BEHIND
THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers

Companies in this Issue

DocuSign, Inc. (DOCU)
Earnings Quality Update

We are reducing our earnings quality coverage of DOCU from 4- (Acceptable) to 3- (Minor Concern) and removing it from our On-Deck Value List.

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

Summary

DOCU's adjusted EPS of $0.72 beat estimates by 6 cents. We see several items that point to this being a low-quality beat. Also, while DOCU did raise full-year guidance for revenues by $9-$11 million and billings by $67 million, it is calling for billings to decline in 3Q24 to $668-$678 million against the $711 million it just posted.

- Stock compensation rising as a percentage of sales to 22.6% is the biggest negative we see. The company's goal is 20% and it has been 20% or less often in the recent past.

The jump to 22.6% added 7 cents to adjusted EPS. With headcount down from 8,061 in 2Q23 to 6,758 in 2Q24, we would not expect to see stock compensation rising as a percentage of sales.

	7/23	4/23	1/23	10/22	7/22	4/22	1/22	10/21	7/21	4/21
Sales	$687.7	$661.4	$659.6	$645.5	$622.2	$588.7	$580.8	$545.5	$511.8	$469.1
Stock Comp	$151.7	$139.8	$145.9	$135.2	$141.2	$110.7	$118.0	$109.4	$100.0	$81.1
Taxes on Exercise	$4.0	$4.2	$1.9	$2.5	$3.4	$5.1	$4.2	$10.1	$11.6	$16.3
Total	$155.7	$144.0	$147.9	$137.7	$144.6	$115.8	$122.2	$119.5	$111.5	$97.4
% of Sales	22.6%	21.8%	22.4%	21.3%	23.2%	19.7%	21.0%	21.9%	21.8%	20.8%
Stock Comp %	22.1%	21.1%	22.1%	20.9%	22.7%	18.8%	20.3%	20.1%	19.5%	17.3%

- Sequentially, interest income rose $5.2 million which added 2 cents to EPS.

- The company is pointing to lower billings sequentially for 3Q24 and then a seasonal surge in 4Q24. This is being attributed to slower renewal rates in 3Q23 followed by recent renewals occurring on time. Thus, some renewals that were slipping into the following quarter last year have already been made. We are concerned that the retention rate of only 102% is expected to decline according to management in 3Q23. The retention rate is a measure of dollar figures paid by renewing clients in the current period vs. the same period last year. Below 100 shows negative growth. We think some of this is due to DOCU chasing new markets AND its base business for home buying/leasing documents being impaired by fewer people relocating. The negative is guidance calls for revenues to exceed billings in 3Q24.

- The longer sales cycle continues with closing still being delayed vs. the abnormal period during Covid. We expected this with the rebuilding of the sales team and roll-out into new markets. We would like to see this start to speed up as DOCU is saying all those changes are now in place. The longer lead time to contract is pressuring EPS too. DOCU capitalizes contract acquisition costs and amortizes that over 5 years. The spread between new acquisition costs and amortization is shrinking. A $3 million swing is about 1 cent in EPS:

	7/23	4/23	1/23	10/22	7/22	4/22	1/22	10/21
New Acq Costs	$46.0	$43.2	$52.8	$45.9	$63.2	$19.1	$44.6	$41.1
Amortization	$38.2	$35.8	$35.5	$34.2	$53.9	$12.2	$30.9	$28.8
Net Difference	$7.7	$7.5	$17.3	$11.7	$10.1	$6.9	$13.7	$12.3

- EPS was pressured again by a larger loss in Professional Services – which again involves training and software setup for clients.

	7/23	4/23	1/23	10/22	7/22	4/22	1/22	10/21	7/21	4/21
Professional Sales	$18.3	$22.1	$15.9	$21.4	$17.0	$19.4	$16.8	$16.9	$19.1	$17.1
non-GAAP Pro Income	($11.1)	($5.5)	($8.9)	$1.6	($5.0)	($2.5)	($9.6)	($6.3)	($2.6)	($3.2)

This was just over 2 cents in EPS headwind.

- On the positive side, DOCU did post a positive 4 cents in GAAP EPS. This is now several quarters where positive GAAP earnings have been reported.

- DOCU is seeing R&D rise again and highlighted a large number of enhancements and new roll-outs coming for its software. It also is noting that many customers are using multiple features. It's still down a little bit y/y as a percentage of sales, but we see the trend as positive.

