BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

November 29, 2018 | www.btnresearch.com

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

Baxter (BAX) EQ Review Update-9/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	4-

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

We are lowering our rating on Baxter (BAX) from a 4- (Acceptable) to a 3- (Minor Concern)

BAX reported adjusted EPS of $0.80 in the 9/18 quarter. This was 6 cps ahead of consensus which the company attributed to "*solid operational performance and ongoing benefit from our business transformation initiatives and the lower tax rate.*"

However, we saw several points of deterioration in the company's earnings quality during the period:

- Inventory days (DSIs) jumped by almost 13 days over the year-ago period. Management blamed this on overproduction at its new North American manufacturing facility, strategic buildup of certain products to ensure availability, but also noted that it was due to missing its sales forecasts. Most of the inventory increase was centered in work-in-process which seems to indicate an unexpected buildup in product was not the major contributor. Nevertheless, the sudden jump increases the risk of an unexpected disappointment in the next couple of quarters.

- Results have been receiving an approximate 3 cps tailwind from a change in the company's US pension plan for the last three quarters. While the company has cited this benefit prominently in its discussion of results, the significant boost will nonetheless be gone after the fourth quarter.

- Results have materially benefitted from discrete items favorably impacting the tax rate versus management's guidance.

Inventory Buildup

BAX saw a noticeable buildup in inventory during the 9/18 quarter, as inventory days (DSI) jumped by almost 13 days over the 9/17 quarter as shown in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$1,531	$1,603	$1,563	$1,616
Inventory	$1,718	$1,622	$1,581	$1,475
COGS YOY growth	-2.9%	8.8%	9.2%	4.7%
Inventory YOY growth	10.8%	6.4%	6.8%	3.1%
Inventory DSIs	102.4	92.3	92.3	83.3

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$1,577	$1,473	$1,431	$1,543
Inventory	$1,550	$1,525	$1,480	$1,430
COGS YOY growth	6.1%	-8.7%	1.5%	0.8%
Inventory YOY growth	-1.1%	-4.1%	-12.0%	-10.8%
Inventory DSIs	89.7	94.5	94.4	84.6

In the opening comments of the third quarter conference call, the company indicated that the buildup in inventory was related to improving product availability:

> *"Before turning to 2018 outlook, I will briefly comment on our cash flow performance. In the first three quarters of 2018, we generated free cash flow of $873 million with improvement in net income offset by higher inventory levels as we worked to rebuild supply for select products to ensure adequate product availability."*

BAX's Puerto Rican IV solution production facilities experienced a shutdown in the third quarter of 2017 from Hurricane Maria. During that time, customers increased their orders to stockpile inventories to prepare for any shortages. In addition, customers changed protocols for medication delivery which changed order and demand patterns for BAX's products. This led to disappointment in segment sales in the 9/18 quarter as management explained in the 9/18 call:

> *"And while not directly related to the hurricane's impact on our production levels, the historic tight supply in the market for IV solutions has also impacted performance*

for the Medication Delivery business this year. Sales of large-volume IV solutions spiked in the first five months of the year, driven by increased purchases, given the protracted industrywide supply challenges, coupled with an intense flu season. Customers rushed to acquire any available IV solutions products. ***This resulted in growing inventory levels across our customer base. Our forecast was built off this elevated run rate and didn't contemplate the level of inventory destocking we're currently experience as supply constraints have eased."***

Management also went on to explain that while some of the inventory build was due to ensuring availability of certain products, there was also a component of the buildup related to lower-than-expected demand:

"One is ***to the extent that you fall short on a sales forecast, it's very difficult to adjust your supply chain planning such that there's not an inventory build that takes place.*** *The second thing is we're very pleased with the performance coming out of our North Cove manufacturing facility but that has been overproducing in terms of getting fully back up to speed ahead of our expectations which is another factor contributing a bit to the inventory build. And then as we said earlier, when we look at year-over-year performance, we did make some strategic decisions to make select product inventory builds. So really, those are the three factors that we see. We do not see this as a structural issue. And frankly, once we kind of tighten up our forecast going into next year, this will be an opportunity for us to claw this back."*

