BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Abbott Labs (ABT) EQ Review

Current EQ Rating*	Previous EQ Rating
5+	na

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 a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We initiate earnings quality coverage of ABT with an EQ rating of 5+ (Strong)

- Free cash flow fell by more than 20% in the trailing 12-month period ended 9/19 compared to the comparable year-ago period. However, cash flow should see a large rebound in upcoming quarters as most of the decline in operating cash flow was the result of the timing of cash tax payments which should normalize going forward. While disclosures do not allow us to calculate the exact impact of lower cash taxes, we estimate it was at least $530 million. This alone brings adjusted operating cash flow almost level with the year-ago figure.

- Working capital has also ballooned over the last year as the company has built out inventory to support new product introductions. Inventory days were up over ten days versus the year-ago third quarter. We are not concerned by the buildup given the explanation which is supported by the fact that some of the increase over the last year is visible in both raw materials and work-in-process. Cash flow growth should see a significant reversal as these products are sold into the channel.

- The other drag on free cash flow growth has been a jump in capex from a buildout in production capacity to support the new products. Capex as a percentage of trailing 12-month sales has risen to over 5% from 4% last year. Like the working capital drain, this should level out and possibly reverse in upcoming quarters.

- ABT has reduced debt from the 2017 St. Jude and Alere acquisitions ahead of schedule. Recent commentary indicates management is not looking to do large acquisitions in the foreseeable future and plans to continue its focus on internal investment and increasing the dividend- which it recently boosted by 14%.

- Pension and postretirement benefit expense declined by $29 million in the 9/19 quarter versus the year-ago period. This was largely driven by lower service cost and lower amortization of actuarial losses from higher assumed discount rates. The company has enjoyed the benefit from higher discount rates the last three quarters, but this will inevitably reverse as lower rates are reflected in the assumptions. ABT is far from alone in facing a lost tailwind from lower pension costs given the rate environment. To put the recent benefit in perspective, lower pension and postretirement benefit expense added an approximate 1.3 cps boost to EPS growth in the period, accounting for almost 15% of the reported increase in adjusted EPS in the period.

- ABT adds back amortization of acquired intangibles to its non-GAAP EPS. Trailing 12-month amortization of intangibles amounted to approximately 30% of adjusted operating profits in the 9/19 quarter. We maintain our usual position that this distorts investors' view of actual profitability as it veils the true cost of the acquisition on profitability. This is especially true for research-intensive companies that would have had to spend heavily to develop the technology and patents had they done so in-house. This concern is tempered for ABT by the fact that much of the intangibles are the result of a single deal (St. Jude) rather than a serial acquisition strategy.

- Depreciation expense declined slightly in the quarter which is not material at this point other than to highlight that depreciation should be increasing in upcoming quarters due to the rise in capex. This benefit was more than offset by a rise in the allowance for doubtful accounts as a percentage of gross receivable which we estimate could have been almost a penny per share headwind in the quarter.

Cash Flow Set for a Rebound

ABT's trailing 12-month free cash flow dropped by more than 20% from the year-ago levels, as seen in the following table:

	9/30/2019	9/30/2018	9/30/2017
T12 Operating Cash Flow	$5,485	$6,175	$5,100
T12 Capex	$1,671	$1,272	$1,109
T12 Free Cash Flow	$3,814	$4,903	$3,991
T12 Dividends	$2,197	$1,943	$1,771
Dividend % of Free Cash	57.6%	39.6%	44.4%
T12 Net Stock Repurchases	$326	$145	$106
Cash Flow after Buyback	$1,291	$2,815	$2,114

The decline is a result of several factors. First was the timing of cash tax payments. The company's disclosures do not allow us to calculate the exact impact of cash taxes on a trailing 12-month basis, but we know that on a YTD basis, cash taxes were $775 million with no mention of cash taxes paid in the year-ago period. However, piecing together commentary from other 10-Qs lead us to an estimate that lower cash taxes boosted operating cash flow by at least $530 million in the 12-months ended 9/19. Adjusting for just this factor would put operating cash flow roughly flat with last year. Note that the company mentions in the 9/19 10-Q that operating cash flow growth was impacted by higher pension contributions, but on a trailing 12-month basis, pension contributions were essentially flat with last year.

