BEHIND THE NUMBERS
Quality of Earnings Analysis
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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

# Henry Schein, Inc. (HSIC) Earnings Quality Update 12/20 Qtr.

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

*We are downgrading our earnings quality rating of HSIC to a 3- (Minor Concern)*

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

## Summary

HSIC reported non-GAAP EPS of $1.00, beating the consensus estimate by a penny. We note both one-time benefits and penalties in the quarter, with the former outweighing the latter. Also, we are concerned by the extension of restructuring actions with no outlook on its scope and size.

### What was weaker?

- Restructurings were originally related to eliminating stranded costs from the Animal Health spin-off. They are now being extended into 2021 due to the "business environment brought on by COVID-19 pandemic."

- More concerning is the company has given a 2021 "floor" guidance for non-GAAP earnings of $3.51 which happens to be the 2019 figure. No GAAP guidance has been given as management cannot estimate how large restructuring charges will be. If they can't estimate the size of the charges, how can they estimate the impact on profitability the charges will have on non-GAAP earnings? Investors should be especially watchful for quarters with conspicuously large charges where estimates are barely met. (See below for a more detailed discussion of the charges.)

- The adjusted tax rate fell to 17.5% in the 12/20 quarter versus 22.2% a year ago due to favorable tax resolutions. This benefit was not removed from non-GAAP earnings and management indicated in the conference call that EPS would have been 10 cps lower in the quarter without it.

- Offsetting part of the tax benefit was a 7 cps impairment of intangible assets which was not removed from non-GAAP results.

- Margins were negatively impacted by write-downs to PPE and COVID-related inventories as pricing and demand factors forced the company to reassess what it will realize from the sale of these inventories. This is ironic given that the pandemic has driven the bulk of the company's growth in recent quarters.

- Margins were also hurt by lower supplier rebates.

## What to watch?

- The pandemic has provided a huge tailwind to HSIC's revenue growth in the last two quarters. Dental distribution revenue (58% of total sales) jumped by 7.2% in the 12/20 quarter as consumables revenue rose by 10% but consumables without PPE (personal protection equipment) and COVID-related products rose by 5%. The geographic dispersion was notable with US consumables ex-COVID rising only 0.4% while the international equivalent rose by 11%. Management interpreted the 0.4% growth as positive considering data showed US dental practice traffic was still 20% below last year.

- Dental equipment revenue fell by 13% which the company speculated may be due to practices putting off purchases until a more favorable tax environment in 2021.

- Medical distribution (37% of sales) jumped by 48.5% due to sales of COVID-related products, most importantly, COVID test kits. Non-COVID-related revenue rose by a much more modest 3.6%.

- Management expressed its belief that COVID revenue should be viewed as recurring revenue, predicting that procedural changes made at medical practices will prove to be permanent. Test demand should fuel another two quarters of revenue growth in medical sales. While predicting what medical and dental practices will be doing three quarters from now is beyond the scope of this earnings quality update, we do not share management's optimism that offices will continue to buy masks and disinfecting supplies at the current rate once the pandemic subsides.

# Supporting Detail

## More Restructurings Plus No GAAP Guidance

Our original review documented our concern about the company extending its restructuring activity in the fourth quarter of 2019 as it adds these charges back to its non-GAAP earnings figures. We assigned a low level of concern to the 2020 charges given they were focused on eliminating stranded costs associated with the 2019 Animal Health spin-off. However, the company has now extended the restructuring program into 2021 citing the "business environment brought on by COVID-19 pandemic."

What is more concerning about these extended charges is the lack of visibility into their size and scope. In fact, management issued guidance for 2021 non-GAAP EPS to be equal to at least 2019's non-GAAP EPS of $3.51. Management was very clear that this is to represent a "floor"- the minimum level to expect for non-GAAP earnings. However, management very interestingly did not offer any guidance for GAAP EPS saying that they are "currently unable in good faith to make a determination of an estimate of the amount or range of amounts expected to be incurred in connection with these activities in 2021, both with respect to each major type of cost associated therewith and with respect to the total cost, or an estimate of the amount or range of amounts that will result in future cash expenditures."

The concern about ongoing restructuring charges is that costs that should be viewed as operating are potentially lumped into the charges and ignored when they are added back to adjusted earnings. The fact that management can estimate the benefit such restructuring activities will provide for non-GAAP profitability without being able to estimate what the one-time costs will be unfortunately adds to the impression that the restructuring adjustments to GAAP earnings can be utilized to make sure non-GAAP earnings will be above the floor. Thus, investors should be watchful for earnings barely hitting targets in quarters with high restructuring adjustments.

# 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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