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Contents

AT&T (T) 3/20 Qtr. Update
Maintain BUY

We are maintaining our BUY recommendation on AT&T. The company again affirmed the dividend even with Covid-19. It expects to continue capital spending as planned although it noted that obtaining permits and getting some work scheduled may take longer than planned and cause total spending to come in a little light. New phone equipment sales were light in 1Q with the retail stores being closed and that should continue in 2Q – that could also be a headwind on some sales.

Adjusted EPS was 89-cents in the quarter up 3-cents y/y excluding 5-cents from Covid-19. Half of the Covid costs should not recur and are related to short-term actions such as putting production costs on hold, waiving late fees and being flexible on customer bills, and boosting wages for some employees.

We were pleased to hear that Mobility had a very strong quarter and its growth offset the investment spending for HBO Max as planned. HBO Max rolls out in late May and will start producing revenue to offset its costs too. Also, management highlighted plans to save $1 billion in operating costs by modifying the retail store base and sales commissions as well as a great emphasis on customer self-installed streaming services and broadband. It also has identified sales of a unit in Europe that is in the regulatory approval process along with some towers and real estate. This will raise $2 billion in cash and include the transfer of $0.6 billion in debt. The sale of its Puerto Rico wireless unit is also underway and will bring in additional cash. Already, capital spending was expected to come in $2 billion below 2019. All of these plans should bolster liquidity and allow the company to resume share repurchases once Covid issues pass as well as retire more debt.

- **Mobility Results at 55% of total EBITDA were strong in 1Q with FirstNet build-out now adding many new customers and devices. Mobility added 14.5 million subscribers/connections y/y for 9% growth** and 3.3 million or 2% growth sequentially. The company will be nationwide on 5G this summer which should help add more customers too. Of note, churn is down 6bp for Postpaid accounts. One basis point of improvement in churn is worth $100 million per year as the company noted on the 4Q19 call. AT&T has customers who are not paying their bill – but are still turned on during the lock-down. The company considered those customers already gone for the stats they reported on churn and customer totals.

- **Mobility results showed 7% EBITDA growth of $511 million on flat revenues for the quarter. Some of that cost reduction came from having the retail stores closed for part of March. AT&T is focusing on $1 billion in cost cuts that will focus on adjusting store numbers, store size, and sales compensation** along with having more customers self-install broadband/TV to skip AT&T visits to homes. There are several headwinds in 1Q20 results too that can bounce back and help future results – we estimate these at $300 million.

    - Roaming fees as fewer people are traveling and waiving late fees on payments cost mobility $50 million in revenues – this will continue in April and May
    - New phone sales were down 25% in 1Q20. That cut $175 million more off revenues. Some of that is moving to online sales but should recover more as stores open again.

    - AT&T booked $250 million in bad debt reserves for non-payments. That would come through every unit, but as the largest part of the company, mobility should have felt this.

- **WarnerMedia EBITDA fell $544 million. Much of that was expected based on investment in HBO Max that launches May 27. The forecast was to spend $2 billion on HBO Max in 2020 and have that covered by growth from Mobility described above.** Also impacting results with the HBO Max launch is AT&T pulled programming off other channels to make it exclusive for HBO Max. That cost revenue and EBITDA by design with the forecast that it will help sell the new service next month. The revenues and costs at other parts of Warner both declined:
    - Turner lost $304 million in advertising revenue and viewers with lost sports but that also meant programming costs were down too by $341 million.
    - Warner Brothers was down $400 million in revenue largely due to closed movie theaters and a tough comp. That was offset by higher TV revenue of $156 million as people stayed home. Total costs only rose $31 million as movie marketing costs dropped. Total costs rose with production costs incurred before the shut-down and bad debt expense.

- **Entertainment saw EBITDA fall $177 million. It was expected to lose about $200 million based in 1Q20 as the last quarter of TV subscribers on special-deal contracts rolling off. 897,000 premium TV clients were lost but was offset by ARPU rising 10%.** Broadband Fiber customers grew and so did ARPU in that area. AT&T TV was relaunched as a streaming service with a DVR late in 1Q. Very few details were given other than to say it met expectations even with the roll-out hitting at the same time as the lock-down. Management expects higher cord-cutting to happen in 2Q. The streaming service is cheaper to operate and could offset other TV decay.