	7/23	4/23	1/23	10/22	7/22	4/22	1/22	10/21
Total R&D	$136.0	$115.4	$125.9	$115.9	$126.5	$112.2	$110.7	$102.6
Total % Sales	19.8%	17.4%	19.1%	18.0%	20.3%	19.1%	19.1%	18.8%
Cash R&D	$90.8	$79.4	$84.6	$80.4	$85.6	$80.0	$79.0	$72.5
Cash % Sales	13.2%	12.0%	12.8%	12.5%	13.8%	13.6%	13.6%	13.3%

- We also take it as a positive that DOCU spent more money on the business and not just R&D in 2Q24. Remember in 1Q24, it guided to a non-GAAP operating margin of 21% and came in at 27% as it delayed spending in several areas as part of the restructuring and efforts. But against guidance of 24%-25% for 2Q24 – it came in at 24.7%. We are taking this as further evidence that the restructuring is largely over and a focus on growth can resume.

Medtronic plc (MDT)
Earnings Quality Update

We are maintaining our earnings quality rating of 3+ (Minor Concern)

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

Summary

MDT reported non-GAAP EPS of $1.20 which beat consensus estimates by 9 cps. Management noted on the call that 2 cps of the beat was from better-than-expected FX experience while 7 cps was operational. It also noted that a higher-than-expected tax rate was offset by lower-than-expected other operating costs and labeled that a wash. It raised full-year guidance by the 7 cps operational outperformance.

Overall, we saw the earnings quality of the quarter as being acceptable other than an increase in inventory levels discussed below which keeps us from raising our rating at this time.

- **Inventory jumped again**. We were encouraged by inventory growth stabilizing in the 4/23 quarter. However, inventory resumed its upward trajectory in the 7/23 quarter as shown below:

	7/28/2023	4/28/2023	1/27/2023	10/28/2022
Total Inventory	$5,668,000	$5,293,000	$5,375,000	$5,055,000
Adjusted COGS	$2,585,000	$2,917,000	$2,631,000	$2,453,000
DSI	199.5	165.1	185.9	187.5

	7/29/2022	04/29/2022	1/28/2022	10/29/2021
Total Inventory	$4,809,000	$4,616,000	$4,514,000	$4,349,000
Adjusted COGS	$2,467,000	$2,543,000	$2,415,000	$2,446,000
DSI	177.4	165.2	170.1	161.8

	7/30/2021	4/30/2021	1/29/2021	10/30/2020
Total Inventory	$4,288,000	$4,313,000	$4,508,000	$4,484,000
Adjusted COGS	$2,491,000	$2,601,000	$2,569,000	$2,660,000
DSI	156.6	150.9	159.7	153.4

	7/31/2020	4/24/2020	1/24/2020	10/25/2019
Total Inventory	$4,551,000	$4,229,000	$4,122,000	$4,042,000
Adjusted COGS	$2,466,000	$2,217,000	$2,342,000	$2,358,000
DSI	180.9	173.6	160.2	156.0

Management made several references in the call about supply improvement so some of this could be due to catching up on production. The company is also planning new product launches which could be driving up inventory. However, the company did not mention inventory at all in the 10-Q or the conference call which seems unusual. This deserves attention going into the next quarter as DSIs are now well above the pre-Covid level.

- **R&D was a little light.** When the company gave guidance for FY 2024 after the previous quarter, it stated "…when we exclude the separation of our Renal Care business, we expect R&D to grow above revenue, as we've signaled for a while now." Higher R&D investment was one of the reasons given for the disappointing guidance it issued then. However, non-GAAP R&D spending was down from $678 million in last year's July quarter to $658 million this year. The company contributed all of its Renal Care business to a JV with DaVita in April and we know that the business generated $325 million in sales in FY 2022. If it was spending 10% on R&D (a very generous assumption), then R&D for the 7/22 quarter ex-Davita would have been about $670 million. If that had grown in line with revenue at 4%, non-GAAP R&D in the 7/23 quarter would have been about $697 million, or 2.5 cps higher than the company reported.

