BEHIND THE NUMBERS
Quality of Earnings Analysis

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Teva Pharmaceutical Industries Limited (TEVA)
Earnings Quality Update

We are lowering our earnings quality rating of NET to 1- (Strong Concern).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

TEVA reported 4Q23 adjusted EPS of $1.00 and for 2023 of $2.56. It beat forecasts by 24 cents for 4Q and by 11 cents for the year. A one-time payment from Sanofi in 4Q was worth 38 cents and was the reason for the beat. In addition to that:

- Adding back share compensation was worth 2 cents and 9 cents to 4Q and full-year adjusted EPS.
- Adding back legal costs which TEVA admits is part of its business model gave TEVA 3 cents for 4Q and 80 cents for 2023 in adjusted EPS.
- The company adds back the amortization of acquired intangibles – that was worth 11 cents in 4Q and 47 cents for 2023.
- TEVA has been restructuring for years. At this point, the bulk of these expenses should be cash costs. That was worth 2 cents in 4Q and 9 cents for 2023.
- TEVA has a catchall of other restructuring, inventory write-offs, and additional litigation costs too. Those were worth 6 cents and 25 cents in EPS.
- Changes in sales allowances cost TEVA 10 cents in EPS in 4Q and helped EPS for 2023 by 18 cents.

TEVA's earnings quality is very low in our view, and a good initial indication is the huge spread between GAAP and non-GAAP numbers. GAAP EPS for 4Q was only 41 cents vs. the $1.00 reported. For 2023, GAAP EPS was a loss of 50 cents against the reported $2.56 in profit.

TEVA also touts an adjusted EBITDA which we believe is materially overstated as well. TEVA would likely have missed this forecast in 2023 without the Sanofi payment.

What to Watch

- The Free Cash Flow forecast of $1.7-$2.1 billion for 2024 should be setting off alarms. It only hit $2.4 billion in 2023 and that required $430 million from the Sanofi payment. It also grew payables by 30 days in 2023, which added $600-$700 million to Free Cash Flow. TEVA says it pays invoices within 120 days – days payable is at 120 days now.

- Free Cash Flow was also already helped by receivables DSOs dropping to add $200 million in 2023. The company paid less in taxes and only made its first opioid settlement payment in 4Q23. All of that will be tough to improve upon in 2024.

- The falling sales allowance still added 18 cents to adjusted EPS in 2023 as TEVA booked a smaller figure for new allowances which was outweighed by a higher amount of the existing allowance that was used in 2023. If it grows sales of new drugs, this tailwind to earnings that has been happening since 2017 could disappear.

- EBITDA is also being inflated by the falling sales allowance. We estimate that TEVA would be reporting EBITDA of about $4.1 billion without this and coming in far below its forecasts of $4.5-$5.0 billion.

- EBITDA is further inflated by adding back legal costs, share compensation, never-ending restructuring charges, and costs to conform to new regulations. We believe a solid case can be made that these recurring and mostly cash costs would result in EBITDA actually coming in about $3.0-$3.2 billion in most years.

- TEVA is cheering its net debt to EBITDA figure of 3.45x after 4Q23 results. This ratio ignores the $4.8 billion in litigation settlements TEVA has already accrued and will need to pay. It is also inflated by all the working capital levers pulled in 2023 that boosted the cash level. Can TEVA stretch payables by 30 days again to produce $600-$700 million more in cash in 2024? Plus, we believe EBITDA is woefully overstated and believe a more realistic net debt/EBITDA ratio for TEVA is 6.9x.

- For a company that supposedly has turned the corner and will put its problems behind it – there were still massive write-offs in 2023. It has been SEVEN YEARS since the disasters started and TEVA still reported a $700 million write-off for Goodwill and $350 million in write-offs for Acquired Intangibles in 2023. Goodwill peaked at $45.0 billion in 1Q17, they kicked off the write-downs with a $17.1 billion impairment in 2017. There have been four impairments since then for another $10.4 billion.

- Acquired Intangibles peaked at $21.7 billion in 2Q17. The amazing part of this is TEVA actually amortized $6.9 billion of these assets and ignored it as a cost, which produced about $5.50 in adjusted EPS or more than two full years of EPS. But, even amortizing one-third of the total, TEVA still found it necessary to take impairments on another $9.5 billion of these assets. Even using TEVA's unrealistic EBITDA figure – factoring in $37 billion in write-offs easily makes the return on capital here negative.