We think there are several areas where additional catalysts still exist for work that has already largely been completed. These include 5G boosting revenues, cutting churn, and helping bundle wireless customers into broadband, streaming TV, and HBO Max. AT&T already retired 2% of the stock in the 1Q, the large debt retirement in 2019 will save $600 million in interest expense for 2020, capital spending will be $2 billion less this year, and the company reported that for 2020 it had $1.5 billion of cost savings identified for 2020 with half already in place. Now another $1 billion of cost cuts has been identified.

Mondelez International (MDLZ) 3/20 Qtr. Update Maintain SELL

We maintain our SELL recommendation on MDLZ after 1Q20 results. We are concerned that the company realized a huge benefit from COVID-19 in the quarter for North America on volume that will create sales headwinds for several more quarters. MDLZ depends on price increases to grow and the headwinds for that in foreign markets may prove too much to overcome.

Also, many of the emerging markets are seeing difficulty with tougher lock-downs preventing shipping and shopping. As usual, Argentina skewed the strength of organic growth. FX, higher logistic costs, and headwinds in emerging markets should remain problems in 2Q:

- **North America posted a 12.2% volume comp in the quarter. That is essentially unheard of and came largely from two weeks of panic-buying.**

North Am	1Q20	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18	2Q18
Price	1.2%	1.9%	1.9%	3.5%	2.0%	2.9%	1.2%	0.6%
Vol/Mix	12.1%	1.2%	0.6%	-1.0%	-1.5%	-2.1%	-3.2%	5.1%

There simply has not been much volume growth in this unit for a long time and 2Q18 was helped by a -6.6% volume comp from 2Q17 when shipments were delayed due to a Malware issue.

MDLZ had Easter in 2Q20 and the lock-down continued, but the panic-buying and empty shelves causing people to buy items simply because they were all that was left - has stopped. MDLZ noted on the call:

> "***<u>This trend (of higher in-home consumption) has extended into April, though at a less elevated rate and predominantly in North America</u>****, as Europe's positive impact in retail is offset by headwinds in our whole travel retail business."*

Earlier in the call, the CEO said:

"***In developed markets, we continue to see elevated demand, though not at the same level as in March***."

Our conclusion is to expect a strong 2Q volumes with Easter and more weeks of lockdown – after that the expect lower volumes against tough comps and likely lower pricing.

- **Argentina continues to skew results for MDLZ as it posts incredible inflation that drives pricing gains, which make it into organic revenue growth – but then MDLZ ignores the huge FX loss that comes with that pricing.**

1Q20 Sales Growth	Price	Vol	Organic	FX	Actual
Latin Am	8.9%	-1.9%	7.0%	-16.3%	-9.3%
Emerg. Mrks	4.1%	4.0%	4.5%	-7.9%	-3.4%
All MDLZ	1.8%	4.6%	6.4%	-3.8%	2.6%

Without Argentina, Latin America's 7.0% organic growth becomes 0.0% and Emerging Market units fall from 4.5% organic growth to 2.4%. **On top of that, the inflated growth that Argentina adds is a drain on profits.** Latin American operating income fell from $115 million to $91 million despite the 7% organic growth and margins adjusted for restructuring items fell 190bp.

- **MDLZ reported on the call that FX will become a larger headwind this year –** *"As we stand today, it (Currency Impact)* ***would decrease full year net revenue growth by approximately 4% – 5% and adjusted EPS by approximately $0.10."***

One of our biggest knocks on MDLZ has been that it reports FX losses nearly every year – yet it continues to push for more price increases to drive earnings. Even in North America now, we think there will be pressure on pricing as well as foreign sales.

