BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Baxter (BAX) EQ Update- 3/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

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

We maintain our rating of 3- (Minor Concern).

BAX reported adjusted EPS of $0.76 in the 3/19 quarter which was 8 cps ahead of the consensus expectation. We estimate that about 3 cps came from timing of R&D spending, about 4 cps from a lower than expected tax rate, and another penny from lower pension expense. As such, we do not view the earnings outperformance as a high-quality beat. Management upped its full-year guidance by 5 cps reflecting the outperformance for the first quarter offset by the anticipation of the R&D benefit reversing during the remainder of the year.

- R&D expense fell precipitously in the quarter due to the timing of projects. After adjustment for one-time items in both periods, R&D as a percentage of revenue fell to 4.3% from 5.1% in the year-ago period. We estimate this provided an approximate 3 cps tailwind to results. Management indicated that the spending will shift into the remainder of the year so this tailwind should disappear going forward.

- We noted in past reviews that year-over-year pension expense was falling significantly after the company froze its US pension plans at the beginning of 2018. However, pension expense continued to decline, falling by $6 million in the 3/19 quarter courtesy of lower amortization of net losses and prior service cost. This added about a penny per share to EPS growth.

- The adjusted tax rate for the quarter was 12.7%, well below the forecast 18% effective rate for 2019 which the company forecast in the fourth quarter. Management stated in the conference call that "The adjusted tax rate was 12.7% for the quarter, favorable

to our expectations, primarily driven by a benefit of $34 million related to stock compensation deduction as compared to $13 million in deductions to previous year…" We estimate that the lower tax rate added about 4 cps to EPS in the quarter.

- Management accelerated the buyback in the last two quarters, spending $1.4 billion in the fourth quarter and another $597 million in the first quarter of 2019. This had the effect of lowering the share count by 5.2% in the 3/19 quarter versus the 3/18 quarter, providing more than half of the 9% adjusted EPS growth in the period. Cash spent on the buyback more than consumed free cash flow after the dividend on a trailing 12-month basis. With debt to EBITDA below 2x, so this is not an immediate problem. In addition, the timing of the purchases appears to make this buyback more of a capital allocation decision than and a way to boost EPS though an ongoing buyback program the company can't afford which we have been critical of with other companies. Still, investors should realize the extent to which recent adjusted growth is coming from a non-operational source.

- Inventory DSIs continued to rise, climbing by almost 11 days versus the year-ago quarter. Management attributed this to unanticipated sales mix shift but indicated in the conference call that there will be improvement in upcoming quarters:

  "Where we expect to see a significant improvement in working capital relates to inventory. This is an area that has disappointed us over the last year. The inventory build up as a result of different sales mix than we anticipated has been a real problem and something that we focused on correcting but it's not something that corrects overnight.

  And in the first quarter of the year, the days inventory on hand will end at roughly at 107 days. By year end, we will expect to see roughly a 10-day improvement in that particular area. And frankly, that will drive the lion share of performance in our cash flow – free cash flow for the year. We've got a new leader in supply chain, Philippe Reale comes to us and we are excited to have him on board."

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 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.

Disclosure

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