BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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November 21, 2019 | www.btnresearch.com

Boston Scientific (BSX) EQ Update 9/19 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 a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We are maintaining our earnings quality rating of 4- (Acceptable).

- BSX closed on its $3.6 billion (net of cash) acquisition of BTG. The company warned that it expected to take a longer than normal time to finalize the allocation of the acquisition price, up to a year. During this time, adjustments to the carrying value of intangibles could result in non-operating gains and losses that investors should be watchful of, but we note that the company has been good about adjusting these items out of non-GAAP results in the past.

- However, we will take this opportunity to once again criticize the company's practice of excluding amortization of acquired intangibles from non-GAAP earnings. In the case of BTG, $1.9 billion of the $3.6 billion purchase price was allocated to intangible assets with $1.5 billion allocated to goodwill. BTG's main asset was its portfolio of pharmaceutical products which the company would have had to incurred substantial amounts to develop on its own had it now acquired them from BTG. However, the money spent on the acquisition for those assets is being totally disregarded in the non-GAAP results. Also, while the add-back of amortization makes this less relevant, we note that the company assigned an amortization period of 10-17 years for its technology-related intangibles from the BTG deal with the high end of that range seeming unusually long for a pharmaceutical asset.

- The recent acquisitions have left the company with a leverage ratio of 4.27 as defined by its debt covenants with the maximum allowable ratio of 4.75. The maximum allowance amounts steps down in 25 bps increments in each quarter after the acquisition. With the company currently not paying a dividend or buying back shares, there should be no problem with keeping debt below the covenant level.

- On-balance sheet receivable DSOs were essentially flat versus the year-ago quarter, as were DSOs based on sold but outstanding receivables. Therefore, we remain unconcerned regarding any artificial benefits to cash flow or sales.

- Deferred revenue days fell by one day versus the year-ago quarter. However, deferred revenue balances arise primarily from sales of the *LATTITUDE* Patient Management System, the absolute amount of deferred revenue increased both year-over-year and sequentially, and revenues were inflated by sales of recently acquired products. These factors erase concern regarding the decline in deferred revenue days.

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.

Disclosure

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