Revenues	1Q20	2019	2018	2017	2016	2015	2014
Price	1.8%	2.2%	1.3%	1.5%	1.6%	3.9%	5.1%
Volume/Mix	4.6%	1.9%	1.1%	-0.6%	-0.3%	-2.5%	-2.6%
FX	-3.8%	-4.4%	-1.4%	0.3%	-4.6%	-12.0%	-5.2%
Net	2.6%	0.3%	1.0%	1.2%	-3.3%	-10.6%	-2.7%

The company has been living on taking pricing far in excess of commodity cost growth to boost income. FX pressure makes it difficult to take pricing as local products often cost less for foreign consumers. Here is the last few years of income growth adjusted for restructuring and key sources of the change:

1Q20 Sales Growth	2019	2018	2017	2016
Adj. Op. Inc Growth	-$38	$269	$343	$657
Pricing	$576	$322	$370	$422
Input Costs	-$340	-$26	-$181	-$131
Vol/Mix	$140	$48	-$160	$11

We believe MDLZ will face some sizeable headwinds on pricing as FX pressures have increased too. There will likely be some commodity cost relief, but, MDLZ's income growth has been tied for years to boosting prices faster than costs.

- **MDLZ had 36% of sales from Emerging Markets last quarter. In addition to some sizeable FX problems, MDLZ laid out several reasons why EM sales are likely to be pressured going forward.** It should be noted that China is 10% of EM and MDLZ says that business is returning now.
    - India is 10% of EM sales and there are now significant closures of stores that provide 75% of MDLZ Indian revenues.
    - SE Asia is seeing more lockdowns in 2Q too. It has having problems similar to India.
    - Eastern and Central Europe had minimal sales issues in 1Q, but restrictions and lockdowns have picked up in April.
    - It is noting that its stronger performing products are at lower price points
    - MDLZ is forecasting a negative mix issue going forward and higher logistics and labor costs for EM too.
    - At the same time, it cannot take pricing – in fact MDLZ said it may need to use pricing to recover business in the weaker one-third of EM.

Keurig Dr. Pepper EQ Update- 3/20 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	2-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We maintain our earnings quality rating of 2- (Weak).

1Q results continued to show several items of concern in our opinion:

- **KDP boosted Accounts Payable again. They rose to $3.24 billion in the quarter and now stand at 254.5 days outstanding.** That smashed the level from 1Q19 of 211.0 days and 4Q19 of 233.5 days. The company continues to support a factoring program for suppliers to use and access cash more quickly. That program relies on KDP's credit rating. Moody's affirmed the company's credit rating 3-weeks ago but still has it on negative watch. The amount of A/P factored is more than $2 billion and could be unwound quickly if KDP's debt rating falls.

- **KDP is reporting its Net Debt to EBITDA ratio fell to 4.2x in 1Q20 down from 4.5x for 4Q19. We still believe KDP is essentially refinancing debt into areas that are excluded from the ratio.** The Accounts Payable is one area and is worth $2 billion+ – that alone moves the ratio to 4.7x. They are doing sale-leaseback transactions to pay down debt – but they are adding to lease obligations, which are also not considered debt. We know lease obligations rose from $312 million at the end of 2018 to $730 million at the end of 2019 following $247 million of sale-leasebacks. They did $201 million more of sale-leasebacks in 1Q20. Total lease obligations may now be $1.1 billion (we need the 10-Q to get an exact figure). These deals impacted the debt ratio by 0.1-0.2x. It still has structured payables of $258 million which is credit card debt that is excluded – that adds another 0.1x to the ratio. **We think the real ratio is closer to 5.0x. Keep in mind – management's goal of 3.5-3.8x on this ratio by year-end will require these novel ways to refinance debt to continue to expand.**

- **The adjusted EBITDA has a few items that probably should not be added back either. $24 million in stock option expense is an annual expense, $116 million in productivity improvements are part of KDP's normal annual goals and spending, $50 million in legal bills (which have been part of life since 2014) and $34 million in losses related to unconsolidated affiliates.** Those would cut EBITDA from $3.46 billion to $3.24 billion – that would add 0.2x to the Net debt/EBITDA ratio also.

