BEHIND THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers

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Dentsply Sirona (XRAY)
Earnings Quality Update

We are keeping our earnings quality coverage of XRAY at 2- (Weak).

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

Summary

XRAY's adjusted 1Q23 EPS of $0.39 beat forecasts by 5 cents but fell y/y from $0.54. The low end of 2023 guidance was raised by $50 million for sales and 5 cents for adjusted EPS. There were fewer earnings levers used this quarter, but inventory rose again and sales were helped by pulling some demand forward:

- Inventory is now 140 days and XRAY sees delays in ordering for tech equipment. **(See below for detail).**

- Inventory reserve rose to $90 million, up $7 million from 4Q22 – a 2.4-cent headwind for EPS.

- The effective tax rate was 25.8% vs. guidance of 22%-23% in 1Q – hurting EPS by 1.4-1.9 cents. A sequential drop in bad debt reserves offset this.

- Highlighting our view that XRAY does not grow sales much over time and merely tracks short-term swings in the distributor market, some of the sales in 1Q23 look suspect:

  - In 1Q21, XRAY gave incentives to buy more CAD/CAM and added $10 million of sales for this type of equipment. In 1Q22, those incremental orders did not repeat and XRAY saw the sales decline by $10 million. That drop gave XRAY an easy comp for 1Q23 and it saw CAD/CAM sales rebound by $10 million. That's a $20 million y/y gain, but the end result is sales are flat vs. 1Q21.

  - Also, overall Tech sales still came in $17 million lower vs. 1Q22. The $20 million swing would have added about 1.2 cents to 1Q23 EPS. Equipment sales guidance was more favorable in 2022 than 2023- they are now expected to decline.

  - In 1Q23, XRAY also announced a price hike for May in Consumable products. It admits this pulled some sales forward into 1Q23. The estimate is another $20 million – and sales were only up $26 million. This source of sales could have added 2.5 cents to EPS.

  - The low-end of 2023 sales guidance was lifted by $50 million. They have already seen $20 million from pulling sales forward plus another $20 million from a y/y swing in CAD/CAM orders. The low-end of EPS guidance was raised by 5 cents and these two sales items are 3.7 cents and the reduction in the share count forecast from 216 million to 14 million shares adds another 1.8 cents.

- For the first time in a while, we did not have a problem with spending levels for stock compensation, R&D, or depreciation. All were at or near normal levels.

- Adjusted SG&A rose y/y by $25 million and sequentially by $21 million. It's a bit early to fully evaluate the addition of more salespeople vs. laying off corporate staff. This type of headwind was expected.

What to Watch

- **Inventory still looks bloated at 140 Days.** Normally, 1Q is higher than 4Q – but after record highs in 4Q, 1Q still grew by 6 days after XRAY pulled $20 million in sales forward. Stripping that out, sales were down y/y and are still being helped by price increases taken in 2022 that have not anniversaried. Three points for sales and pricing to note from the earnings call:
    - XRAY expects negative organic growth on equipment in 2023 as fewer customers want to finance at higher interest rates. Plus, they just increased sales by $10 million y/y.
    - The company expects volume to pick up in China in 2H23, but it is seeing -35% to -40% pricing changes on some products and does not expect volume to offset that.
    - It still intends to rationalize the SKUs and has identified products there. That type of process normally means price-cutting and then new products have to compete against the discontinued sales in the channel.

DSIs	4Q	3Q	2Q	1Q
2022	134	134	129	120
2021	100	109	112	110
2020	91	115	176	143
2019	109	133	130	139
2018	102	136	124	144
2017	114	127	121	126

- HSIC's Inventory DSI continues to rise and XRAY already added more CAD/CAM inventory at dealers:

HSIC	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Inventory	$1918	$1963	$1,818	$1,823	$1,871	$1,861	$1,784	$1,688	$1,626
DSI	83	81	77	80	77	72	72	74	73

- PDCO's Inventory and DSIs are also showing elevated levels and have not gone down during 2022 either:

PDCO	Jan 23	Oct 22	Jul22	Apr22	Jan22	Oct21	Jul21	Apr21
Inventory	$939	$877	$875	$786	$869	$830	$770	$737
DSI	68	62	66	55	63	57	56	53

- **Where is the top-line growth?** This is supposed to be a long-term growth story with population growth, emerging markets growth, aging populations needing more dental care, and a surge in aligners.