- **Revenue growth was stronger than expected in the quarter.** However, management was very transparent about its expectation that the negative impact of volume-based procurement (VBP) activity in China expected later in the year: *"We also had some of the VBP impacts that we expected in the first quarter delayed into the -- later in the fiscal year. And we're expecting Russia to be a bigger drag given the new sanctions that were put in place in late May."*

Okta, Inc (OKTA)
Earnings Quality Update

We are maintaining our earnings quality rating of OKTA at 2- (Weak).

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

Summary

OKTA did not change its definition of non-GAAP results in 2Q24. This is the first time without a change in some time. The company reported $0.31 in non-GAAP EPS which beat forecasts by 10 cents. It further boosted guidance by $30 million in revenue for the fiscal year, which is expected to boost non-GAAP operating income by $50 million from prior guidance and EPS is now expected to come in 25 cents higher for the year than 1Q24 guidance. The bump in revenue growth was good to see. After beating by $21 million there, we were surprised that the company only boosted total annual revenue guidance by $30 million. That makes us wonder if the long sales cycle in 1Q helped 2Q benefit from more pent-up closings. **We are skeptical of the earnings beat quality on several fronts and believe more than 10 cents of non-GAAP EPS can be seen as short-lived items:**

- Investors should take note of the falling Depreciation/Amortization/Accretion line on the cash flow statement. OKTA adds back the amortization of acquired intangibles to non-GAAP EPS. However, it does not add back Depreciation or Accretion. Those two items have all but disappeared in recent earnings as OKTA does not spend much on capital spending and net PP&E has declined. Also, the change to ASU-2020-06 eliminated the accretion of convertible debt discounts. We know what the total of this line item is and we know how much amortization OKTA is adding back:

	2Q24	1Q24	4Q23	3Q23	2Q23	1Q23
Dep/Amort/Acc	$18	$25	$26	$27	$31	$30
Amort added back	$18	$23	$22	$21	$22	$20

Last year, OKTA was still reporting $9 million and $10 million of expense from this area in 2Q and 1Q. This year, it was $0 and $2 million. **The $9 million gain added 4 cents to non-GAAP EPS in 2Q24. We doubt this cost figure can improve from zero going forward.**

- We noted after last quarter that OKTA is simply not replacing PP&E which seems odd for a high-tech company. Capital spending was $0 in 1Q24 and $2 million for 2Q24. More alarming is net PP&E is now $49 million, down from $59 million at the start of the year.

- Investors may want to notice how much of OKTA's recent income is coming from changes in interest income growth. This is real EPS, but it's hardly worthy of the tech PE valuation multiple of 74x forecasted $1.20 in non-GAAP EPS:

	2Q24	1Q24	4Q23	3Q23	2Q23	1Q23
Non-GAAP	$0.31	$0.22	$0.30	$0.00	-$0.10	-$0.27
Interest Income	$18.0	$17.0	$10.0	$4.2	$4.7	$1.7
Interest Inc. EPS	$0.08	$0.07	$0.04	$0.03	$0.03	$0.01

24% of OKTA's EPS is interest income. This figure jumped with the FED's moves, and while there are some easy y/y comps coming up, this type of growth may not continue. If we pull 30 cents out of the expected $1.20 in non-GAAP EPS for fiscal 2024 due to interest income, OKTA's P/E jumps from 74 to 98x.

- R&D adjusted for stock compensation increased in 2Q24. That was after it dropped sequentially in 2Q23. We would expect OKTA to enjoy some operating leverage as sales grow. The sequential sales growth did improve for 2Q24 which is a positive. However, it's not as though sales have doubled since adjusted R&D was consuming 22% of sales. This still looks like an area where OKTA is picking up some recent non-GAAP EPS by under-investing:

	2Q24	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22
Revenues	$556	$518	$510	$481	$452	$415	$383	$351
Sequential Growth	7.3%	1.60%	6.00%	6.50%	8.90%	8.30%	9.20%	11.20%
Adj. R&D Exp.	$98	$95	$88	$79	$86	$93	$85	$74
Adj. R&D % Sales	17.63%	18.30%	17.30%	16.50%	19.00%	22.30%	22.10%	21.00%
EPS help vs 20%	$0.06	$0.04	$0.06	$0.11				
EPS help vs 22%	$0.10	$0.08	$0.14	$0.17				

OKTA beat forecasts by 10 cents. We believe a case can be made that cash R&D spending coming in at a lower percentage of sales added 6-10 cents to EPS.

