BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Danaher Corporation (DHR)
Earnings Quality Update- 9/21 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earning quality rating of DHR of 4- (Acceptable)

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

Summary

DHR reported non-GAAP EPS of $2.39 in the 9/21 quarter which was 24 cps ahead of expectations. Revenue likewise came in $227 million higher than Wall Street analysts were anticipating. Core revenue growth remains strong with the huge push from Covid testing demand although this could moderate some as the comparisons will normalize YOY after the fourth quarter.

Overall, we do not have a significant problem with DHR's earnings quality. We have noted before that the company adds back amortization of acquired intangibles to non-GAAP results which we believe is a distortion of economic reality as it ignores most of the cost of acquisitions. This was only increased in the most recent quarter by the Aldevron deal. The amortization add-back, which included only 1 month of Aldervon amortization, was 49 cps in the 9/21 quarter, up from 20 cps just a year-and-a-half ago.

While not especially material to current earnings, we do think investors should take note of the settlement the company struck with Quidel during the quarter. In 2017, DHR's wholly-owned subsidiary, Beckman Coulter, sued Quidel Corporation to dissolve its exclusive supply agreement with Beckman. The agreement forced Beckman to sell its BNP assay products only

through Quidel. Some onlookers postulated that Beckman did this in retaliation for Quidel rejecting an earlier takeover offer from DHR. Regardless, dissolving the agreement would allow Beckman (DHR) to sell the BNP assays directly to the public.

In July, Beckman and Quidel entered into a series of agreements to resolve the litigation. The key components of the deal include:

- Beckman (DHR) can now develop and sell its own BNP-type tests.

- Beckman's commitment to supply certain BMP test kits to Quidel was terminated

- Beckman obtained the right to distribute and sell the BNP assay currently sold by Quidel.

- In consideration, Beckman has to pay Quidel a series of mostly fixed payments of approximately $75 million per year through 2029. A third-party valuation specialist placed the value of these payments at $581 million.

Of the $581 million future liability, $547 million was recorded as a pretax contract settlement expense in the 9/21 quarter which the company said was "due to the unfavorable nature of the prior arrangement." Another $34 million was capitalized as an intangible asset acquired in the settlement. DHR recognized the full $547 million contract settlement expense on the 9/21 quarter's income statement but added it all back to its non-GAAP results. Due to the extended payment terms of the deal, this is considered "non-cash financing" activity. Over the term of the deal, DHR will record the $75 million outflows in the financing section of its cash flow statements and only the imputed interest will be recorded as an operating cash outflow.

While the accounting treatment of this deal was done under GAAP guidelines, we nevertheless see this as undermining the quality of reported earnings over the terms of the deal for multiple reasons:

- DHR can't sell these assays without paying Quidel $75 million a year. From that perspective, they are cost of goods that should be matched against incoming revenue from the sale of these tests in DHR's income statement. However, they have been lumped into the 9/21 quarter which will overstate reported profits in future quarters not to mention the fact that from a non-GAAP perspective, they never happened.

- The cash flow statement is also being distorted. As we noted in the above point, these cash outflows should be viewed as a part of ongoing operations. However, virtually all of them will end up being reported as financing cash flows, thus overstating cash from operations.

The $75 million in annual spending amounts to less than 10 cps for a company reporting almost $9.00 per share in annual earnings. Nevertheless, we believe investors should be aware of how this transaction was handled and be watchful for any similar matters in the future.

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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