The other major factor impacting operating cash flow growth is a buildup of working capital to support new products. The following table shows a breakout of inventory days for the last eight quarters:

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Finished Products DSI	78.0	77.3	75.2	69.4
Work in Process DSI	16.0	16.2	15.3	14.4
Materials DSI	26.4	27.3	25.9	25.7
DSI	120.3	120.8	116.3	109.4

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Finished Products DSI	68.0	62.8	71.1	65.6
Work in Process DSI	16.3	15.6	15.7	13.2
Materials DSI	25.6	24.6	25.4	22.1
DSI	109.9	103.0	112.3	100.9

Inventory days have been on a noticeable upward trend for several quarters as the company has recently introduced several new products including the *FreeStyle Libra* glucose monitors*, MitraClip* device used in the treatment of mitral valve regurgitation, along with other diagnostic products. We can see in the DSI breakout above that the increase in inventory has been driven by not just a buildup in finished products but also materials and work-in-process as the new products have worked their way through the production process. This has been offset some by an increase in accounts payables days:

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Trade Accounts Payable	$3,029	$3,222	$3,045	$2,975
Trade Accounts Payable Days	83.0	89.4	86.7	85.8

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Trade Accounts Payable	$2,730	$2,503	$2,476	$2,402
Trade Accounts Payable Days	79.3	69.4	72.7	67.3

However, our "back of the envelope" calculation indicates that the rise in inventories consumed more than $300 million more than the increase in payables for the twelve months ended 9/19. A significant reversal in cash flow growth can be expected in the upcoming quarters as these inventories are sold into the channel.

Capex Growth Should Also Moderate from Elevated Levels

The other source of the free cash flow decline has been the ramp-up in capital spending to support increased production levels. This has led to capital spending rising to 5.3% of revenue from about 4% two years ago:

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
T12 Capital Spending	$1,671	$1,624	$1,454	$1,394
T12 Revenue	$31,355	$30,935	$30,723	$30,578
T12 Capex % of T12 Revenue	5.3%	5.2%	4.7%	4.6%

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
T12 Capital Spending	$1,272	$1,181	$1,138	$1,135
T12 Revenue	$30,402	$29,575	$28,445	$27,390
T12 Capex % of T12 Revenue	4.2%	4.0%	4.0%	4.1%

This should level off and reverse in upcoming quarters as the new production capacity comes online, freeing up more cash to expand the dividend. We found the following management commentary from the June conference call to be a good summary of the company's capital position:

> *"So, the next need was obviously we've got some capital to put into plant and expansion. And we put a fair amount into both Diagnostics and Libre at this point. We're investing in expansion of plant manufacturing for MitraClip and other products. So, given that we've got an awful lot of growth happening and the potential for more, obviously,* ***we've got to support that growth from a plant and capital standpoint*** *in a timely fashion and appropriate quality and so forth, and we're doing that. And so, this capital use et cetera there.* ***Will we continue to pay down debt? We will.*** *We'll be prudent and careful about making sure it makes sense, it's the right debt, right time and all that good stuff.* ***We will maintain a healthy, strong dividend. We increased it substantially at the end of last year; we will continue to grow our dividend.*** *Given where the PE is now, I've been told by a number of shareholders that trying to get that yield rate, upward dividend funds are happy as difficult, but that's a nice problem to have. We will continue to grow our dividend, it's been the hallmark of the Company for decades, and it will continue to be."*

The company has paid down the debt from its 2017 mega-acquisition of St. Jude Medical and Alere ahead of schedule with debt to adjusted EBITDA now below 2x. Management has indicated in recent commentary that it does not plan for any major acquisitions in the foreseeable future as investing in new products, expanding the dividend and the possibility of accelerating the buyback are its focus.