- Sales and Marketing expenses were essentially flat against the higher sales in 2Q24. This is three quarters in a row where we believe OKTA is adding to non-GAAP EPS by under-investing in this area. Every $10 million they underspend is worth 4 cents in EPS:

	2Q24	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22
Adj Sales/Mrk	$220	$218	$219	$249	$226	$213	$188	$165
% sales	38.9%	42.1%	42.9%	51.7%	49.9%	51.3%	49.1%	47.0%
Stock comp	$41	$38	$40	$42	$39	$39	$34	$39

- Headcount grew sequentially for the first time in a year. That also points to likely more growth for R&D and sales & marketing. 2Q24 may have been helped by timing if more of the new employees arrived later in the period:

Headcount	4Q	3Q	2Q	1Q
fiscal 24			5,806	5,683
fiscal 23	6,013	6,037	5,776	5,342
fiscal 22	5,030	4,584	4,176	3,056

- Capitalized Commission growth picked up too. That is a positive, but it grew less than sales (5.3% vs 7.3%.)

	2Q24	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22
Capitalized Comm	$319	$303	$302	$280	$272	$266	$266	$206

The surge in new capitalized commissions against the amount of past commissions being amortized helped drive EPS by 6 cents in 2Q24. It is unlikely that was forecast given the slow trends for closing deals OKTA was discussing during 2Q on the 1Q24 call.

	2Q24	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22
New Cap. Comm	$40	$25	$39	$33	$28	$21	$80	$36
Amortiz Cap. Comm	$26	$23	$23	$21	$20	$19	$17	$15
Positive earnings	$14	$2	$16	$11	$8	$2	$63	$21
EPS impact	$0.06	$0.01	$0.09	$0.07				

OKTA is still saying it is seeing a smaller part of sales coming from new customers and more from upselling existing clients. That is important because new customer commissions are amortized over longer periods than renewals (5 years vs 2 years), which widens the spread between new capitalizations and amortizations and helps EPS. It did say that sales are going better than the last several quarters when customers wanted shorter contracts and it was tougher to get new customers to close. We would watch this area closely as it is possible that some contracts that OKTA expected to hit in 1Q24 appeared in this 2Q instead. Sales rose by $38 million sequentially and OKTA beat guidance by $21 million – yet, OKTA boosted guidance by only $30 million for the year.

- Deferred Revenue also rose 4.6% but was lower than reported sales growth. We still do not see anything too concerning here as it remains above 200 days.

	2Q24	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22
Deferred Rev.	$1,242	$1,187	$1,260	$1,063	$1,011	$971	$996	$778
Sales	$566	$518	$495	$481	$452	$415	$383	$351
Def. Rev. Days of Sales	202	204	234	203	206	208	239	204

Patterson Companies, Inc. (PDCO)
Earnings Quality Update

We are raising our earnings quality rating of PDCO to 3+ (Minor Concern) from 2+ (Weak)

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

Summary

PDCO met adjusted EPS forecasts of 40 cents for fiscal 1Q24 (ending in July 2023) and affirmed guidance of $2.45-$2.55 for fiscal 2024. The only adjustment to EPS was adding back amortization of acquired intangibles, amounting to 8 cents. The in-line performance was after a large beat of 14 cents following PDCO's reduction to fiscal 2023 guidance from $2.25-$2.35 to $2.25-$2.30. The issue for PDCO meeting forecasts largely arose from weaker equipment sales offset by some small margin gains:

- PDCO guided to a 25% tax rate for fiscal 2024, with 1Q coming in at 23.5%, which added 0.8 cents to adjusted EPS.

- EPS was negatively impacted by the cost to sell receivables by 2.7 cents.

- EPS was hurt by losses in selling equipment contracts offset by derivative gains that netted to a headwind of 1.7 cents.

- Declining share compensation had been driving EPS, it was flat y/y for 1Q24.

- Equipment fell 6% y/y, particularly in digital tech. That impacted overall sales and comes after a period of strong sales following Covid. We have seen XRAY note that interest rates are impacting sales as much of the equipment is financed by dentists. This could continue to temper PDCO sales.

Given these headwinds, we would argue that the 40-cent adjusted EPS was solid.

