as a separate company in 2020. The upstream business includes oil field chemicals and well chemical drilling and generated roughly $2.4 billion in sales in 2018, which was roughly two thirds of energy segment sales.

Economic Moat | by Seth Goldstein Updated May 01, 2019

We assign a wide moat rating to Ecolab. We analyze the company's competitive advantage through our framework for commodity processors. Moaty businesses in this space tend to benefit from switching costs, intangible assets, or cost advantage. We view switching costs as the key moat source that allows Ecolab to generate excess returns.

Ecolab's installed base and consumables model, commonly known as the razor and blade model, is the most important driver of high switching costs. The company leases proprietary cleaning equipment and devices to its clients and then sells a steady stream of the consumables required to keep the machines running. In addition to the cost savings that Ecolab's products customers appreciate, Ecolab minimizes downtime for key pieces of its customers' machinery, allowing its business processes to proceed without costly interruptions. Additionally, customers are motivated to avoid the costs associated with swapping to new equipment and retraining staff.

In addition to a continual emphasis on reducing water, energy, and labor expenses, Ecolab now offers cleaning equipment that will automatically keep regulatory compliance records for its water treatment and manufacturing customers. This regulatory aspect allows Ecolab to act as a regulatory compliance consultant. In turn, this further strengthens the company's switching costs as customers would otherwise face increased regulatory compliance costs by choosing a competitor to replace Ecolab.

Further, Ecolab focuses on cross-selling products, which also contributes to switching costs. For a customer with cleaning and sanitation needs, managing each order from each supplier has a fixed-cost component. Thanks to both the scope of Ecolab's product offerings and the company's global scale, it serves as a one-stop shop for its customers. In turn, the customer is able to save time and money aggregating orders and re-orders across a variety of products and services by engaging solely with Ecolab. For example, a hotel customer who uses Ecolab's products for dishwashing, laundry, cleaning, and pest control would have to manage a more complex and more costly supply chain if it were to replace Ecolab with multiple suppliers. This dynamic supports modest pricing power for Ecolab.

Ecolab is the largest player in the fragmented cleaning and sanitation industry, which allows it to service large global organizations that are outside the reach of local and regional players. In addition to its global customers, Ecolab targets expanding restaurant or hotel chains. For brands such as Shake Shack, that are expanding to a national footprint, Ecolab is a preferred cleaning supplier as Ecolab can supply the same dishwashers, cleaning products, and quality to new locations across the United States. The scale also allows restaurants and hotels with a global or national franchise model to ensure uniform cleaning standards and maintain the same cleaning process among franchises.

Even during the latest downturns for many of Ecolab's restaurant and lodging or energy production customers, the company's returns on invested capital remained safely above its cost of capital. We think the company's consistent excess returns are likely to continue for at least the next 20 years. We forecast a midcycle ROIC around 22%, which is well above the company's 7% cost of capital. Even in our bear case, which assumes a continued downturn across many of Ecolab's end markets, we project the company to safely outearn its cost of capital and continue to generate positive economic profits.

Fair Value and Profit Drivers | by Seth Goldstein Updated Oct 29, 2019

Our fair value estimate is $185 per share. Our cost of capital for Ecolab is roughly 7%.

We think total revenue will grow in the midsingle digits, on average, over the next decade. Given our expectation for rising global fresh water costs, the water treatment business should benefit from a secular trend toward water conservation from the use of water management systems. This will boost annual revenue growth to the high-single-digit range for the industrial water business. As rising fresh water costs increase Ecolab's value proposition to its industrial customers, we expect water profit margins to expand from the industrial segment average of 14% in 2018 to the low 20s, in line with the institutional business. We also expect the healthcare business to benefit from the secular trend of an aging U.S. population, which should propel growth to the high-single-digit range.

