BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Henry Schein, Inc. (HSIC)
Earnings Quality Update- 3/21 Qtr.

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

We maintain 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 beat consensus estimates by 40 cps while topping revenue targets by over $100 million. We remain concerned regarding the degree to which the company's growth is still reliant on PPE and COVID-related products. We remain watchful of the restructuring program, looking for any increase in charges or extension of the program. Also, we note there were both positive and negative one-time items in the quarter.

- HSIC continues to benefit from growth in personal protection equipment (PPE) products such as masks and gloves as well as the sale of COVID test kits. The company disclosed that PPE and COVID-related sales amounted to $458 million in the 3/21 quarter compared to approximately $158 million in the year-ago first quarter. The growth in these products amounted to an amazing 60% of the company's total sales growth in the period. Management commented that test kits sales amounted to $180 million in the quarter and we assume that figure was negligible in the 3/20 period. If we subtract the $180 million in test kit sales from the total $458 million PPE and COVID-related figure, that implies PPE-only sales of $277 million. That was $119 million above last year's COVID-related sales of $158 million which accounted for 24% of total company growth. Test kit sales already declined from $270 million in the 12/20 quarter and price deflation is expected to further depress that figure. Management warned in the conference call that it is now seeing growth for PPE products beginning to moderate.

- We note that despite the strong growth in PPE and COVID-related products, health care distribution margins declined *“due to adjustments recorded for PPE inventory and COVID-19 related products, as well as influenza diagnostic kits, caused by volatility of pricing and demand experienced during the quarter.”* We assume the reference to lower demand factor refers to flu test kits which were in low demand due to an almost total lack of flu cases this winter. Meanwhile, the company noted that its cash flow in the quarter suffered due to the buildup of working capital, *“specifically an increase in inventories due to stocking of PPE and other COVID-19 related products.”* We believe the inventory writedowns despite strong sales growth for these products reflects how much prices deteriorated since the purchase of inventory that was sold this quarter. The continuing trend of declining demand and deflation may foretell more inventory charges to come.

- The company recorded a gain from the reversal of previous receivables reserves of $2.7 million compared to last year’s first quarter where HSIC incurred an unusually high $14.5 million in expense to build up its bad debt reserves at the beginning of the pandemic. This beneficial swing added almost 10 cps to earnings growth in the period.

- More than reversing the benefit of the positive bad debt provision expense was the negative swing in stock compensation expense. In the 3/20 quarter, the company incurred a $17.5 million stock compensation credit when it reduced its estimate of how many shares would be exercised during the pandemic to zero. In the 3/21 quarter, stock compensation reversed to a $12.8 million expense. The negative swing shaved over 16 cps off earnings growth.

- The company’s adjusted effective tax rate rose to 25.1% versus 22.5% last year which cost about 3.4 cps in earnings growth.

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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