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BTN Earnings Quality Review

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# Dahanher (DHR)

Our review of Danaher's (DHR) accounting turns up little in the way of concerns. We have the following observations:

- DHR regularly makes large acquisitions, divestitures and spin-offs. Regardless, its restructuring related charges are relatively small.

- Despite incurring ongoing expenses related to productivity improvement and acquisition related activities, the company does not add all of these charges back to adjusted earnings, which we view as conservative.

- Cash flow is growing steadily. Management noted a drain on recent cash flow growth from an increase in working capital which appears to be largely centered in a decrease in accounts payable relative to sales. Payable days is down to 30, which seems very low. We do not view this as a concern and would expect to see payable days increase in the quarters ahead to the benefit of cash flow.

- Capital spending is rising but is not a concern.

## Acquisition Activity

DHR has been in the process of reshaping its business over the last several years through an ongoing series of acquisitions and split offs. This is an overview of the activity over just the last three years:

**<u>2017</u>**
-Paid $386 million for 10 smaller companies, none of which was material to results.
-Discontinued a molecular diagnostic products line, resulting in a $76 million charge

<u>2016</u>

-Paid $4 billion for Cepheid
-Paid $882 million for 7 smaller businesses
-Separated its Test and Measurement, Industrial Technologies segment through a distribution to shareholders.

<u>2015</u>

-Paid $13.6 billion for Pall
-Paid $670 million for 9 smaller businesses
-Split off the majority of its communication business to shareholders

The company has obviously made some very sizeable acquisitions and divestitures, but we note that despite this, DHR has taken relatively small acquisition-related charges. Interestingly, the company states in its financial results that it "*deems acquisition-related transaction costs incurred in a given period to be significant, (generally relating to the Company's larger acquisitions,) if it determines that such costs exceed the range of acquisition-related transaction costs typical for the Company in a given period*." As a result, the company's adjusted EPS contains relatively little in adjustments for charges despite its recent multi-billion acquisitions. For example, in 2017, the company added back only $76 million in pretax restructuring and impairment charges related to its decision to exit a molecular diagnostic products line which resulted in the write-off of all inventory and tooling it deemed useless. (The inventory does not appear to have been sold.) In addition, the company added back only $84 million in acquisition-related costs, restructuring costs, and inventory and deferred revenue fair value adjustments in 2016 related to its $4 billion acquisition of Cepheid.

Meanwhile, DHR incurred productivity improvement and restructuring related charges approximating $80 million in each of the last three years which it did not add back to adjusted earnings, but rather treated as ongoing costs. In our experience, this is considerably more conservative than most companies undergoing this level of acquisition activity and restructurings.

## Cash Flow and Working Capital

DHR has seen its cash from continuing operations steadily rise in recent years:

| | 12/31/2017 | 12/31/2016 | 12/31/2015 |
|---|---|---|---|
| Operating Cash Flow | $3,478 | $3,088 | $2,832 |
| Capex | $620 | $590 | $513 |
| Free Cash Flow | $2,858 | $2,498 | $2,319 |
| Dividends | $378 | $400 | $354 |

The only negative on cash flow we can cite is a slight increase in working capital. Management stated in the 10-K that operating cash flow was held back by an increased use of working capital:

> "The aggregate of trade accounts receivable, inventories and trade accounts payable used $243 million in operating cash flows during 2017, compared to $96 million of operating cash flows used in 2016. The amount of cash flow generated from or used by the aggregate of trade accounts receivable, inventories and trade accounts payable depends upon how effectively the Company manages the cash conversion cycle, which effectively represents the number of days that elapse from the day it pays for the purchase of raw materials and components to the collection of cash from its customers and can be significantly impacted by the timing of collections and payments in a period."

A closer look at the cash conversion cycle shows that year-over-year increase in days to convert has come mostly from a decrease in accounts payable. Note that days payable (DSPs) are subtracted from days of receivables outstanding (DSO) and days sales of inventory (DSI) to get to a days to convert figure.

| | 12/31/2017 | 12/31/2016 | 12/31/2015 |
|---|---|---|---|
| DSO | 70.1 | 68.9 | 75.5 |
| DSI | 82.6 | 82.7 | 86.2 |
| DSP | 30.1 | 32.1 | 35.2 |
| Days to convert | 122.6 | 119.4 | 126.5 |

We find it somewhat strange that the company has not been able to stretch its payables more given that its size would seem to give it more leverage over suppliers. Regardless, we view this working capital drain on cash as minor and likely temporary, and will be looking for it to reverse in upcoming quarters.

## Rising Capex

On the subject of cash flow, it is worth noting that DHR's capital spending has been rising the last few years, as shown in the above table. Management is forecasting another increase in 2018 to $700 million, or 13% over 2017. With the dividend consuming only about 13% of free cash flow and the company not dependent on a buyback for growth, the company is more than capable of absorbing the increase and we view this as a positive investment in the business.

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