What to Watch

- Inventory issues have improved for PDCO. The LIFO charge in 4Q23 was $16.0 million against $10.2 million in 4Q22 and $21.0 million in 4Q21. Given recent inflation, we expected some increase. That should have been a 4-cent headwind y/y. However, PDCO did not have nearly the overhang of Covid PPE supplies falling in price during fiscal 2023. It still had negative impacts on margins, donations of inventory were $0 in fiscal 2023 vs. $49.2 million in fiscal 2022. The charge for obsolete inventory was nearly flat at $11.2 million vs. $12.5 million – a small tailwind of 1 cent for fiscal 2023.

- Total inventory levels also look better overall with DSI at 66:

PDCO	Jul23	Apr 23	Jan 23	Oct 22	Jul22	Apr22	Jan22	Oct21	Jul21	Apr21
Inventory	$913	$795	$939	$877	$875	$786	$869	$830	$770	$737
DSI	66	54	68	62	66	55	63	57	56	53

66 days vs 66 days y/y after 54 vs 55 days y/y in 4Q looks tame. However, remember that by the time July 2022 ended, PDCO had written off $61.6 million in inventory vs. only $11.2 million during fiscal 2023. The incremental $50 million represents 3.5 days of inventory. Also, from the end of July 2022 – January 2023, PDCO was purposefully taking on more inventory because it was being offered deals and it also wanted to carry more inventory to meet demand. Thus there were quarters in the last fiscal year where DSI was up about 5 days y/y before taking into account the 3.5 days of inventory write-offs.

- Selling receivables continues to be a bigger EPS headwind due to rising interest rates as the sales are routinely now losses booked into operating income. Historically, this was less than $1 million per quarter when interest rates were abnormally low. It's been $3.5 million the last two periods and is costing PDCO 2.7 cents per quarter.

	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21
Adj. EPS	$0.40	$0.84	$0.62	$0.63	$0.32	$0.71	$0.55	$0.58	$0.43	$0.38
Gain/Loss on A/R	-$3.424	-$3.503	-$3.254	-$3.211	-$1.435	-$9.690	-$0.663	-$0.894	-$0.721	-$1.263
EPS Impact	-$0.027	-$0.027	-$0.026	-$0.025	-$0.011	-$0.076	-$0.005	-$0.007	-$0.006	-$0.010

- Selling finance contracts that PDCO uses for equipment purchases by customers was a 1.7-cent drag on EPS in 1Q24. PDCO sells these contracts and marks the value of the outstanding contracts and residuals to market each quarter. The gain/loss is netted against sales. So without the gain/loss, the sales figure and the operating income figure would change by the same amount. However, the math makes the operating margin figure move:

($ in mm)	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Sales	$1,576.7	$1,721.2	$1,600.9	$1,626.2	$1,523.3	$1,638.8	$1,596.7	$1,649.2	$1,614.9	$1,561.8	$1,551.3
Adj. Op. Income	$47.8	$114.9	$85.4	$69.4	$44.2	$82.2	$70.1	$74.3	$57.6	$47.7	$70.9
Adj. Op. Margin	3.03%	6.67%	5.33%	4.27%	2.90%	5.02%	4.39%	4.51%	3.57%	3.05%	4.57%
Gain/Loss Fin. Conts.	-$8.927	$0.969	$2.417	-$8.456	$0.988	-$9.946	-$5.143	-$3.363	$0.073	-$1.836	-$1.484
Sales w/o Gain/Loss	$1,585.7	$1,720.2	$1,598.4	$1,634.7	$1,522.3	$1,648.7	$1,601.8	$1,652.5	$1,614.8	$1,563.6	$1,552.8
Op Inc. w/o G/L	$56.775	$113.914	$82.987	$77.860	$43.207	$92.189	$75.228	$77.700	$57.515	$49.535	$72.403
Op Margin w/o G/L	3.58%	6.62%	5.19%	4.76%	2.84%	5.59%	4.70%	4.70%	3.56%	3.17%	4.66%

In 1Q24, the loss mark cost PDCO 55bp in margin. Our concern is that gains are getting smaller and losses are getting larger with higher interest rates. Most software will not identify this as the reason for margins moving up and down. PDCO is touting its margin improvements, but this may be a headwind that is difficult to overcome consistently.

- However, PDCO also hedges with interest rate derivatives to offset these gains and losses. The problem for operating margin is the hedging gains and losses are below the operating income line. They normally have the inverse relationship they are designed for, but do not always fully offset the gains/losses from marking the equipment contract sales.