- **KDP issued $1.5 billion in notes in April and paid down bank debt. The company notes that the net impact of this does not change the total amount of borrowing. We would disagree because the new notes are only guaranteed by the Dr. Pepper assets** which generate about half the company's cash flow. Here is the note from the prospectus:

  > *"The Notes will not be guaranteed by all of our subsidiaries and will therefore be structurally subordinated to all existing and future liabilities of our subsidiaries that are not guaranteeing the Notes (excluding any amounts owed by such subsidiaries to us). For the year ended December 31, 2019, our non- guarantor subsidiaries accounted for $4,985 million of our consolidated net sales and $1,037 million of our consolidated income from operations."*

We discussed this in our first report from March – Dr. Pepper is about half the free cash flow, and has been the biggest source of stretching payables to produce that cash flow:

2019	Guarantors	Non-Guarantors
Operating Income	$1,349	$1,037
Operating Cash Flow	1487.0	1424.0
Capital Spending	$143	$187
Free Cash Flow	1344.0	1237.0
Cash Flow from Payables	$679.0	$197.0

The total amount of senior notes now carried by the Guarantors is now $13.2 billion for a unit that without stretching working capital is generating $800-$900 million in cash from operations.

- **We believe investors should still be concerned that price increases to bottlers may not be sustainable.** Those were 2.4% in the quarter against negative volume growth of -1.7%. The pricing was 0.4-cents of the adjusted 29-cents reported. Also, Latin America where adjustments for FX and other items added 0.8 cents to the 29-cents. **Also keep in mind, KDP reported adjusted EPS rose from 25-cents to 29-cents or 16%. However, 2019's figure was rounded down from 25.5-cents and 2020's figure was rounded up from 28.7-cents. – real growth was actually 12.5%** with 4.7% coming from the pricing gains to bottlers and Latin America both where volume growth was negative.

- **One of our other concerns was that there is very little organic growth at KDP. 1Q results are not sustainable in our view. The key drivers for EBITDA growth were customers stocking up on canned soda at the grocery store during the initial panic buying with the Covid-19 lockdown (up 26% y/y on adjusted operating income growth) and Latin America (rising 142% y/y on adjusted operating income growth) on negative volume.** Coffee is expected to be hit by people working at home hurting office sales going forward. **Adjusted EPS rose by 3.2 cents y/y – 2.3-cents came from the panic buying at stores in March and 0.8-cents from Latin America. Adjusted EBITDA rose from $733 million to $802 million – with $58 million of the $69 million coming from those areas.** Remember, there is supposed to be $200 million in cost reductions per year from 2019-2021 from restructuring. That alone should have added $50 million too. We think this calls into question some of the forecasts for cost cutting and EBTIDA growth to further lower the debt ratio.

D.R. Horton (DHI) Update

After our review of potential inventory impairments for home builders last week, D.R. Horton (DHI) provided some positive news this week that could point to much smaller impairment chances than the market has been expecting.

- DHI reported that unit orders were only down 11% for the month through April 28. They noted that cancellations normally peak in the last few days of a month, but for a home builder to be reporting a very small loss of volume during the shut-down looks positive to us.

- DHI also reported that sales orders were picking up in later April vs. the start of the month.

- The company has also been selling its spec homes rapidly. Units closed rose 8% in the quarter, while units in inventory only rose 4%. DHI is also slowing its lot acquisitions to better match inventory with lower demand levels.

- Losing pricing is a key metric of an impairment as we discussed last week. DHI reported higher pricing for homes (up 2%) and a 200bp increase in gross profit margins. It further noted that sales incentives have increased but all the programs being used are common tools DHI has used in the past such as helping reduce closing costs, throwing in a free refrigerator, or some landscaping. That may lower gross margin a bit, but DHI is not guiding to big drops in net pricing.

Henry Schein (HSIC) EQ Review

Current EQ Rating*	Previous EQ Rating
4-	4-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We initiate earning quality coverage of HSIC with a rating of 4- (Acceptable).

HSIC is one of the largest distributors of medical and dental products and practice management solutions in the world. Dental products account for roughly 65% of sales, medical about 30%, and technology and services about 5%.

HSIC has a relatively high short interest at approximately 10% of the float. However, this is similar to that of competitor Patterson Dental (PDCO) and is likely a reflection of concerns about secular trends for the medical distribution markets. HSIC's risk section of its 10-K is packed full of warnings about the potential for its products to be sold by online platforms. (Yes, Amazon has been mentioned in conversations on the subject in the past.) Also, some suppliers such as Dentsply (XRAY) have made efforts to bolster their direct distribution activities. Offsetting this is the secular trend towards aging America driving an increase in demand for dental care and HSIC's longstanding relationships with providers could allow it to cash in on that trend for years to come. A conclusion on these trends is beyond the scope of this earning quality initiation.

