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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Baxter International (BAX) EQ Review

Current EQ Rating*	Previous EQ Rating
4-	NA

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

We initiate coverage of Baxter International (BAX) with a 4- (Acceptable)

While there have been several one-time items impacting results at BAX in recent periods, none of these are very alarming when considering size and the openness of management disclosure.

- Results in the 6/18 quarter benefitted from a year-ago charge to deconsolidate its Venezuela operations. The company also amended its US pension plan which resulted in an approximate 3 cps swing in EPS in the period. In addition, it lengthened its estimate for useful life of its enterprise resource planning software which added about a penny to EPS in the each of the last two quarters. The Venezuela impact was adjusted out of its non-GAAP disclosure and while the pension issue was not, the company very openly discussed the impact in its 10-Q and conference call. While the change in estimated life of the ERP was only disclosed in a footnote, the penny impact was not material given the company beat estimates by 6 cents in the quarter.

- Accounts payable days (DSPs) jumped by 5 days in the first half of the year from the timing of supplier payments. While the company's DSP is reasonable compared to peers, the jump is notable. We expect this to moderate in upcoming quarters. However, the increase in payables means other accrued expenses included in the account materially declined. There is not enough information to determine the source of the decline, but it could potentially involve rebate accruals and other accrued expenses which is a potential concern.

- BAX has material payments back and forth with Baxalta related to service and manufacturing agreements from their separation. These have yet to distort reported results, but they should be monitored each quarter.

- The company securitizes some receivables generated in Japan, but the amounts are currently not material.

- Like most medical device companies, BAX adds amortization of acquired intangibles back to adjusted earnings, which overstates the profitability of the company.

Boost from Changes in Pension Plan and Depreciation Changes

BAX's reported results benefited from a decline in other income and expense in the 6/18 quarter. One of the main factors driving the beneficial swing was a $33 million charge in the 6/17 quarter related to the deconsolidation of the company's Venezuela operations. The company adjusted for this amount in its adjusted EPS presentation.

In addition to the Venezuela charge, other income also benefitted from a change in its pension plan. In January of 2018, BAX amended its US pension plan to freeze benefit accruals for current employees at the end of 2022. This resulted in a $57 million reduction in the projected benefit obligation (PBO) which, in turn, reduced amortization expense and a net pension benefit of $14 million in the 6/18 quarter compared to an $8 million expense in the year-ago period. This $22 million swing in pension expense would have added about 3 cents per share to EPS growth in the period. We note that the company did not adjust this amount out of its adjusted EPS figures. However, management did discuss this impact prominently in both the 10-Q and the conference call.

BAX disclosed that in the 1Q 2018, it extended the estimated useful life of its enterprise resource planning (ERP) software which resulted in a $6 million reduction in depreciation expense which added about a penny per share to EPS in each of the last two quarters. The company did not adjust for this in its non-GAAP disclosures but rather mentioned it in its property, plant and equipment footnote in the 10-Q. While we would have preferred to see this more prominently displayed, given its relatively small impact and the fact that the company beat EPS estimates in the $0.06 and $0.08 in the 6/18 and 3/18 quarters, respectively.

Cash Flow Boost from Payables

BAX lumps its accounts receivable balances into its other accrued liabilities amounts on its balance sheet. While it itemizes this account in its 10-K, it does not in its 10-Q. However, it does note in its liquidity discussion in the 10-Q that days payable jumped to 56.2 days for the first half of 2018 versus 51.6 days in the comparable year-ago period due to the timing of supplier payments which was an obvious boost to cash flow growth in the period. We are not alarmed by the increase as BAX's days payable are relatively in-line with similar medical companies such as Medtronic (62), Boston Scientific (50) and Zimmer Biomet (56). Still, none of these companies saw a similar increase in the 6/18 quarter. We would, therefore, expect to see the increase in days payable level off in the upcoming quarters.

