August 10, 2021

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Abbot Laboratories (ABT)
Earnings Quality Update- 6/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are reducing our earnings quality rating of ABT to 3- (Minor Concern).

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

Summary

ABT topped the consensus earnings estimate by 15 cps in the 6/21 quarter. The stock had already recovered much of its previous decline after the company significantly downgraded its outlook for the year in late May due to a lower than expected outlook for COVID-related test products. At that time, the company took full-year non-GAAP EPS guidance down to $4.30-$4.50 from the previous guidance of “at least $5.” Despite the 15 cps earnings beat, management did not raise full-year guidance which appears to give it more room to “surprise” to the upside in the next two quarters. However, management admitted in the conference call for the most recent quarter that one-third of the beat was due to higher than anticipated COVID-related sales. This plus the charges we discuss below prompt us to reduce our earnings quality rating from a 5+ (Strong) to a 3- (Minor Concern).

ABT regularly takes smaller restructuring charges which are added back to non-GAAP results. However, restructuring charges jumped from their pre-6/21 quarterly average of about $40 million pre-tax to over $500 million in the 6/21 period. We think it is worth noting the components

of the restructuring charge the company took during the quarter and its potential impact on the quality of upcoming quarters.

ABT announced in the quarter an extension of its restructuring plan which the company said was related to its Diagnostic Products segment to *"align its manufacturing network for COVID-19 diagnostic test with changes in projected testing demand driven by several factors including significant reductions in cases in the US and other major developed countries, the accelerated rollout of COVID-19 vaccines globally and the US health authority's updated guidance on testing for fully vaccinated individuals."* The company forecasted total pre-tax costs of $500-$625 million to be incurred through 2021. This includes $250-260 million in inventory writedowns, $80-$115 in fixed asset write-downs and $170-$250 million in other exit costs with these other costs including contract cancellations and employee-related costs.

ABT charged $500 million against this plan in the 6/21 quarter with $248 million of that consisting of inventory writedowns. These charges presumably reduced the carrying value of the inventory to net realizable value (NRV). ABT will likely sell this inventory in the second half of the year and if it is able to sell it for more than the estimated NRV, it could experience an artificial boost to profits in the second half. Given the rise in concern over variants and the fact that the company reported stronger than expected COVID-related revenue in the quarter a few weeks after downgrading its COVID-related forecast seems to increase the likelihood that the company could realize higher than expected prices on the inventory in question in the second half. Note that every $20 million the company can pick up in gross margin represents a penny per share in earnings. Investors should be watching for signs of this in unexpectedly high gross margins in the upcoming third quarter.

Also, the "other exit costs" components of the total expected charge of $170-$250 million seems very large and the company stated it will contain "employee-related costs." Of the $500 million in charges in the 6/21 quarter, $171 million were classified as including "contract cancellations and employee-related costs." We worry that such open-ended amounts could easily contain costs for employee time spent dealing with COVID-related products where the non-operational nature of the expense is in question. Such amounts reduce the quality of earnings in the quarters they occur.

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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