In the institutional business, we expect Ecolab to continue increasing share as its products help customers meet regulatory standards, reduce total operating costs, and prevent food safety incidents. The business will also benefit from increased consumer preference for fresh food and a rise in the number of long-term care facilities. As food-service providers serve an increasing proportion of fresh food, this carries additional supply chain complexity from a cleaning and sanitation perspective, which allows Ecolab to further engrain itself in its food-service customers' business. We forecast mid-single-digit revenue growth for the institutional segment.

Thanks to pricing power provided by switching costs, as well as the continual development of new products, we think Ecolab's operating margins will expand to roughly 19% by 2028 from under 15% in 2018.

Risk and Uncertainty | by Seth Goldstein Updated May 01, 2019

Ecolab's main customers in the institutional segment are affected by changes in travel and dining activities. A prolonged recession could dent demand for vacations, business travel, and dining out. Additionally, the company has significant foreign-currency exposure with more than 40% of sales generated outside the United States.

Ecolab’s sales proposition to many of its customers in the industrial and institutional segments includes the assurance that a customer will meet regulatory standards and will not experience a disastrous outcome, such as a product recall or bacteria outbreak. This is particularly important for Ecolab’s customers in the food manufacturing, restaurant, and hospitality industries. If one or more of Ecolab’s customers were to experience a disastrous outcome, the firm could lose multiple customers as Ecolab’s reputation for selling successful outcomes could suffer.

The long-term profit growth of the industrial water business is highly dependent on rising fresh water costs. Increasing water expenses will improve the value proposition of Ecolab's water management systems. Should fresh water costs stop rising, demand growth for water management systems from Ecolab's industrial customers would likely slow.

We view the energy operations as riskier than Ecolab's industrial and institutional segments as much of the energy business is tied to movement in oil and gas prices. However, Ecolab plans to spin off the bulk of this business in 2020, which should reduce this risk for the businesses.

Stewardship | by Seth Goldstein Updated Apr 04, 2019

We assign an Exemplary stewardship rating to Ecolab. Douglas Baker Jr. has been CEO and chairman since 2006. He started at Ecolab in 1989 and held numerous positions, including COO, before moving to his current roles. We think Baker and the rest of management at Ecolab deserve credit for the firm's consistent performance and annual ability to generate returns on capital that outpace costs of capital.

In our opinion, Ecolab has consistently outmaneuvered Diversey, its primary competitor in the cleaning and sanitation market, through an emphasis on total cleaning-related costs, service, and cross-selling additional products and services. The result has been market share gains and the expansion into new customer end-markets such as long-term care facilities and pharmaceutical manufacturing. We credit management with the continual investment in the development of new products that increase customer switching costs by either reducing water and energy costs or provide services such as managing regulatory compliance.

At first glance, the decision to acquire Nalco was a bit of a gamble for management. However, we deem the Nalco acquisition a success. Ecolab has successfully turned Nalco’s water business into a platform that spans multiple industries, such as food, beverage, and pharmaceutical manufacturing, in addition to the legacy energy and chemicals production customers. As global fresh-water costs rise, we think this business will be well-positioned to grow profits from implementing systems that reduce customers' water usage.

Ecolab's water treatment systems will reduce customer expenses and allow Ecolab to further engrain itself in its customers' business models.

In 2012, management doubled down on its energy business by announcing a deal to acquire Champion Technologies for $2.2 billion. We wouldn't argue that the Champion acquisition was poorly timed, given the downturn in oil prices shortly after the acquisition. However, management has been able to steer the energy business into more downstream markets such as refining and petrochemicals through the downturn, and we think the business is well positioned for long-term success. Further, we are in favor of management's decision to spin-off the upstream energy business as we think it did not fit as well with the business model throughout the rest of the company. As such, the spin-off will create two focused businesses.

Management’s short-term compensation is based on annual EPS targets, while long-term incentives are based on a three-year average return on invested capital. We are in favor of the return on invested capital measure as we think it incentives management to invest in the company’s moat sources, which include customer switching costs and patented specialty cleaning products.

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