($ in mm)	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22	1Q22	4Q21	3Q21
Gain/Loss Fin. Conts.	-$8.927	$0.969	$2.417	-$8.456	$0.988	-$9.946	-$5.143	-$3.363	$0.073	-$1.836	-$1.484
Hedge Gain/Loss	$6.775	$0.693	-$1.849	$13.072	-$1.948	$10.030	$3.688	$3.304	-$1.187	$1.786	$0.145
Net Impact	-$2.152	$1.662	$0.568	$4.616	-$0.960	$0.084	-$1.455	-$0.059	-$1.114	-$0.050	-$1.339
Adj. EPS	$0.40	$0.84	$0.62	$0.63	$0.32	$0.71	$0.55	$0.58	$0.43	$0.38	$0.58
EPS impact G/L	-$0.017	$0.013	$0.004	$0.036	-$0.008	$0.001	-$0.011	$0.000	-$0.009	$0.000	-$0.011

Normally this program nets out to +/- 0-1 cent of EPS. We see that in 2Q23 it was a positive 3.6 cents. In 1Q24, this was still a 1.7-cent loss for PDCO and note that 4Q23 saw a gain on both marking equipment contracts and the interest rate derivatives.

- There are revenue issues to watch beyond the tough comps for dental equipment sales:

  - PDCO noted that it still picked up pricing in the recent quarter. That was not quantified, but with dental consumables growing only 4.6% and animal health consumables by only 3.5%, it would not take much in the way of pricing pressure to impact sales growth. On dental consumables, PDCO continues to point to PPE items like gloves and masks having pricing pressure that is hurting the top line.

  - PDCO continues to report that it is increasing its private-label offerings. Those should be lower priced than name-brand items it purchases from suppliers. That can pressure revenue growth too.

  - Animal health sales have slowed against tough comps. (See next point) Historically, growth was not very strong – flat-to-low single digits for a 1.5%-2.0% margin business. PDCO had a large impairment of goodwill here only a few years ago.

- Several margin wildcards remain too:

  - Boosting private label may also hurt PDCO's ability to earn rebates and other volume incentive rewards from suppliers. Having those fall would impact operating income.

  - PDCO has cut both advertising and stock compensation in recent years – every $10 million that these could rise would cost the company about 8 cents in EPS:

	f23	f22	f21	f20	f19	f18
Advertising	$6.9	$1.5	$0.1	$5.7	$8.4	$6.9
Non-Cash Compensation	$15.5	$23.8	$30.5	$37.4	$38.4	$38.7

- The animal health business is lower-margin at about 3%. However, it is also larger than the dental business. People buying more pets during Covid and adding an acquisition helped the Animal Health business grow. However, growth rates are now falling rapidly. If the lower margin business grows less quickly – that may be a help to overall operating margins:

Animal Consumables	4Q	3Q	2Q	1Q
fiscal 24				3.5%
fiscal 23	2.4%	4.4%	0.6%	5.6%
fiscal 22	7.4%	7	15.8%	15.7%
fiscal 21	12.9%	9.2%	6.5%	0.1%

Perrigo Companies plc (PRGO)
Earnings Quality Update

We are raising our earnings quality rating of PRGO to 3+ (Minor Concern) from 3- (Minor Concern)

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

Summary

PRGO's 6/23 non-GAAP EPS of $0.63 beat the consensus estimate by 12 cps. The company highlighted on the call and in its presentations that 8 cps of that beat came from the reversal of tax reserves which was not built into the forecast. We saw no other significant quality problems with the quarter. There were no changes in the final allocation of the purchase price of the HRA Pharma acquisition as the balance sheet was finalized in the previous quarter. This prompts us to raise our earnings quality rating to 3+ (Minor Concern).

We believe inventory is the main accounting item to watch in the next couple of quarters. DSIs based on non-GAAP COGS rose by 7 days YOY but were flat sequentially. As we covered in our last review, inventory balances are hard to read as the company looks to replenish low stock in the wake of supply chain issues and unusually high demand for formula after a competitor faced production problems. Retailers have also been correcting their own inventories after overordering last cold season. Management noted on the call retail inventories were normalizing and we expect PRGO's inventory numbers to stabilize over the next couple of quarters.

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.

Disclosure

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