  XRAY is saying China is reopening, it is adding more salespeople, it has another price hike coming in May. Yet, forecasts call for sales $3.90-$3.95 billion. XRAY did $4 billion or more in sales from 2017-2021 except for Covid's 2020.

  It has taken four price hikes since 4Q21. It also changed the definition of Organic Sales so it no longer excludes precious metal price inflation since 2020, giving it another source of price hikes in recent years. Yet it still appears that sales growth is largely dependent on periods when it can stuff the channel.

  The below table shows the growth rates for the last six first quarters. 2020 and 2021 reflect the start of Covid and making up a lost 2Q and 3Q of 2020 in the rebound.

	1Q23	1Q22	1Q21	1Q20	1Q19	1Q18
Sales	$978	$969	$1,027	$874	$946	$956
Y/Y Change	0.9%	-5.6%	17.5%	-7.6%	-1.0%	6.2%
Org./Internal Chg.	5.1%	-1.4%	12.1%	-4.3%	3.9%	-1.1%

Henry Schein, Inc. (HSIC)
Earnings Quality Update

We are maintaining our earnings quality rating of HSIC at 3- (Minor Concern).

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

Summary

HSIC's adjusted EPS of $1.21 missed by 2 cents. The company also cut 2023 guidance from $5.25-$5.42 to $5.18-$5.35 which will be lower than 2022 due to an expected 5-10-cent dilution from the Biotech Dental acquisition. We also think investors should be concerned with the new change in reporting non-GAAP earnings that as of 1Q23 excludes amortization of acquired intangibles and clouds the true earnings picture:

- Adding back amortization was 14 cents of the $1.21 in EPS for 1Q23. That lowers the P/E from 17 to 15x. More concerning is HSIC is adding more acquisitions and assigns almost the entire purchase price to goodwill and intangible assets – so there is no expense on the income statement. We think this inflates earnings and ignores the cash outflow.

    - From 2020-2022, HSIC spent $789 million on deals. It allocated $485 million to goodwill that is not expensed and $451 million to intangible assets which will be added back.

    - In 2022, these deals only reported about $220 million in incremental sales. But, HSIC is ignoring $126 million of amortization plus even over 40 years, goodwill would be a $12 million cost. There is not much information on all the margins for these deals, but HSIC's gross margin is generally 30%. These acquisitions would need a 60% gross margin just to break even with the amortization cost.

    - Adding back amortization and ignoring goodwill results in operating income of $1.0 billion for 2022 vs. $806 million keeping the $126 million of intangible amortization and $72 million expense for $2.9 billion of goodwill. That boosts earnings by 25% and ROI from 16% to 19%.

- It is difficult to make a case that HSIC can sustain hefty share repurchases along with many acquisitions. Acquisitions plus share repurchases already exceeded free cash flow in 2021 and 2022.

	1Q23	1Q22	2022	2021	2020
Free Cash Flow	-$4	$74	$506	$631	$550
Acquisitions	$1	$5	$158	$571	$60
NonCtrlg Subs	$8	$10	$38	$60	$19
Cash for Repos	-$13	$59	$310	$0	$471
Repurchases	$100	$0	$485	$401	$74

This is not dire. Debt is only $1 billion net of cash, but HSIC has four new deals already for 2023.

- HSIC does add back transaction costs for acquisitions and that cost 1Q23 4 cents in EPS vs. 1.5 cents in 1Q22. We like that it does not adjust for this, but given that more deals are coming, the incremental spending y/y may recur.

- Last year in 1Q22, bad debt reserves rose by $3 million and HSIC wrote off $3 million giving it a $6 million expense. This year it was only $3 million – this added 2 cents to EPS.

- Lower stock compensation added $2 million and we estimate depreciation declined again by at least $1 million. Together, this is another 2 cents to 1Q EPS.