On the earnings quality front, HSIC entered a large joint venture in 2018 and a huge spin-off in 2019 which complicate the analysis of reported results. We also would like to have seen more detail regarding some of these events. Still, we do not have significant concerns with the company's overall quality of reported results currently.

Specifically we note:

- HSIC completed the spin-off of its Animal Health business to Vets First Choice in the first quarter of 2019 to form publicly traded Covetrus (CVET). Proceeds from the deal allowed the company to significantly reduce debt during the year. We do note that CVET has underperformed since going public which included a large earnings miss in the June quarter which led to a 30%+ stock price decline. HSIC is now the subject of multiple CVET shareholder lawsuits alleging overstated prospects for the new company. We have no opinion regarding the statements made, but this is a relatively minor contingency of which HSIC investors should be aware.

- In 2018, HSIC formed a joint venture called Henry Schein One, LLC by combining certain practice management products and services with the dental brands services business of Internet Brands. HSIC holds a 76% interest in the venture with Internet Brands' share recorded as a non-controlling interest. We estimate that the total value of the deal including future ownership interests to be granted to Internet Brands was approximately $1.6 billion with goodwill recorded on HSIC's balance sheet of $530 million reflecting expected future synergies. While HSIC refers to the deal as a non-cash transaction, the fact that goodwill was created indicates that assets were contributed by one or both of the parties. However, disclosures make it unclear who contributed what. This is an issue we hope to gain more clarity on in the future.

- HSIC spent over $650 million in cash on acquisitions in 2019 but detail was not provided as the company stated that no one acquisition was material to results. Nevertheless, revenue rose by 6.9% in 2019 after adjustment for one-time royalties and of this, 3.4% was generated by acquisitions. We applaud the company for not adding intangibles amortization back to non-GAAP results, and the current useful lives used to calculate amortization look reasonable. However, if acquisitions become an ongoing part of the strategy, investors should be wary of either a change in non-GAAP disclosures or an extension in useful lives.

- The company recorded a $60 million jump in sales to companies in which it has an equity interest. Likewise, cash flow benefitted from a $71 million increase in cash distributions from equity interests. Both items look nonrecurring.

- Over the last two years, the company has recorded restructuring charges of just under $70 million which is about 6% of pre-charge operating income over the same time frame. While this is certainly a material amount, we would not be alarmed about this if the charges stopped there. However, the company announced in the fourth quarter that it will be incurring additional charges related to its 2019 spin-off of the Animal Health business but it has yet to quantify them.

Animal Health Spin-Off

On 2/7/19, HSIC spun off its Animal Health business by merging it into Vet's First Choice to form publicly-traded Covetrus (CVET). In the transaction, HSIC received a $1.12 billion distribution from CVET as well as $361 million in proceeds from CVET issuing common stock which HSIC utilized to reduce debt on its balance sheet. After the deal, HSIC shareholders owned 63% of the total CVET shares. Operations contributed to CVET have been accounted for as discontinued operations since the spin-off.

In connection with the spin-off, HSIC is providing transition services for up to 24 months for which it was paid $17.5 million in 2019. Also, CVET agreed to purchase certain products from HSIC through August of 2020. Sales to CVET in 2019 amounted to $81.3 million. It is unclear whether these revenues will continue after August or at what level they will be at.

A contingency worth noting regarding CVET is that after the spin-off, the stock has significantly underperformed with a particularly bad June quarter earnings miss driving the stock price down over 30%. As a result, HSIC is currently the target of multiple lawsuits alleging that the company misled investors by overstating the prospects of the Animal Health Business. HSIC disclosed the following in its 10-K:

> *"The complaint alleges violations of Sections 10(b) and 20(a) of the Exchange Act and SEC Rule 10b-5 and asserts that defendants' statements in the offering documents and after the transaction were materially false and misleading because they purportedly overstated Covetrus's capabilities as to inventory management and supply-chain services, understated the costs of integrating the Henry Schein Animal Health Business and Vets First Choice,*

understated Covetrus's separation costs from Henry Schein, and understated the impact on earnings from online competition and alternative distribution channels and from the loss of an allegedly large customer in North America just before the Separation and Merger. The complaint seeks unspecified monetary damages and a jury trial. Pursuant to the provisions of the PSLRA, the court appointed lead plaintiff and lead counsel on December 23, 2019. We intend to defend ourselves vigorously against this action."

