BEHIND THE NUMBERS
Quality of Earnings Analysis
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Becton, Dickinson and Company (BDX) Earnings Quality Update 12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are upgrading our earnings quality rating of BDX to 3+ (Minor Concern) from 3- (Minor Concern)

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

Summary

BDX's revenue jumped by 25% in the 12/20 quarter as Integrated Diagnostic Solutions revenue doubled as a result of COVID test demand. This drove non-GAAP EPS of $4.55 which was $1.39 ahead of the consensus estimate. Our rating increase reflects a leveling out in receivables factoring although longer-term issues such as material intangibles add-backs and a high debt load remain concerns.

What improved?

- Factored receivable DSOs fell by 2 days versus the year-ago quarter and were flat sequentially. Total adjusted receivables DSOs also fell 7 days YOY and 4 days sequentially. It does not appear that cash flow growth received an artificial boost in the three months ended 12/20 from accelerated factoring but this trend should be monitored going forward.

What deteriorated?

- BDX's effective adjusted tax rate fell to 14.6% in the 12/20 quarter from 15.3% a year ago. This added about 2.5 cents to EPS in the period. This is not material given the size of the earnings beat in the quarter.

What to watch

- We have criticized BDX in the past for adding back the amortization of intangible assets to its non-GAAP earnings figures. While virtually all med-tech companies do this, the distortion on BDX's earnings is especially large as its adjustment amounted to almost 40% of non-GAAP EPS for the trailing-12 month period ended 12/20.

- The 2017 acquisition of Bard left BDX with a substantial net debt load which currently sits at $14.5 billion or 3.3 times adjusted EBITDA. Also, keep in mind that the company has an additional $2.4 billion in litigation accruals related to product liability lawsuits not included in these debt figures.

Supporting Detail

Reduction in Factored Receivables

We have noted in previous reviews that BDX maintains a receivables factoring program under which it sells accounts receivable to third parties. The transfers are accounted for as a sale and receivables are removed from the company's balance sheet. Before the 12/19, quarter, BDX did not disclose the amount of transferred receivables as they were considered immaterial. However, BDX reported in the 12/19 quarter that its balance sheet excluded over $300 million in receivables that had been transferred to third parties. This amount has moved between $200 and $340 million in the quarters since. To calculate a useful DSO figure, we must add back the receivables that have been transferred to third parties but are still outstanding at the end of the period. The following table shows this adjusted DSO breakdown for the last eight quarters:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Sales	$5,315	$4,784	$3,855	$4,253	$4,225	$4,584
Balance Sheet Receivables	$2,370	$2,398	$1,993	$2,160	$2,074	$2,345
B/S Receivable DSOs	40.6	46.1	47.0	46.2	45.2	47.1
Factored but Outstanding	$284	$256	$317	$246	$328	nm
Transferred DSOs	4.9	4.9	7.5	5.3	7.1	0.0
Adjusted DSOs	45.4	51.0	54.5	51.5	52.3	47.1

We can see that DSOs based on receivables that have been factored are down significantly from a year ago and flat sequentially. Also, total adjusted DSOs are down YOY and down sequentially. We do not see evidence of cash flow growth for the three months ended 12/20 receiving an artificial boost from factoring activity. This trend should be regularly monitored for signs of an acceleration in factoring.

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 Concern)- 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 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 upcoming quarters. 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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