- In August 2022, HSIC started a new restructuring plan to reduce headcount and align some new businesses. We expect these costs to be added back to non-GAAP EPS. However, we also see within these charges are accelerated depreciation and asset impairments. That should give short-lived positive bumps in margins as these future costs were already expensed with a write-off that was ignored. In 1Q23, this was $7 million and should further lower future depreciation.

- HSIC has been actively repurchasing shares and a lower share count added 5 cents to EPS.

- Operating margin before restructuring costs fell 100bp from 7.7% to 6.7% for 1Q23. This is largely the result of plummeting sales of Covid-related items taking down gross profit in dollar terms by $20 million and then experiencing a $38 million increase in operating costs. HSIC already wrote down Covid inventory in the past and is guiding to a 35 to 40-cent negative impact for 2023. It estimates that 24 cents of this issue was realized in 1Q23.

- Inventories are at high levels at 83 days and have been rising. One of the operating plans for the company is to take advantage of special buying incentives from its suppliers. This results in HSIC buying more inventory, but at better prices. It ties up cash longer but can help margins.

HSIC	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Inventory	$1918	$1963	$1,818	$1,823	$1,871	$1,861	$1,784	$1,688	$1,626
DSI	83	81	77	80	77	72	72	74	73

We would be most concerned that some items may be obsolete (like its Covid tests) and need to be written off. Also, we believe since HSIC uses FIFO accounting and there has been inflation for about 8 quarters now that may be ebbing – it will be selling some inventory acquired at higher costs without the same level of pricing gains as in the past. This may pressure gross margins. 10bp of gross margin pressure is 1.7 cents in lost EPS per quarter. Gross margin jumped 70bp in 2022 and rose 100bp in 1Q23. So the inflation/FIFO benefit has likely helped EPS growth, but may not be sustainable or expand at past rates.

Wesco International Inc. (WCC)
Earnings Quality Update

We are maintaining our earnings quality rating of WCC of 5- (Strong).

We are also adding WCC to our Top Value List

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

Summary

WCC's adjusted EPS of $3.75 topping the 1Q23 estimate by 17 cents. The company had guided to a 27% tax rate and it came in at only 18.9% in 1Q23 vs. 18.3% in 1Q22. The entire difference of $21.2 million was from tax benefits related to exercising and vesting in stock awards. This was 40 cents of EPS. Without this, WCC would have missed guidance. WCC called this an oddity and reconfirmed a forecast of a 27% tax rate for the remaining quarters of 2023.

The market drove the stock down over 15% due to concerns over higher inventory and the potential for a slowdown hitting sales and margins. However, we believe the concerns may prove to be overdone. Higher inventories are a result of the timing of shipping orders that were delayed due to supplier log jams which are now letting up. Record backlogs will help lift volumes in the face of any slowdown in new orders and while margins may indeed be pressured as higher-priced inventories are run through, the average cost inventory method should see lower prices for new inventory flow through the income statement quickly. This differentiates WCC from companies like Sealed Air (SEE) which may have difficulty pushing through price increases as it runs off more expensive inventory. The above factors plus the fact that the company trades for only 7.5x forward EPS and just over 6x EBITDA prompts us to add WCC to our Top Value list.

We consider WCC's earnings quality to be high, with two items added back to adjusted EPS being integration costs and other expense/income that represent FX losses and non-service cost components of pension plans.

Noteworthy items in the quarter:

- **WCC does not add back the amortization of acquired intangibles like many other companies.** That is a positive for the quality of adjusted earnings. Also, the merger and integration charges are shrinking and becoming less material to results:

	1Q23	1Q22	2022	2021	2020
Merger/Integration	$19.5	$25.6	$67.4	$158.5	$132.2
Accel. Amortization		$5.4	$9.8	$32.0	
Gain on sale				$8.9	$19.8
Market Value Adj.					$43.7
Adj to Inventory					$18.9
Total	$19.5	$31.0	$77.2	$181.6	$175.0