Another observation we would make is that combined "accounts payable and other accrued liabilities account" days of sales actually declined by ten days, as shown in the following table:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Accounts Payable and Other Accrued Liabilities	$2,524.00	$2,533.00	$2,733.00	$2,572.00
COGS	$1,603.00	$1,563.00	$1,616.00	$1,579.00
Payable Days	143.7	147.9	154.3	148.6

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Accounts Payable and Other Accrued Liabilities	$2,471.00	$2,330.00	$2,612.00	$2,499.00
COGS	$1,473.00	$1,431.00	$1,543.00	$1,487.00
Payable Days	153.1	148.6	154.5	153.4

If payable days increased, yet the whole account fell on a days COGS basis, it means the other component must have collectively shown a considerable decline. Here are the components of the account as of 12/17:

	12/31/2017
Accounts Payable	$920
Dividends Payable	$87
Employee Compensation and Withholdings	$548
Property, Payroll and Certain Other Taxes	$143
Business Optimization Reserves	$100
Accrued Rebates	$218
All Other	$717
	$2,733

According to the latest 10-Q, the business optimization reserve has declined to $75 million, but this does not explain the DSP decline by itself. Accrued employee compensation expense could have also been impacted by the change in pension plan in the first quarter. It is obviously impossible to determine the source of the decline, so we are not raising alarms over this issue at the moment. However, given the potential that accrued rebates or other expense accruals could have been involved, this is most definitely an area to keep an eye on when the 10-K comes out next year.

Payments To and From Baxalta

In 2015, BAX separated from Baxalta by distributing approximately 80% of the shares of Baxalta to BAX shareholders. The two companies also initiated both transaction services agreements and manufacturing and supply agreements under which BAX records revenue from Baxalta, associated cost of sales and reimbursements to marketing and administrative expenses. Fluctuations in the net amounts paid to Baxalta have not materially impacted results in the last four quarters, as seen in the following table:

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Reduction of marketing and admin under Baxalta TSA	$2.0	$7.0	$9.0	$11.0
Revenue recognized under Baxalta MSA	$7.0	$6.0	$4.0	$6.0
COGS Recognized under Baxalta MSA	-$36.0	-$37.0	-$37.0	-$35.0
Net Expense Recognized from Baxalta	-$27.0	-$24.0	-$24.0	-$18.0

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Reduction of marketing and admin under Baxalta TSA	$16.0	$20.0	$22.0	$26.0
Revenue recognized under Baxalta MSA	$6.0	$6.0	$8.0	$6.0
COGS Recognized under Baxalta MSA	-$50.0	-$48.0	-$50.0	-$47.0
Net Expense Recognized from Baxalta	-$28.0	-$22.0	-$20.0	-$15.0

While the net expense recognized under the Baxalta agreements has not materially impacted the growth in reported profits so far, we still see this as an area that has the potential to distort results due to the timing of amounts recognized, making this an area to keep an eye on in future quarters. We also observe that we find it unusual that while the components of the net impact have shifted considerably, the net impact always manages to be in the mid $20 million range.

Securitization of Receivables

BAX disclosed that it maintains a securitization program for certain receivables generated in Japan. However, the amounts in question are relatively small ($64 million outstanding at the end of the 6/18 quarter versus $63 million last year.) This is nowhere near as extensive as some other companies we have reviewed, so this is currently not a point of concern.

Amortization of Acquired Intangibles

In the 3/18 quarter, the company acquired two products from Mallinckrodt which it accounted for under the purchase method. The initial payment was $148 million which was adjusted upward by $12 million in the 6/18 quarters. In addition, the fair value of possible contingency payments was estimated to be $14 million. The bulk of the purchase price was allocated to intangible assets with an estimated useful life of 10 years. Also in the 3/18 quarter, BAX paid $72 million to acquired the rights to Bivalirudin and Dexmedetomidine from Celerity. The entire purchase price was capitalized and is being amortized over 12 years. However, the company adds all amortization of acquired intangibles back to earnings to arrive at its adjusted EPS. We are very aware that this is a typical industry practice, but we will point out that such treatment of acquired intangibles is an understatement of expenses. If the company had developed these products on its own, it would have had to pay research and development costs which would have been charged against earnings over time. Amortizing the acquired intangibles over the useful life of the assets recognizes this but adding them back is pretending the shareholder capital was never spent. To put this in perspective, total amortization of intangibles was $0.06 per share in the 6/18 quarter while the company reported adjusted EPS of $0.77 per share, implying EPS would have been almost 8% lower if the company recognized these amounts in earnings.

Business Optimization Charges

In the second half of 2015, BAX initiated a Business Optimization program to enhance efficiency. Actions have included optimizing manufacturing's, R&D and supply chain networks. So far, the company has spent $661 million and expects an additional $170 million

in pretax charges and $70 million in capital expenditures to complete the plan. The plan is expected to be substantially complete by the end of the year. Large charges which are added back to adjusted results always call into question the quality of the adjusted earnings and we will be skeptical if another large plan is announced after the conclusion of the current one.

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 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

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