We have not reviewed CVET's results and have no opinion regarding whether misleading statements were made, but we view this as a relatively minor contingency of which investors should be aware.

Henry Schein One, LLC

HSIC has several joint ventures, the largest of which is Henry Schein One, LLC which was formed on 7/1/2018. Henry Schein One was created through a non-cash transaction combining products and solutions of HSIC's Practice Solutions and international practice management businesses with the dental business of Internet Brands. Consider the following disclosure on the transaction from the 10-K:

On July 1, 2018, we closed on a joint venture with Internet Brands, a provider of web presence and online marketing software, to create a newly formed entity, Henry Schein One, LLC. ***The joint venture includes Henry Schein Practice Solutions products and services, as well as Henry Schein's international dental practice management systems and the dental businesses of Internet Brands.*** *Internet Brands holds a 26% noncontrolling interest in Henry Schein One, LLC that is accounted for within stockholders' equity, as well as a freestanding and separately exercisable right to put its noncontrolling interest to Henry Schein, Inc. for fair value following the fifth anniversary of the effective date of the formation of the joint venture. Beginning with the second anniversary of the effective date of the formation of the joint venture, Henry Schein One will issue a fixed number of additional interests to Internet Brands through the fifth anniversary, thereby increasing Internet Brands' ownership by approximately 7.6%. Internet Brands will also be entitled to receive a fixed number of additional interests, in the aggregate up to approximately 1.6% of the joint venture's ownership, if certain operating*

> *targets are met by the joint venture in its fourth, fifth and sixth operating years. These additional shares are considered contingent consideration that are accounted for within stockholders' equity; however, these shares will not be allocated any net income of Henry Schein One until the shares vest or are earned by Internet Brands. A Monte Carlo simulation was utilized to value the additional contingent interests that are subject to operating targets*

Elsewhere, the company refers to the deal as follows:

> *"During the third quarter of 2018, we **formed Henry Schein One, LLC with Internet Brands through a non-cash transaction** resulting in approximately $390.3 million of noncontrolling interest representing Internet Brands' current 26% minority interest and $160.6 million of deferred additional ownership interests of Internet Brands in Henry Schein One, representing up to an additional 9.2% ownership interests at December 28, 2019, a portion of which is contingent upon the achievement of certain operating targets."*

Also:

> *"Senior management from Henry Schein and Internet Brands serve on the board of Henry Schein One. The goodwill recorded as part of the acquisition primarily reflects the value of future synergies. We allocated all of the goodwill to our Technology and value-added services reporting segment. As of December 28, 2019, the goodwill associated with this transaction is $533.9 million. None of the goodwill recognized is deductible for income tax purposes, and as such, no deferred taxes have been recorded related to goodwill."*

From this we can identify the key points of the deal:

- This was a non-cash transaction. No detail is given as to the dollar amount of assets contributed by either party.

- HSIC owns 74% of the JV with Internet Brands owning the remainder.

- Internet Brands has the right to put its share of the JV to HSIC on the fifth anniversary of the deal.

- Likewise, in 2028, HSIC will be able to require Internet Brands to sell its share of the JV to HSIC.

- On the second anniversary, Henry Schein One will begin issuing additional ownership shares to Internet Brands each year to boost its ownership by approximately 7.6% with an additional 1.6% contingent upon certain milestones being met.

- The transaction resulted in $550.0 million in noncontrolling interest being recorded in stockholders' equity with $390.3 from the initial deal size and $160.6 million from the future issuance of additional ownership interests to Internet Brands.

- $533.9 million was recorded as goodwill to reflect the value of future synergies.

Other disclosures indicate that:

- As part of the deal, HSIC agreed to pay Internet Brands $31 million a year for ten years for the right to use intellectual property.