- **Inventories grew again. DSI's reached 78 days, up from 67 days in 1Q22**. WCC was deliberately adding more inventory as orders grew to avoid out-of-stocks. It highlighted that it was losing 1%-2% of sales growth in 2022 for this reason. In 1Q23, supply bottlenecks opened more and caused deliveries of new inventory to arrive faster than orders could be shipped to customers. This was almost four days of higher inventory compared to 4Q22 and Management expects this to be worked down during 2023. Unlike other companies that have seen a similar situation, WCC is still posting solid volume growth, which should speed this process. **(See below for detail).**

- **Inventories are accounted for under the average-cost method. Commodity costs are declining now and could provide a tailwind for cost of goods sold and help preserve some gross margin even as pricing gains slow**. Initially, we could see pricing decline faster than COGS, but that gap should narrow. It is also important to remember that boosting cross-selling leverages fixed costs and helps margins. Backlogs are at record highs too, which should help volume growth remain positive. When we adjust for lower pricing but higher volume, in most scenarios, EPS could still increase. Plus, there are volume rebates that impact sales and cost of goods sold. Lower pricing going forward could impact margins, but the higher volume growth should offset that too. **(See below for detail).**

- Cash flows are under pressure from the higher inventory levels and higher receivables while payables declined. Management is pointing to some short term problems such as suppliers delivering faster than WCC can ship orders leading to a buildup in inventory.

The company is guiding to working capital being released into cash flow going forward. **(See below for detail).**

Inventory Growth is a Red Flag But May Correct Quickly

When we first looked at WCC in December, the higher inventory was an obvious issue to examine. Our view after 3Q22 was that WCC keeps hitting new records for backlog, its volume growth is very positive, and it is still achieving cross-selling from selling more product to Anixter customers. Two quarters later, DSI's rose by 2 more days:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Inventories	$3,730	$3,499	$3,490	$3,166	$2,881	$2,666	$2,570
DSIs	77.8	74.2	75.7	67.1	66.8	63.5	61.1

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
y/y Vol. Growth	6.0%	8.0%	9.0%	13.0%	13.0%	10.0%	9.0%
Cross-Sell Target	$1.8b	$1.6b	$1.4b	$1.2b	$850mm	$600mm	$500mm
Cross-Sell Achieved	$1.45b	$1.2b	$966mm	$729mm	$525mm	$365mm	$200mm
Backlog Growth y/y	21%	44%	60%	80%	90%	88%	60%

The explanations for the inventory moves made sense to us because while WCC was seeing strong demand, it was still experiencing some delays in receiving inventory components needed to complete orders. It does not ship orders until it can deliver the full amount of what the customer ordered. This can result in a buildup in inventory when WCC receives product in the current period, but doesn't ship it until the next. The first big inventory jump was in 1Q22 and again in 3Q22. Per management, this was due to:

- 1Q22 – "Supply chain challenges have continued to impact certain pockets of our business.
    - We believe our sales growth could have been 1% to 2% points higher if we were able to secure additional products from our suppliers to meet demand.

- We continue to strategically invest in our inventories in the quarter to address these challenges

- Backlog reached another record level this quarter and was up 25% sequentially from December, and up more than 9% from the prior year."

- 2Q22 – "Supply chain challenges have continued to impact certain pockets of our business

  - We estimate that the lack of availability of certain products from our suppliers reduced sales by approximately the same amount as in the first quarter

  - Backlog reached another record level this quarter and was up more than 10% sequentially from March and up more than 80% from the prior year."

- 3Q22 – "Supply chain challenges have continued to impact certain pockets of our business.

  - We estimate that the lack of availability of certain products reduced sales by approximately 1% to 2%, consistent with the first and second quarters.

  - Backlog reached another record level this quarter and was up 5% sequentially from June and up more than 60% from the prior year.

  - We have not experienced any cancellations of projects in the backlog. Given current supply chain constraints, we are seeing some projects delayed, similar to what we saw in the first half of the year."

- 4Q22 – "We are seeing signs of supply chain pressures easing in certain product categories. Backlog continues to be at historically high levels. In total, backlog was up 44% year-over-year and was down approximately 1% sequentially from the end of September. The sequential change in backlog was primarily driven by increased availability of security products within our CSS business that allowed us to ship certain customer projects."