We can get a little more insight into the source of the build by looking at the inventory components as a percentage of total inventory which is shown for the last eight quarters in the table below:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Raw Materials % of inventory	21.7%	22.9%	22.8%	23.5%
Work in Process % of inventory	13.0%	11.0%	10.5%	7.9%
Finished Goods % of inventory	65.3%	66.1%	66.7%	68.6%
	100.0%	100.0%	100.0%	100.0%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Raw Materials % of inventory	22.6%	21.6%	21.7%	22.3%
Work in Process % of inventory	8.7%	9.2%	8.8%	8.5%
Finished Goods % of inventory	68.6%	69.2%	69.5%	69.2%
	100.0%	100.0%	100.0%	100.0%

We see that the bulk of the build has been in work in process which seems to indicate that the largest part of the buildup is related to increasing production rather than the company sitting on a glut of finished product it will have to discount or write off. Nevertheless, given the sudden jump and management's admission that overzealous sales forecasts played a role in the spike, we believe there is a risk that the next quarter could be negatively impacted by the elevated inventory level.

Easy Pension Comps Ending After Next Quarter

In January of 2018, BAX announced it was freezing the accrual of new benefits after December 31, 2022 for current employees in its US pension plan. This resulted in an immediate reduction in the projected benefit obligation of $57 million. As a result, periodic pension cost fell to a lower level in the 3/18 quarter, as seen in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Pension Expense	$14.0	$15.0	$14.0	$36.0
	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Pension Expense	$36.0	$36.0	$35.0	$35.0

The company has highlighted the beneficial impact of lower pension costs in its commentary on operating results. Nevertheless, the above table puts in perspective that the last three quarters have benefitted from an approximate $22 million (3 cps) tailwind as a result of this non-operating factor which will disappear after the 12/18 quarter.

Lower Tax Rates Boosting Results

The last three quarters have all benefitted from lower than expected tax rates. In the first quarter, the company beat expectations, but admitted this was partially due to lower than expected tax rates during the conference call:

> *"On the bottom line, adjusted earnings increased 21% to $0.70 per diluted share. This exceeded our previous guidance of $0.60 to $0.62 per share, driven largely by*

> *operational performance and a **lower than expected tax rate, due to certain discrete items we recognized during the quarter."***
>
> *The adjusted tax rate was 14.5% for the quarter, which reflected a benefit of $13 million from FAS 123-R stock compensation guidance as well as certain discrete items we recognized in the quarter that favorably impacted the rate.*

The company lowered its guidance for a full year-2018 tax rate to 19%. The second quarter once again benefitted from a lower than expected rate with management offering the following color:

> *"The adjusted tax rate was 17% for the quarter, which includes a benefit of $15 million from stock compensation. And as previously mentioned, adjusted earnings of $0.77 per diluted share exceeded our guidance of $0.69 to $0.71 per share driven by solid top-line performance, our business transformation initiatives, a **lower than expected tax rate,** and other income."*
>
> *"On the bottom line, adjusted earnings increased 22% to $0.77 per diluted share. This exceeded our previous guidance of $0.69 to $0.71 per share, driven by solid top-line performance, the ongoing benefit of our business transformation initiatives, **a lower than expected tax rate**, and other income."*

The company again lowered its forecasted full-year rate to 17% rate during the second quarter conference call. However, management again cited a lower than expected rate in the third quarter during the conference call:

> *"The adjusted tax rate was 17.1% for the [9/18] quarter, which includes a benefit of $9 million from stock compensation. **This came in favorable to our expectations, driven primarily by certain discrete items recorded in the quarter."***

The company is still expecting a 17% rate for the full year.

We estimate that the lower rate could have added 2-3 cps to the most recent quarter. While the company would have still topped estimates in the period without this, investors may have become too dependent on a benefit that could very well reverse in upcoming quarters.

Explanation of EQ Rating Scale

Rating	Explanation
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 recent 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.

Disclosure

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.