TEVA Has a Different Calculation for Free Cash Flow

TEVA has a securitization deal for receivables in Europe. When it sells the receivables, it effectively sells the receivables at a discount. Thus, it collects some cash up-front, but the rest is booked as DPP – Deferred Purchase Price. It is paid last as the collections occur. TEVA records these DPP collections in the Investing Section of the Cash Flow Statement. TEVA reports this cash collection in its definition of free cash flow.

- We do not have a problem adding this in as it reflects a collection of working capital.

- However, notice that it is a significant part of Free Cash Flow and can be lumpy, making it risky to rely on a similar benefit next year.

TEVA FCF	**2023**	**2022**	**2021**	**2020**	**2019**
Cash from Ops	$1,368	$1,590	$798	$1,216	$748
DPP Collection	$1,477	$1,140	$1,648	$1,405	$1,487
Capital Spending	-$526	-$548	-$562	-$578	-$525
Asset Sales	$68	$68	$311	$67	$343
Acquisitions	$0	-$7	$0	$0	$0
Free Cash Flow	$2,387	$2,243	$2,195	$2,110	$2,053

Guidance for 2024 Free Cash Flow Raises Several Questions

With 4Q23 earnings, TEVA guided to Free Cash Flow of only $1.7-$2.0 billion. That should have set off some alarms in our view given that it has not been that low in five years. Also, from 4Q22 to 3Q23, TEVA was guiding for 2023 Free Cash Flow of $1.7-$2.1 billion. While it topped these forecasts, we see several areas where 2023 results will be difficult to repeat:

- $500 million came in as revenues in 4Q23 related to its collaboration with Sanofi on an anti-TL1A drug. TEVA noted on the earnings call that this netted out to $430 million for revenue and Free Cash Flow. That may not repeat for 2024.

- TEVA stretched its payables in 2023 in dollar terms and days outstanding:

TEVA FCF	2023	2022	2021	2020	2019
Accounts Payable	$2,602	$1,887	$1,686	$1,756	$1,718
COGS	$8,200	$7,952	$8,284	$8,933	$9,351
Depreciation	$537	$576	$528	$537	$609
Days Outstanding	115.8	86.6	74.3	71.9	67.1
Adj Days for Depr.	123.9	93.4	79.3	76.5	71.7

  - In 2022, TEVA said payable grew due to higher accrued expenses owed on opioid cases. The payables account rose by only $200 million and days payable rose 14-16 days.

  - In 2023, TEVA reported it set up programs whereby suppliers can sell their TEVA receivables to banks and collect cash faster. This program grew in 2023 and TEVA noted that it pays its suppliers within 120 days.

  - Notice that days payable is now almost at 120. Accounts payable rose by $715 million in dollar terms in 2023 and $630 million of the increase was due to the 30-day jump in days payable.

  - **These higher payables would have helped Cash from Operations by $630-$715 million in 2023. Will this repeat?**

- TEVA began to securitize some US receivables in 2022. These do not have a DPP like the European receivables. In 2022, TEVA removed $820 million in receivables from the balance sheet and saw $820 million in additional cash flow from operations. Note the big jump from 2021 to 2022. **In 2023, TEVA boosted this cash flow by another $41 million.**

- Adding back the receivables securitized and bad debt reserves – receivables declined in 2023 by $240 million from 112.7 days outstanding to 103.9. That is on slightly higher sales of $15.3 billion (adjusting out the $500 Sanofi payment) vs. $14.9 billion in 2022. **We think TEVA picked up about $200 million in cash flow in this area too.**

- TEVA also made a transfer of intellectual property that resulted in a tax credit of $272 million. **The company does not quantify the lower amount of taxes it paid in 2023, only that it paid less than in 2022.**

- Other working capital changes saw accrued expenses rise by $620 million, inventory rose $188 million, and prepaid expenses rose $93 million. **Together, these three areas helped cash flow by $339 million.**

- In 4Q23, TEVA made its first opioid settlement payment. Much more on this below, but TEVA owes billions of dollars in this area. This could become a drag on free cash flow too.