- 1Q23 – “While an improving supply chain is a positive for Wesco, our customers and suppliers, it has created some near-term timing issues around inventory.
    - Specifically, we are adjusting our order patterns to reflect shorter lead times versus last year.
    - Our current inventory levels support our record backlog and our expectation to deliver 6% to 9% revenue growth in 2023.”
    - The increase in inventory in the quarter was due to a few factors. As we continue to see supply chains normalize, certain suppliers are accelerating their pace of shipments to us.
    - While the improved availability of product is a positive for our customers, recall that we do not typically ship product to our customers until their entire order is available.
    - As we make progress shipping the backlog of projects, we expect to see a normalization of inventory levels, which will drive cash generation through the rest of the year.

Our conclusion is inventory levels should decline as new inventory costs less per unit. With average cost accounting, WCC won’t see the same bigger swings of LIFO where deflation would quickly lower COGS or FIFO where WCC would need to work through all the current inventory before the lower costs are seen. Being able to fulfill more of the backlog, eliminating the delays that have cost WCC about 1%-2% of organic growth in recent quarters, and meeting its goal of achieving another $350 million in cross-selling – should make it possible for WCC to reduce inventories by ten days, or about $475 million. Plus, management is already seeing lower prices for many inventory categories which should lower the inventory investment in dollar terms.

Can WCC Navigate Inventory Declining Without Margin Loss?

Since the Anixter merger, WCC has been successful in both lowering costs while boosting revenues with cross-selling. The latter results in spreading fixed costs over more sales which helps margins. Also within the margin gains are price increases that WCC took when commodity costs were rising:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
y/y Pricing	5%	6%	8%	8%	8%	6%	5%
y/y Volume	6%	8%	9%	13%	13%	10%	9%
Gross Margin	21.9%	21.9%	22.1%	21.7%	21.3%	20.8%	21.3%
EBITDA Margin	7.6%	8.1%	8.6%	7.1%	7.4%	6.6%	7.0%

The pricing is likely to decline throughout 2023. However, the backlog and speedier turnover of orders should allow volume growth to remain solid. Plus, cross-selling is still continuing which helps volumes even more. That is what WCC points to as the key reason for recent margin growth. It also points to total sales growth and it's obvious that a good part of that is due to pricing.

It seems likely that with average cost inventory, the cost of inventory will decline more slowly than the pricing, but both should come down. Eventually, the rate of decline may match, but in the near-term WCC has inventory acquired at higher costs still making up more of the average that is expensed. To estimate the near-term impact of this, let's take 1Q23 and cut pricing by 100bp and assume COGS only falls by 50bp:

1Q23	Baseline	Price -1% COGS -0.5%	Price -2% COGS -1%	Price -1% COGS -1%	Price -2% COGS -1%
Sales	$5,521.9	$5,466.7	$5,411.5	$5,466.7	$5,411.5
COGS	$4,313.4	$4,291.8	$4,270.3	$4,270.3	$4,227.1
Gross Profit	$1,208.5	$1,174.8	$1,141.2	$1,196.4	$1,184.3
Margin	21.9%	21.5%	21.1%	21.9%	21.9%
Adjusted EPS	$3.75	$3.28	$2.81	$3.58	$3.41

Initially, the EPS impact could be much higher assuming the deflation hits pricing harder than COGS. Eventually, this should move closer to the two right columns where pricing and costs fall

in tandem and margins holds on the lower sales. **There are many items that could positively impact this too:**

- All signs still point to volumes increasing: cross-selling is still picking up, backlog is at record highs, and more orders can be fulfilled. If we increase the volume by 5% from the baseline in each scenario above – The baseline EPS already increases from $3.75 to $4.59. If we then shrink the pricing and COGS the same as above – EPS still shows some growth:

