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BTN Research

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Becton Dickinson (BDX) 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 Becton Dickinson (BDX) with a 4- (Acceptable)

The acquisition of CR Bard in the 12/17 quarter clouds the comparability of results which makes it impossible to get a clear picture of the company's accounting. However, a review of BDX's and Bard's results prior to the acquisition did not reveal any red flags that indicate aggressive accounting. Therefore, we are initiating coverage of BDX with a 4- rating with the expectation of improving insight when the acquisition anniversaries over the next two quarters.

We do have a couple of observations regarding the application of purchase accounting, as well as litigation liabilities picked up in the Bard acquisition.

- BDX's adjusted EPS adds back the amortization of acquired intangibles. We realize this is typical practice in the industry, but we still believe it distorts the economic reality of the transaction by ignoring the cost of ongoing investments in technology. We estimate EPS in the quarter would have been almost 40% lower if amortization expense is considered.

- BDX faces several new litigation threats picked up in the Bard acquisition in the areas of pelvic mesh, women's health and its vena cava filters. While we do not have insight into the likelihood of negative outcomes, current BDX shareholders should be aware of these contingencies.

Amortization of Intangibles

As we have noted with other medical companies, acquisitions typically result in very large percentages of the acquisition prices being allocated to goodwill and intangibles assets. In the case of intangibles, the balances are amortized over the expected useful lives of the assets in question. BDX is using a period of 14 years to amortize developed technologies and 13 years for customer relationships. In a research-intensive industry such as medical devices, the R&D spent developing these assets is a very real expense which must be replicated in the future for the company to remain in business. The amortization expense is intended to recognize this fact. However, as with most companies in the industry, BDX adds the amortization of acquired intangibles back to its adjusted non-GAAP EPS to arrive at the figure used by most analysts to assess growth and calculate valuation metrics for the company. In the case of BDX, the company added back $433 million pre-tax (about $1.25 per share after tax) in purchase accounting adjustments to adjusted EPS in the 6/18 quarter. This included a $56 million increase to the inventory step-up adjustment related to inventory acquired from Bard. This implies that the bulk of the remainder or approximately $1.09 per share represents the amortization of intangible assets. BDX reported adjusted EPS of $2.91 for the 6/18 quarter, meaning that EPS without the amortization adjusted out would have been almost 40% lower than reported.

We understand that the practice of ignoring amortization of intangibles is the industry norm, but we will still point out that it distorts economic reality by failing to recognize the cost of investments of shareholders capital. For that matter, so does GAAP not requiring goodwill amortization, but don't get us started.

Litigation Exposure Picked up from Bard Acquisition

A full analysis of litigation claims is beyond the scope of our EQ Review Ratings. In addition, the footnotes of virtually all medical products companies are littered with various claims made against the companies, so we generally refrain from listing each one. However, we do sometimes come across disclosures that catch out attention. In the case of BDX, we found its disclosures regarding its hernia products, women's health products, and its inferior vena cava filters worthy of notice as these were all inherited in the 12/17 quarter acquisition of CR. Bard. Thus, existing BDX shareholders might not be completely familiar with them. Highlights in the disclosures include the fact that the company was found guilty of negligent failure to warn users in one of the filter multi-district litigation cases which it intends to challenge. In addition, we note the following disclosure regarding insurance recoveries:

> *"In January 2017, the Company reached an agreement to resolve litigation filed in the Southern District of New York by its insurance carriers in connection with Women's Health Product Claims and Filter Product Claims. The agreement requires the insurance carriers to reimburse the Company for certain future costs incurred in connection with Filter Product Claims up to an agreed amount. For certain product liability claims or lawsuits, the Company does not maintain or has limited remaining insurance coverage."*

BDX also disclosed that its Bard-related product liability accruals were approximately $2 billion. It has $124 million in funds set aside and it expects $294 million in recoveries with the bulk of that related to an indemnification agreement with Medtronic. The company has suspended the buyback after the Bard deal to focus on paying down debt. The dividend is also well covered at less than 50% of trailing free cash flow, so we are not concerned about it. With about $1.4 billion in cash on the balance sheet, the company should have no problem covering payments as they arise. Nevertheless, such a large contingency still has the ability to produce a negative surprise.

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 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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