The disclosure on this deal is very lacking in our opinion. The company refers to this as a "non-cash transaction, yet it resulted in the booking of goodwill of $533.9 million This means that one or both of the parties contributed assets to the deal. We can infer that the total value of the deal was approximately $1.5 billion ($390 million non-controlling interest/26%) for the initial consideration plus the $136 million in additional ownership to be paid out to Internet Brands for a total of approximately $1.65 billion. If we subtract the $530 million in goodwill, we get an estimated $1.1 billion in tangible assets contributed to the deal. However, an examination of the changes in the balance sheet from 6/18 to 9/18 does not offer a clear picture of how the assets were distributed. We will be following up with this issue in future reviews.

Acquisitions and Intangibles Amortization

HSIC made several acquisitions during 2019 which the company did not itemize due to no one transaction having a material impact on results. However, the combined spending on acquisitions was an amazing $653 million. Also, excluding the $80 million in sales to Covetrus under the transition services agreements (which could end as early as August 2020), revenue rose by 6.9% in 2019. Of this, 3.4% was generated by acquisitions. To maintain the current growth rate, the current revenue growth rate, the company will have to continue to spend to acquired new revenue.

Acquisitions added almost $400 million to goodwill while other intangible assets jumped by over $250 million. To HSIC's credit, it does not add intangible amortization back to its adjusted non-GAAP earnings numbers as some health care companies are prone to do. If regular acquisitions (as opposed to large JV deals) become more prevalent going forward, investors should be wary if management elects to start making this adjustment.

Overall, HSIC uses reasonable amortization periods to calculate amortization of intangibles. Roughly 75% of intangibles are classified as "Customer Relationships and Lists". The company uses a 10-year period to amortize this intangible component which compares favorably to Cardinal Health's 10-18 year range and McKesson's 12-year period used for its recent acquisitions. HSIC's 8-year period used to Trademarks and Trade Names is even more conservative relative to peers. Product Development is less than 10% of the intangibles balance and is amortized over 8.6 years. If these assets are software related, we would expect a useful like closer to 3 years. However, 8 years is more reasonable for a medical-related product. If we adjust the useful life on this asset to 6 years, amortization expense would increase by only about 2 cps per year which is immaterial.

Sales to Equity Interests

HSIC disclosed the following under related party transactions in its 10-K:

> *"During our normal course of business, we have interests in entities that we account for under the equity accounting method. During our fiscal years ended 2019, 2018 and 2017, we recorded net sales of $87.7 million, $27.0 million, and $23.4 million, respectively, to such entities. During our fiscal years ended 2019, 2018 and 2017, we purchased $18.1 million, $10.8 million, and $8.8 million, respectively, from such entities. At December 28, 2019 and December 29, 2018, we had in aggregate $60.7 million and $61.4 million, due from our equity*

affiliates, and $5.3 million and $1.0 million due to our equity affiliates, respectively."

The company's largest equity investment was in Hu-Friedy Mfg, a manufacturer of dental instruments, which it sold in the fourth quarter along with some smaller investments for proceeds totaling more than $300 million. HSIC was not involved in running the business and had no representation on the board, and we are not certain what a manufacturer would acquire from HSIC. The revenue may be related to the $81 million in sales made to Covetrus assuming HSIC holds a stake in those shares. Regardless, the $60 million jump in sales may well reverse in upcoming quarters.

In addition, we note that the company shows a $71 million distribution from equity investments in 2019 on the cash flow statement which compares to $20 million distributions in both of the previous years. Like the sales increase, this appears to be one-time in nature.

New Restructuring Charges to Be Announced

HSIC has taken regular restructuring charges over the last two years under an initiative to rationalize operations which was started in July of 2018. Those restructuring costs totaled just under $70 million over the last two years which is about 6% of pre-charge operating income over the same time frame. While this is certainly a material amount, we would not be alarmed about this if the charges stopped there. However, the company already announced another wave of charges in the 10-K:

> *"On November 20, 2019, we committed to the contemplated initiative, intended to mitigate stranded costs associated with the Animal Health Spin-off as well as to rationalize operations and provide expense efficiencies. These activities are expected to be completed by the end of 2020. We 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, 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. We will disclose this information after we determine such estimates or range of estimates."*

Some charges related to the Animal Health spin-off are reasonable, but we will be interested to see just how large the charges are as well as any detail to their makeup when announced.

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 Concerns"	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 may 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 the next quarter. 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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