		Vol up 5%	Vol up 5%	Vol up 5%	Vol up 5%
1Q23	**Baseline**	**Price -1% COGS - 0.5%**	**Price -2% COGS - 1%**	**Price -1% COGS - 1%**	**Price -2% COGS - 1%**
Sales	$5,521.9	$5,740.0	$5,682.0	$5,740.0	$5,682.0
COGS	$4,313.4	$4,506.5	$4,483.8	$4,483.8	$4,438.5
Gross Profit	$1,208.5	$1,233.6	$1,198.2	$1,256.2	$1,243.5
Margin	21.9%	21.5%	21.1%	21.9%	21.9%
Adjusted EPS	$3.75	$4.10	$3.61	$4.41	$4.24

  Even lower volume growth can offset a decent amount of lost pricing and still allow WCC to grow EPS.

- WCC records shipping and handling charges as an expense in SG&A and it also charges customers for them in revenues. This does not have an impact on earnings, but can change the margin. Shipping costs could decline with lower fuel prices. That has the impact of lowering sales, but EBITDA would be flat. That could add a small number of basis points to EBITDA margin.

- WCC gives clients volume rebates. These are recorded as a reduction to sales and effectively cut pricing. A change of 10bp is worth about 8 cents per quarter in EPS. These appear to be coming down more than they are rising of late – this could be a small EPS tailwind.

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Rebates	$95.5	$93.0	$120.5	$102.3	$95.1	$85.9	$85.8
Sales	$5,521.9	$5,558.5	$5,445.9	$5,483.5	$4,932.2	$4,851.9	$4,728.3
Rebates % pricing	1.7%	1.6%	2.2%	1.8%	1.9%	1.7%	1.8%

- Also, keep in mind that WCC earns volume rebates from its suppliers that reduce cost of goods sold. This is only reported annually and it is a smaller item than what WCC gives its customers. In 2022, this lowered COGS by $246 million while the customers were given over $400 million via reductions to sales. With volumes still rising, it seems the rebates from suppliers could rise.

We definitely see the bear case that price increases will continue to drop and that can have an outsized impact on margins. However, the volume growth that looks baked in can mitigate that quite a bit. Plus, as inventory declines, the spread for the drop in pricing vs cost of goods should narrow. That is what makes this different than companies like Sealed Air (SEE), and Stanley Black & Decker (SWK) where volume declines are unwinding margin leverage at the same time pricing is tougher to take. The reason we're moving WCC to our Top Value list is it trades for only 7.5x forward EPS and just over 6x EBITDA.

All of Working Capital May Help Cash Flow Going Forward

Cash flow at WCC has been under pressure because working capital assets are up while payables are largely flat:

Cash Flow	1Q23	4Q22	3Q22	2Q22	1Q22
Net Income	$197	$219	$240	$221	$182
Depr/Amort	$44	$43	$43	$46	$47
Basic Cash flow	$242	$262	$283	$267	$229
Work Cap Chg	-$524	$153	-$410	-$426	-$411
Cash from Ops	-$255	$422	-$106	-$133	-$172

- We know Inventory is a big part of this and have discussed already:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Inventories	$3,730	$3,499	$3,490	$3,166	$2,881	$2,666	$2,570
DSIs	77.8	74.2	75.7	67.1	66.8	63.5	61.1

- However, while inventory has been rising, Accounts Payable has not. There are quarters where this is falling and hurting cash flow too. We expect inventory to drop and free up cash while payable may be neutral or a small headwind if the price of commodities declines:

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Payables	$2,579	$2,652	$2,579	$2,652	$2,341	$2,140	$2,246
DPOs	55.3	57.8	55.9	56.2	54.3	51.2	55.6

- Trade receivables, like inventory and payables, have increased with dollar prices per unit. Also, DSO's rose about 3 days from 3Q21 to 2Q22. It has since jumped another 2 days. Less pricing growth should help here. On the earnings call, WCC noted that it doesn't ship orders until all the components are available – that could delay orders that hit near the end of the quarter. Also on the call, it was reported that collections jumped at the end of March but recovered to normal levels in early April.

	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Trade A/R	$3,807	$3,663	$3,622	$3,636	$3,284	$2,758	$2,956
DSOs	62.1	60.6	61.2	60.3	59.9	56.1	57.6

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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