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Becton, Dickinson & Co. (BDX) EQ Update- 12/19 Quarter

Current EQ Rating*	Previous EQ Rating
3-	4-

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 lowering our earnings quality rating to 3- (Minor Concern) from 4- (Acceptable)

BDX reported non-GAAP EPS of $2.65 in the 12/19 quarter which was 2 cps ahead of the consensus with revenue also topping estimates. Note that the YOY 2% decline in non-GAAP was due to the expiration of a royalty and a tough comp from an 11.2% tax rate in the year-ago quarter.

Despite the earnings beat, the stock price was hammered due to the company reporting that it will take longer than expected to resolve issues with the FDA over its *Alaris* pump. The lost revenue and higher cost led management to lower its fiscal 2020 (ended Sept.) estimates for revenue growth to 1.5% to 2.5% compared to the consensus estimates of 4.0% to 4.5%.

Note that our reduced rating is a result of one-time benefits to the 12/19 quarter and in no way reflects the situation with the *Alaris* pump or the lowered guidance.

- DSOs based on balance sheet receivables fell by 4.5 days YOY in the 12/19 quarter. However, after adding back $328 million in factored receivables that were removed from the company's balance sheet, DSOs rose by 3.3 days. BDX has disclosed in the past that it can factor receivables as a way of managing working capital, but it has not quantified the impact in the last several quarters as it was immaterial to results. DSOs typically track very steadily at BDX and the sudden jump in the adjusted 12/19 figure could be an indication that sales were pulled forward into the 12/19 quarter at the expense of the next.

- Amortization of intangible assets in the 12/19 declined by $33 million (about 9 cps) compared to the comparable year-ago period. However, gross amortizable intangible assets have remained steady for the last eight quarters. In addition, the bulk of intangible assets resulted from the 12/17 quarter acquisition of CR Bard and almost all are being amortized over 13-14 years which further indicates that the drop in amortization is not due to intangibles becoming fully amortized. We have noted in the past that the company adds back amortization of intangibles to its non-GAAP earnings figures which totally ignores the cost of the Bard deal. However, this means that non-GAAP figures did not benefit from the lower intangible amortization, unlike reported GAAP numbers.

- Lower share-based compensation added about 3 cps to earnings growth in the quarter.

- Inventory DSI rose by almost 7 days over the year-ago quarter. There was no discussion of the cause of the spike, but medical product companies" DSIs can be volatile and we suspect this could be due to supporting product launches. Therefore, we do not attach a high degree of concern to it at this point.

Spike in Factored Receivables Hides DSO Increase

On the surface, BDX's accounts receivable DSOs fell by almost 4 days compared to the year-ago quarter as shown in the table below:

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Sales	$4,225	$4,585	$4,350	$4,195
Trade Receivables	$2,074	$2,345	$2,220	$2,279
Trade Receivables Days of Sales	45.2	47.1	46.4	48.9

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Sales	$4,160	$4,403	$4,278	$4,222
Trade Receivables	$2,216	$2,319	$2,243	$2,293
Trade Receivables Days of Sales	49.0	48.5	47.7	48.9

However, BDX has disclosed in the past that from time to time, it will factor receivables to third parties to manage its working capital. These amounts are treated as sales and removed from the accounts receivable account. For the last several quarters, there has been no mention of these sold receivable balances as the amounts were not material to the company's results. However, this changed in the 12/19 quarter. Consider the following disclosure from the 12/19 10-Q:

> *"Over the normal course of its business activities, the Company transfers certain trade receivable assets to third parties under factoring agreements. Per the terms of these agreements, the Company surrenders control over its trade receivables upon transfer. Accordingly, the Company accounts for the transfers as sales of trade receivables by recognizing an increase to Cash and equivalents and a decrease to Trade receivables, net when proceeds from the transactions are received.* ***The Company's balance of Trade receivables, net at December 31, 2019 excludes trade receivables of $328 million that have been transferred to third parties under factoring arrangements.*** *The costs incurred by the Company in connection with factoring activities were not material to its consolidated financial results. The Company's transfers of trade receivables during the three months ended December 31, 2018 were not material to its consolidated financial results."*

According to the disclosure, the 12/19 trade receivables balance should be adjusted upwards by $328 million to get an idea of the total receivables balances generated during the quarter. When we do this, we get an adjusted DSO figure of 52.3 which is a 3.3-day increase over the year-ago quarter. This is the first such jump in receivables in several quarters and could be an indication that sales were pulled into the quarter at the expense of the next.

Drop in Amortization of Intangibles

BDX's amortization of acquired intangibles fell by $33 million YOY in the 12/19 quarter despite gross intangible assets remaining relatively constant. The following table shows the breakout of gross intangible assets and the quarterly amortization of intangible assets for the last eight quarters:

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Developed Technology	$14,010	$13,960	$13,972	$13,976
Customer Relationships	$4,610	$4,608	$4,610	$4,586
Product Rights	$115	$110	$115	$118
Trademarks	$407	$407	$407	$407
Patents and Other	$488	$445	$433	$407
Amortized Intangible Assets	$19,630	$19,530	$19,537	$19,495
Amortization of Intangibles	$345	$365	$378	$376

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Developed Technology	$13,958	$13,966	$13,937	$13,948
Customer Relationships	$4,585	$4,584	$4,585	$4,566
Product Rights	$119	$121	$121	$131
Trademarks	$407	$407	$407	$408
Patents and Other	$404	$397	$388	$382
Amortized Intangible Assets	$19,474	$19,475	$19,438	$19,435
Amortization of Intangibles	$378	$376	$375	$370

The bulk of these intangible assets resulted from the acquisition of CR Bard in the 12/17 quarter. Disclosures indicated that developed technologies were being amortized over an average of 14 years while customer relationship assets are being amortized over 13 years. Based on the gross balances and the amortization periods of the largest categories, it does not appear that the sudden drop in amortization expense that occurred in the 9/19 quarter and more pronounced drop in the 12/19 quarter were related to an intangible asset becoming fully amortized. **We estimate that the substantial YOY drop in the 12/19 quarter would have added over 9 cps to growth in GAAP EPS in the period.**

As we have noted in past reviews, the company adds back the amortization of intangible assets to its non-GAAP EPS figures under the "purchase accounting adjustments" line item. We disagree with the logic behind doing this as it totally

ignores the cost of the Bard acquisition. To put this in perspective, non-GAAP EPS of $2.65 in the 12/19 quarter included $1.27 of purchase accounting adjustments added back to it. Still, the unusual decline in amortization expense would not have had an impact on growth in non-GAAP EPS.

Lower Share-Based Compensation

The following table shows share-based compensation disclosed on the cash flow statement for the last 8 quarters:

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Share-based compensation	$82.0	$53.0	$56.0	$59.0

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Share-based compensation	$93.0	$61.0	$54.0	$66.0

The YOY decline in share-based compensation in the 12/19 quarter added about 3 cps to EPS in the period. We view this as a non-operational benefit

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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