Reducing Sales Allowances Continues to Drive EBITDA and EPS – If TEVA Grows Again – This Could Become a Headwind

We have discussed this in the past. About half of TEVA's gross sales disappear when netted against a series of allowances. If the price of a drug declines in the market, which is common, the distributors need to reduce the price of their inventory and TEVA lets them reduce the amount they pay on invoices. Medicare and other government programs get a lower price too. Distributors can earn rebates on volumes sold that discount their invoices, and all customers have the right to return product. The size of these total allowances is huge.

TEVA Allowances	2023	2022	2021	2020	2019	2018	2017
Beginning Allowance	$3,750	$4,241	$4,824	$6,159	$6,711	$7,881	$7,839
New Allowance	$12,621	$12,915	$13,426	$14,415	$16,767	$18,899	$21,181
Used Allowance	$12,866	$13,351	$13,960	$15,806	$17,323	$20,004	$21,277
Ending Allowance	$3,535	$3,750	$4,241	$4,824	$6,159	$6,711	$7,881
New vs Used	-$245	-$436	-$534	-$1,391	-$556	-$1,105	-$96
Adj. EBITDA	$4,818	$4,598	$4,911	$4,912	$4,685	$5,319	$6,665
New vs Used EPS	$0.18	$0.34	$0.40	$1.04	$0.41	$0.86	$0.08
Adj. EPS	$2.56	$2.52	$2.58	$2.57	$2.40	$2.92	$4.01

- Notice that TEVA has recorded a smaller new allowance than what it used for years now. The allowance has been more than cut in half. The used allowance includes provisions to provide for prior years' sales. We did not add in translation adjustments from FX.

- Looking at TEVA results, it normally hits guidance on the nose or is +/- $0.03 per share. Look at how much of its EPS over the years has come from reducing this allowance. TEVA picks up 20-100 cents in EPS from just this item.

- This is also a big part of the reported EBITDA (more on that below).

- TEVA reports its sales net of this allowance. This is a huge lever to use to impact the reported sales figure. Net sales in 2023 were $15.3 billion without the Sanofi payment. The allowance it took was $12.6 million – that's 45% of gross sales gone. For 2022, the $14.9 billion in reported sales were chopped by $12.9 billion or 46%.

- It would be a significant hit to both sales and EPS if the new allowance booked started to match the allowance used.

- Keep in mind, TEVA is reporting that it plans to grow going forward. It still has many products in decline. But, if it grows – this total allowance should start to rise again and become a headwind for Sales, EPS, and EBITDA.

TEVA's Reported EBITDA Looks Very Overstated to Us

Teva has been reporting adjusted EBITDA of about $4.6-$4.9 billion for several years. It is guiding to $4.5-$5.0 billion for 2024, which does not look out of the ordinary at first glance. However, we believe TEVA's adjusted EBITDA is overstated by unrealistic adjustments in addition to having benefited from unrepeatable factors in 2023.

The first problem we have with the EBITDA is the declining sales allowance discussed above has a meaningful impact on EBITDA. We also believe the Sanofi payment should not be viewed as recurring EBITDA. We computed an EBITDA removing these two items referred to as "BTN1 EBITDA" in the below table. It is closer to $4.1 billion. For all of 2023, TEVA was forecasting EBITDA of $4.5-$4.9 billion and came in at $4.8 billion. Without these two items – it missed forecasts.

TEVA EBITDA	2023	2022	2021	2020	2019	2018	2017
Adj. EBITDA	$4,818	$4,598	$4,912	$4,911	$4,685	$5,319	$6,665
Allowance Income	$245	$436	$534	$1,391	$556	$1,105	$96
Sanofi	$430	$0	$0	$0	$0	$0	$0
BTN1 EBITDA	$4,143	$4,162	$4,378	$3,520	$4,129	$4,214	$6,569
Litigation	$1,043	$2,082	$717	$60	$1,178	-$1,208	$500
Regulation changes	$4	$7	$23	$23	$45	$14	$47
Other R&D	$0	$0	$15	$37	-$15	$83	$221
Restructuring	$111	$146	$133	$120	$199	$488	$535
Misc. Restructuring	$330	$465	$318	$114	$155	$143	-$527
Share Compensation	$121	$124	$118	$129	$123	$152	$129
BTN2 EBITDA	$2,534	$1,338	$3,054	$3,037	$2,444	$4,542	$5,664

We also point to a number of recurring charges that TEVA adds back to its adjusted EBITDA figure. It is clear that if legal costs were not ignored, EBITDA would be 20-45% lower. Those are all cash expenses in legal bills and settlements that have to be paid. We are fine if investors want to exclude settlements as they are lumpy and unpredictable, but they need to be added to the debt figure because TEVA does have to pay that out. However, legal fees are regular and recurring and we are comfortable saying that legal fees should be viewed at about $200 million of recurring cost that should not be added back.

