BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Baxter (BAX) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3-

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

We are raising our rating to 3+ (Minor Concern) from 3- (Minor Concern)

- Inventory DSIs rose by 8 days over the year-ago quarter, but this was due to lower sales and the company building inventories to assure product availability during COVID and ahead of hurricane season. DSIs had been trending downward in the previous three quarters and we are no longer concerned with that situation.

- BAX acquired the product rights for *Seprafilm Adhesion Barrier* from Sanofi in February of 2020 for $342 million. Of the purchase price, $28 million was booked as goodwill which will not be amortized, $286 million was booked as developed product rights and amortized over ten years while $10 million was booked as customer relationships and amortized over 7 years. BAX adds all amortization of acquired intangibles back to its non-GAAP earnings figures. We believe ignoring this expense gives an unrealistic view of earnings as the company would have had to have incurred R&D to develop the product in-house if it had not acquired the asset. Such costs would have been expensed as incurred. However, we do note that BAX's amortization add-backs amount to just over 10% of non-GAAP EPS which is among the lowest in the group. For reference, this figure is closer to 25-30% for peers Zimmer Biomet (ZBH), Boston Scientific (BSX), and Medtronic.

- The company recorded a $17 million impairment charge related to developed-technology assets due to a decline in market expectations for the product. A similar charge amounting to $31 million was taken in the year-ago quarter.

- R&D spending declined 16% after adjustment for one-time items due to discretionary spending cuts related to COVID. However, this is likely to reverse in the second half of the year. Management expects to spend an incremental $150 million on COVID-related expenses during the year with much of that already incurred. As many companies are experiencing, the second half should see these incremental expenses fade as some of the discretionary cuts such as R&D reverse.

- The company's 10-Q still identifies a material weakness in internal control over financial reporting related to the restatement of results in 2019 stemming from the company's incorrect use of a non-GAAP FX rate convention which led to the overstatement of earnings by about 3% from 2016-2019. While obviously a major error, we did not view the issue as an intentional earnings manipulation by management. We also view the issue as being under control, but the company indicated earlier in the year it would continue to flag the area as a material weakness until adequate time had passed with no problems.

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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