BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Boston Scientific (BSX) EQ Update

Current EQ Rating*	Previous EQ Rating
4-	4-

*For an 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 reported adjusted EPS of $0.35, a penny shy of the consensus estimates. The company had several relatively minor unexpected items not included in its original outlook for the quarter, however, they essentially offset themselves. A gain related to litigation payments received of about 2 cps was offset by an approximately equal impairment related to the withdrawal of its mesh products. Likewise, a slightly lower than anticipated tax rate was largely offset by make-whole call payments related to the February bond offering. With all the small back and forth items, we are not viewing the miss with too much concern although it certainly was not a decisive beat.

- Accounts receivable days adjusted for receivables derecognized under the securitization program declined by three days and the rate of factoring slowed. We remain unconcerned about the company's receivables balances.

- We note that deferred revenue ended the quarter at $369 million (13.5 days of sales), down from $373 million (13.3 days) in the 12/18 quarter and $393 million (15.1 days) in the year-ago first quarter. This is a mild concern as the decline on the days of sales basis could be an indication of accelerated revenue recognition in the current quarter. However, given the contraction in receivables days, we are not as concerned about aggressive revenue recognition in the quarter.

- BSX announced on January 20th that it closed the acquisition of the remaining 80% of privately-held Millipede for $325 million with an additional $125 million in payments contingent upon meeting certain commercial milestones. Millipede was formed in the first quarter of 2018 to develop a Transcatheter Annuloplasty Ring System for the treatment of severe mitral regurgitation. BSX's original investment included an acquisition option agreement. BSX made an upfront cash payment of $90 million at the time. By the fourth quarter of 2018, Millipede had successfully completed in-human clinical trials and BSX exercised its option to acquire. Arrangements like this are commonplace in the pharma and medical device industry, but we remain critical of them as we see them as essentially a way to keep R&D expense off the income statement. The original investment was capitalized, as was the payment for the remainder of the company. Of the $510 million total purchase price, $271 million was booked as goodwill and $295 million was booked as indefinite-lived intangibles, neither of which will ever be amortized.

- BSX recorded a reversal of $28 million to its reserve for contingent consideration related to past acquisitions. To the company's credit, the boost to profit was adjusted out of its non-GAAP results.

- The company received a one-time cash payment related to its litigation with Edwards Life Sciences which resulted in a $25 million net gain. This was also adjusted out of the non-GAAP earnings figure.

- Subsequent to the quarter, the FDA ordered all makers of transvaginal surgical mesh products to stop selling products in the US due to reclassification as high-risk devices. The company recognized $25 million in pre-tax charges related to inventory, intangibles write-offs and return reserves.

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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