BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Boston Scientific (BSX) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4-	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 maintaining our rating of 4- (Acceptable)

BSX reported adjusted EPS of $0.37 which was 12 cps ahead of the consensus. There were one-time items impacting results both ways. BSX is adding back an increasing amount of amortization of acquired intangibles along with a growing amount of acquisition/divestiture charges, restructuring charges, and litigation charges. This is eroding the quality of non-GAAP earnings in our mind, but we are not downgrading our rating at this time.

What deteriorated?

- BSX's IRS examination of tax years 2014-2016 was completed during the quarter which resulted in the company recording an $88 million, or 6 cps benefit to income tax expense in the quarter. This was NOT adjusted out of the company's non-GAAP earnings figures. This unexpected benefit accounted for half the EPS upside in the quarter. (Concern level: LOW)

- The company carries $6.8 billion of intangible assets racked up during its history of acquisitions. However, it has taken multiple impairment charges including over $450 million during the first nine months of the year. The bulk of these charges related to writing of in-process R&D from the Apama Medical intangibles following the company's decision to not pursue commercialization due to delays from COVID and new technology developments.

- BSX recorded a $260 million pre-tax charge for litigation in the quarter which was again added back to non-GAAP results.

What Improved?

- Adjusted EPS was penalized by 4 cps in the quarter as the company recorded $63 million in one-time sales rebates related to changing to a consignment inventory model for its new WATCHMAN Left Atrial Appendage Closure Device. This would have offset much of the one-time tax benefit noted above.

What to watch

- The company maintains an accounts receivable factoring program through which it sells receivables to third party finance companies to accelerate the receipt of cash. Outstanding receivables sold and removed from the balance sheet fell to 11.8 days of sales from 12.1 a year ago and over 14 in the previous quarter. Total receivables DSOs adjusted for factoring fell by 6 days YOY. We are not alarmed by the progress of receivables in the quarter and will continue to monitor for sudden accelerations in factoring, especially those that mask an overall increase in receivables generated in a quarter.

- BSX adds back the amortization of acquired intangibles which continues to rise as the company makes acquisitions. Amortization expense on a trailing 12-month basis was more than 30% of pre-COVID adjusted earnings.

An Updated Look at Non-GAAP Reconciliations

Like most of the med-tech industry, BSX's non-GAAP reconciliations is a long list and is shown in the below table for the last eight quarters:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
GAAP Earnings Before Taxes	-$227	-$181	$22	-$6
Amortization Expense	$197	$197	$201	$200
Intangible Asset Impairment Charges	$219	$34	$198	$1
Acquisition/Divestiture-Related Charges	$111	$60	-$23	$121
Restructuring and Related Charges	$23	$23	$30	$44
Litigation-Related Charges	$260	$0	$0	$223
Investment Impairment Charges	-$65	$0	$0	$1
EU MDR Implementation Costs	$8	$7	$5	$4
Discrete Tax Items	$0	$0	$0	$0
Debt Extinguishment Charges	$0	$0	$0	$86
Total GAAP Earnings Before Taxes Adjustments	$753	$321	$411	$680
Adjusted Earnings Before Taxes	$526	$141	$434	$674

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
GAAP Earnings Before Taxes	$91	$145	$457	$296
Amortization Expense	$176	$162	$161	$162
Intangible Asset Impairment Charges	$0	$37	$67	$0
Acquisition/Divestiture-Related Charges	$304	$225	-$24	$22
Restructuring and Related Charges	$14	$11	$12	$37
Litigation-Related Charges	$25	$15	-$148	$85
Investment Impairment Charges	$1	$1	$1	$0
EU MDR Implementation Costs	$2	$0	$0	$0
Discrete Tax Items	$0	$0	$0	-$7
Debt Extinguishment Charges	$0	$0	$0	$0
Total GAAP Earnings Before Taxes Adjustments	$522	$451	$69	$299
Adjusted Earnings Before Taxes	$613	$596	$527	$596

We have addressed the add-back of amortization of acquired intangibles. Acquisition/divesture charges is a catch-all which often contains material amounts such as the cost of canceling derivative contracts related to the BTIG acquisition in 2H '19. The company gives the following discussion of the charges in its 2019 10-K:

> *"**Acquisition/divestiture-related net charges (credits) or payments** - These adjustments may consist of (a) contingent consideration and Zytiga™ licensing arrangement fair value adjustments; (b) gains on previously held investments; (c)*

due diligence, deal fees and other fees and costs related to our acquisition and divestiture transactions; (d) inventory step-up amortization and accelerated compensation expense; (e) ***integration and exit costs****; and (f) separation costs and gains primarily associated with the sale of a business or portion of a business…*

…Examples of integration and exit activities include the movement of business activities; the elimination or combination of redundant roles and business processes; the consolidation or closure of facilities and legal entities; and the transfer of product lines between manufacturing facilities. These integration and exit activities take place over a defined timeframe and have a distinct project timelines, are incremental to activities and costs that arise in the ordinary course of our business and are not considered part of our core, ongoing operations. *In addition, our acquisition-related charges in 2019 included expenses for instruments entered into solely for the purpose of financing or hedging the BTG Acquisition, including net interest expense and hedging expenses. Subsequent to September 30, 2019, we did not incur and will not incur any hedging gains or losses related to the BTG Acquisition, and we are not classifying any interest expense subsequent to the BTG acquisition date as an acquisition/divestiture-related item. Acquisition/divestiture-related net charges (credits) are excluded from management's assessment of operating performance and from our operating segments' measures of profit and loss used for making operating decisions and assessing performance."*

There is not an updated definition in the company's quarterly filings, describing the content of the $111 million charge added back in the 9/20 quarter. We do know that adjustments in contingent consideration amounted to only $6 million in the quarter and we are uncertain as to the composition of the remainder.

Regular restructuring charges are also becoming more of a concern. Over the last eight quarters, restructuring charges have amounted to almost 5% of non-GAAP pretax earnings. The company gives the following description of restructuring charges in the 10-K:

"Restructuring and restructuring-related net charges (credits) or payments *- These adjustments primarily represent* ***compensation-related charges****, fixed asset write-offs, contract cancellations,* ***project management fees*** *and other direct costs associated with our restructuring plans. These restructuring plans each consist of distinct initiatives that are fundamentally different from our ongoing, core cost reduction initiatives in terms of, among other things, the frequency with which each action is performed and the required planning, resourcing, cost and timing.*

> ***Examples of such initiatives include the movement of business activities, facility consolidations and closures and the transfer of product lines between manufacturing facilities,*** *which, due to the highly regulated nature of our industry, requires a significant investment in time and cost to create duplicate manufacturing lines, run product validations and seek regulatory approvals. Restructuring initiatives take place over a defined timeframe and have a distinct project timeline that begins subsequent to approval by our Board of Directors. In contrast to our ongoing cost reduction initiatives, restructuring initiatives typically result in duplicative cost and exit costs over this period of time, are one-time shut downs or transfers and are not considered part of our core, ongoing operations."*

The ongoing nature of these charges and the fact they include employee compensation and fees increases the likelihood in our mind that operating expenses could be included and added back in non-GAAP results.

Litigation costs includes the typical intellectual property-related expenses but the largest components involve BSX's problems with its past product liability issues, most recently the pelvic mesh products. Hopefully, this issue will be resolved in the near future and not be replaced by another.

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 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.

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