- Other R&D and having to adapt to meet new regulation changes do not sound like items TEVA can ignore. Both recur on a regular basis and lumpiness should not excuse them from EBITDA in our view.

- Restructuring – especially seven years after TEVA detonated – are more likely to be cash costs such as severance, getting out of leases, and cancelling contracts. They are not heavily focused on asset write-downs at this point which would be non-cash. The miscellaneous restructuring also includes more R&D items and inventory write-downs (part of the normal operating model).

- Share compensation isn't huge but it is a regular charge and it's not even very lumpy. Employees want that and TEVA is certainly diluting shareholders as a result of it.

- If we make litigation only $200 million – EBITDA becomes $3.1-$3.3 billion in most years without adding back the other recurring costs.

TEVA's Debt Figure Looks Much More Onerous With These Adjustments

TEVA cheered the progress it's making on debt reduction on the conference call:

> *"During Q4 2023, we repaid the full $500 million under our $1.8 billion revolving credit facility, and as of December 31 and as of today, there is no amount outstanding under the revolver.* ***As a result, our net debt to EBITDA also improved, coming in at 3.45 times for Q4 2023****. As part of our capital allocation strategy, we expect our net debt reduction to continue* ***as we continue to progress towards our long term target of two times net debt to EBITDA by end of 2027."***

Wow, 3.45x EBITDA!! We don't think the company is even in the solar system on that – let alone the proverbial ballpark! Here's the company's calculation:

TEVA Debt	2023
Short term Debt	$1,672
Long term Debt	$18,161
less Cash	-$3,226
Net Debt	$16,607
Adj. EBITDA	$4,818
	3.45

- We believe a realistic figure for EBITDA is $3.2-$3.3 billion as explained above.

- The cash balance looks large – but we know TEVA pulled in cash at the end of 2023 with the Sanofi payment of $500 million. It also picked up $600-$700 million from stretching payables and another $200+ million from receivables. We doubt any of that recurs in 2024.

- TEVA also has a $4.8 billion accrual set-up to pay opioid settlements at this point. That has to be paid out of cash flow too and to us represents more debt.

We adjusted TEVA's Net Debt to EBITDA under three different scenarios shown in the following table and explained below:

TEVA Debt	TEVA	#1	#2	#3
Short term Debt	$1,672	$1,672	$1,672	$1,672
Long term Debt	$18,161	$18,161	$18,161	$18,161
less Cash	-$3,226	-$3,226	-$3,226	**-$2,426**
Litigation Debt	**$0**	**$4,771**	**$4,771**	**$4,771**
Net Debt	$16,607	$21,378	$21,378	$22,178
EBITDA	**$4,818**	**$4,818**	**$3,200**	**$3,200**
Debt ratio	**3.45**	**4.44**	**6.68**	**6.93**

- #1 – We added in only the litigation payments to be made to debt and kept TEVA's EBITDA – notice that Debt to EBITDA rises a full turn from 3.45x to 4.44x.

- #2 – We added litigation to debt and used the more realistic $3.2 billion in EBITDA described earlier. Debt to EBITDA jumps to 6.68x.

- #3 – We made one more adjustment to scenario 2 by removing $800 million from the cash line. Debt to EBITDA doubles from TEVA's reported 3.45x to 6.93x.

We don't believe we're being too harsh in this exercise at all. We believe free cash flow will be under pressure if TEVA cannot repeat the working capital items that helped in 2023. Repaying more of the litigation is going to run through cash from operations too. Remember that only 4Q23 had a litigation payment so far. That should be a higher cash drain in 2024-2027.

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 Concern)- 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 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 upcoming quarters. 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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