Pension Expense Decline Adding a Little Over a Penny per Share to Growth

Like many companies, ABT has been enjoying lower pension expense the last three quarters courtesy of the impact of higher discount rates from last year. The following table shows the components of pension and postretirement benefits for the last eight quarters:

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Service cost — benefits earned during the year	$68	$67	$70	$78
Interest cost on projected benefit obligations	$97	$98	$97	$88
Expected return on plans' assets	-$183	-$185	-$185	-$177
Net amortization of:	$0	$0	$0	$0
Amortization of actuarial losses	$39	$38	$39	$59
Amortization of prior service cost (credits)	-$8	-$7	-$8	-$11
Total 3 Month Pension/Postemployment Benefit Expense	$13	$11	$13	$37

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Service cost — benefits earned during the year	$83	$73	$85	$76
Interest cost on projected benefit obligations	$89	$89	$90	$83
Expected return on plans' assets	-$178	-$179	-$179	-$162
Net amortization of:	$0	$0	$0	$0
Amortization of actuarial losses	$59	$58	$62	$45
Amortization of prior service cost (credits)	-$11	-$11	-$11	-$10
Total 3 Month Pension/Postemployment Benefit Expense	$42	$30	$47	$32

The following table shows the key assumptions used in the calculation of the pension obligation and periodic pension cost:

	12/31/2018	12/31/2017	12/31/2016
Benefit Obligations Assumptions			
Discount Rate	4.00%	3.40%	3.90%
Rate of Compensation Increase	4.30%	4.40%	4.30%
Net Benefit Cost Assumptions			
Discount Rate	3.40%	3.90%	4.30%
Expected Return on Plan Assets	7.70%	7.60%	7.60%
Long-Term Change in Compensation	4.40%	4.30%	4.30%

We see that the benefit obligation as of the end of 2018 benefitted from an increase in the assumed discount rate while benefit costs would have been penalized by a decline the discount rate. It appears that so far in 2019, costs have been reduced by a rebound in the

discount rate. However, the lower rates from the current environment will likely negatively impact both the pension benefit obligation and subsequently costs in upcoming quarters. The lower pension costs have provided an average of about a penny of EPS growth in the first three quarters of the year. This represented almost 15% of the growth in adjusted EPS in the quarter.

Adding Back Intangible Amortization

Like most medical and tech companies, ABT chooses to add back the amortization of intangibles to its non-GAAP results. In the trailing 12-month period ended 9/19, amortization of intangibles amounted to almost 30% of adjusted operating income. Most of this amortization is related to the intangibles picked up in the 2017 St. Jude Medical deal and to a lesser degree, the 2017 Alere acquisition. Amortization expense actually declined by $60 million in the 9/19 quarter as certain intangibles became fully amortized. This brings up an interesting point in favor of adjusting results for intangible amortization as obviously, the company did not suddenly become $60 million more profitable in the quarter. Nevertheless, we stand by our usual position that completely ignoring acquired intangible amortization leads to a distorted view of profitability as the cost of the acquisition is never reflected in profits (aside from interest expense or share dilution). This is particularly true of serial acquirers in research-intensive industries who essentially pick up the benefits of developing new products without expensing the development costs. In the case of ABT as it has not been on a recent acquisition spree and the intangibles are largely the result of a single deal.

Other Minor Offsetting Issues

We note that depreciation expense declined by less than half a penny per share in the 9/19 quarter and appears to be more related to a timing issue and could be due to accelerated depreciation related to restructurings. This is not a material issue other than to remember that the spike in capex should lead to rising depreciation in upcoming quarters.

The slight depreciation decline was more than offset by a rise in the allowance for doubtful accounts to 6.1% of gross receivables from 5.7% in the 6/19 quarter. We estimate this could have been almost a penny per share earnings headwind.

Explanation of EQ Rating Scale

Rating	Description
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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