BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Baxter International (BAX) EQ Review-6/19 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 are maintaining our earnings quality rating of 3- (Minor Concern)

- The adjusted 6/19 quarter's tax rate of 10.8% was better than management's expectations due to a favorable tax ruling and stock compensation deductions. Management did not quantify these impacts, but we note that its previous estimated effective tax rate for the full year was 18%. This implies as much as a 7 cps benefit to adjusted EPS in the quarter or almost all of the 8 cps beat.

- R&D adjusted for unusual items fell to 5.0% of revenue versus 5.8% last year. The 10-Q states that the decline was due to the "timing of project-related expenditures compared to the prior year" and favorable currency translation. However, in the call, management attributed the decline in adjusted R&D to "benefit from our efforts to enhance our processes and optimize our R&D organization while prioritizing strategic investment in our innovative pipeline." Management had indicated in previous calls that it expected an increase in R&D spending in the remainder of 2019. This is the second quarter of more than 3 cps in tailwind from lower adjusted R&D and we doubt that tailwind will last the year.

- BAX discloses contract assets in its footnotes. These represent unbilled receivables and are mostly related to its contract manufacturing and software products where work is done or products are provided ahead of billing. Disclosure began with the adoption ASC 606 in 2018 so we only have a few quarters of data. Over that time, the balance has tracked closely to $80 million but jumped to $89 million in the 6/19 quarter versus $79 million last year and $73 million in the 3/19 quarter. Such a sudden jump in unbilled receivables can indicate the company has become more aggressive in recognizing revenue in the current period. This is admittedly not a material increase, but it is an area to keep an eye on in future periods.

- The company took a $31 million impairment charge related to a developed technology intangible asset due to declining market expectations. This amount was removed from the adjusted EPS figure.

- The year-over-year climb in inventory DSIs moderated to just 3 days in the 6/19 quarter. Management has been candid in admitting this was a problem area it was looking to fix and reiterated that it expects inventory to return to a "normal level" by the end of the year.

- The company noted in the 10-Q that the quarter ending 9/19 will benefit from the recognition of $40 million of insurance proceeds related to Hurricane Maria.

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 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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