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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

January 17, 2019 | www.btnresearch.com

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Boston Scientific (BSX) 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 BSX with a rating of 4- (Acceptable)

BSX reported EPS of $0.35 in the 9/18 quarter which was a penny ahead of the consensus estimate. Management also stated in the conference call that EPS "include[d] approximately $0.02 of negative FX impact, which is $0.01 to $0.02 greater than our expected $0.00 to $0.01 headwind at the time of guidance." However, management also noted that the tax rate of 5.3% was considerably lower than the forecasted 13-14% range due to "greater clarity related to the tax reform and its impact on our tax structure." We estimate this added about 2.5 cps to earnings in the quarter. Adjusted for these factors, the quarter appeared to be a slight miss. Guidance for full-year 2018 was narrowed to $1.38-$1.40 from the previous $1.37-$1.41.

We saw a few minor items in the company's results that are worthy of note:

- The company maintains accounts receivables factoring programs in several European countries as well as with a Japanese bank. Receivables days of sale (DSO) based on receivables remaining on the balance sheet have been tracking relatively steadily, as have DSOs calculated on outstanding receivables derecognized under the factoring program. This alleviates concerns that the factoring program could be masking a problem with growing receivables or providing an unsustainable boost to recent cash flow growth. However, we do note that growth in Yen-denominated factored receivables has significantly outgrown the other components as well as the growth rate in Asia Pacific sales. While difficult to draw a solid conclusion with the available data, this trend should be monitored in upcoming quarters.

- The allowance for bad debts as a percentage of receivables has fallen to 4% from about 5% a year ago. We do not view this as being a material concern at this point as it would only take about a penny per share charge to restore the reserve to year-ago levels.

- Accounts payable days (DSPs) jumped by over 7 days over the year-ago quarter. We believe this is simply a timing issue and are not overly concerned at the moment.

Receivables Factoring Program

BSX maintains receivables factoring programs in several European countries as well as a factoring agreement with a Japanese bank. Receivables are sold to third parties without recourse to the company. The receivables are derecognized from the balance sheet at the time of sale. The following table shows receivables on the balance sheet, outstanding derecognized receivables, and the calculation of adjusted days of sales (DSO) for the last eight quarters:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$2,393	$2,490	$2,379	$2,409
Accounts Receivable	$1,580	$1,587	$1,580	$1,548
Derecognized Euro Receivables	$158	$161	$178	$171
Derecognized Yen Receivables	$194	$216	$219	$157
Total Derecognized Receivables	$352	$377	$397	$328
Adjusted Receivables	$1,932	$1,964	$1,977	$1,876
Accounts Receivable DSO	60.2	58.2	60.6	58.6
Factored Receivable DSO	13.4	13.8	15.2	12.4
Total Adjusted DSO	73.7	72.0	75.8	71.1

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$2,222	$2,257	$2,160	$2,191
Accounts Receivable	$1,470	$1,444	$1,429	$1,472
Derecognized Euro Receivables	$167	$165	$156	$152
Derecognized Yen Receivables	$162	$157	$154	$149
Total Derecognized Receivables	$329	$322	$310	$301
Adjusted Receivables	$1,799	$1,766	$1,739	$1,773
Accounts Receivable DSO	60.4	58.4	60.4	61.3
Factored Receivable DSO	13.5	13.0	13.1	12.5
Total Adjusted DSO	73.9	71.4	73.5	73.8

Both balance sheet receivable DSOs and factored receivable DSOs have been trending relatively steadily on a year-over-year basis. This alleviates the concern that the factoring program is masking an increase in credit terms by moving the receivables off the balance sheet. In addition, there does not appear to be a rapid acceleration in the use of factoring that is providing a large, temporary boost to operating cash flow growth.

However, we do observe that growth in Yen-denominated factored receivables has outgrown both Euro-denominated receivables and balance sheet receivables. In addition, the 20% year-over-year growth in Yen-denominated factored receivables far outpaced the 6% growth in Asia Pacific sales. Without Yen-denominated sales and total Yen receivables, it is difficult to reach a conclusion that Japanese sales benefitted from the aggressive extensive of receivables. Still, the trend is worth noting and will be more of a concern if it continues into future quarters.

Decline in Bad Debt Percentage

While it is not yet a major concern, we note that BSX's allowance for bad debts has fallen to 4% of receivables compared to just over 5% a year ago.

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Beginning Allowance	$63.0	$67.0	$68.0	$81.0
Charged to Expenses	$6.0	$4.0	$4.0	$0.0
Utilization of Allowance	-$4.0	-$8.0	-$5.0	-$12.0
Ending Allowance	$66.0	$63.0	$67.0	$68.0
Allowance % of Gross Receivables	4.0%	3.8%	4.1%	4.1%

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Beginning Allowance	$74.0	$75.0	$73.0	$75.0
Charged to Expenses	$9.0	$2.0	$3.0	$4.0
Utilization of Allowance	-$2.0	-$3.0	-$1.0	-$6.0
Ending Allowance	$81.0	$74.0	$75.0	$73.0
Allowance % of Gross Receivables	5.1%	4.7%	4.8%	4.6%

It would take a charge of only about a penny per share to increase the reserve back to year-ago levels, so this is not a material issue yet but is worth monitoring in future quarters.

Accounts Payable Days Jumped

BSX's accounts payable days (DSPs) jumped significantly in the 9/18 quarter as seen in the following table:

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
COGS	$672.0	$739.0	$672.0	$674.0
Accounts payable	$453.0	$403.0	$404.0	$530.0
COGS YOY growth	$0.1	$0.2	$0.0	$0.1
Accounts payable YOY growth	$0.2	$0.1	$0.1	$0.2
Accounts payable DSPs	61.5	49.8	54.9	71.8

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
COGS	$637.0	$632.0	$650.0	$618.0
Accounts payable	$371.0	$376.0	$376.0	$447.0
COGS YOY growth	$0.1	$0.0	$0.1	$0.1
Accounts payable YOY growth	$0.2	$0.3	$0.6	$1.1
Accounts payable DSPs	53.1	54.3	52.8	66.0

Payables levels are not alarmingly high overall, and we have not seen any mention of the cause of this jump. We are not especially concerned by the increase but will continue to watch the payables trend in upcoming quarters.

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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