BEHIND
THE NUMBERS
Quality of Earnings Analysis
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Patterson Companies, Inc. (PDCO) 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 maintain our earnings quality rating of PDCO of 3- (Minor Concern)

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

Summary

PDCO beat estimates by 7-cents in 3Q21. We see that it picked up 2.3-cents from a lower tax rate, 1.6-cents from higher investment income, lower travel expenses added 2.3-cents, lower stock compensation helped by 0.7-cents, lower depreciation 0.9-cents, and rounding up 2021 and down 2020 results helped by 0.7-cents. There's 8.5-cents worth of oddities that may not be sustainable. We still believe the travel expenses will rise going forward.

Total y/y EPS growth was 11-cents. PDCO also had $95 million in higher sales. The company is touting a 30bp gain in operating margin as well. The lower depreciation, stock compensation, and travel expenses were 31bp of the margin gain.

Working capital looks to be in better shape, but it may actually be too low now. That could help margins going forward, but may require more cash investment. Cash flow could come under pressure from rising capital spending and DPP receivables.

What is strong?

- PDCO's sales were poor earlier in this year and they were not hitting volume targets with suppliers. In 3Q, management noted that the stronger sales enabled more rebates to come through which helps margins and income levels.

- Working capital for Inventory and Receivables looks low. That produced cash flow in 3Q and could help margins in the near-term if PDCO can get better terms for larger orders, spread fixed costs and transportation over more volume, and/or doesn't need to discount on sales.

Inventory DSI	**4Q**	**3Q**	**2Q**	**1Q**
fiscal 2021		62	56	64
fiscal 2020	75	69	64	71
fiscal 2019	62	70	65	73

Receivable DSOs	**4Q**	**3Q**	**2Q**	**1Q**
fiscal 2021		49	52	60
fiscal 2020	59	52	57	55
fiscal 2019	57	55	56	56

What is weak?

- **Sales growth of $95 million actually looks very poor.**
  - $41 million came from dental consumables – of that, $33 million was higher sales for COVID supplies. PDCO believes it will keep this increased sales permanently.

We disagree as dentists already bought gloves and masks and were cleaning the offices and equipment pre-COVID. The incremental supplies are things like hand sanitizer for clients and additional cleaning products – which have been in short supply at retailers, online, and other channels, which likely drove some of those sales to PDCO. As the supply chain issues are further resolved, we think some of those sales vanish and others return to normal places of fulfillment like Target, Kroger, Costco, etc.

  - $69 million came from animal consumables – PDCO touted that it rolled out new products – which to us means stocking the channel and those sales do not necessarily equal consumer sell-through. This unit was further helped by a surge of new pet adoptions and thus initial vet-visits and treatments. Historically, this area grows at 3% and it just posted an 8.5% figure. The October quarter had much of COVID issues returning to normal and PDCO only had a 3.6% growth rate in this unit after a -0.4% figure in July.

- **Adjusted operating margin gain of 30bp also looks very poor.** PDCO touted that it sold more private label products, which carry higher margins. Hitting rebate targets means higher margins too. Management also noted that higher-margin SKUs increased as a percentage of sales. But, why aren't these factors driving margins?

  - Depreciation fell by $1.1 million and added 7bp to margin
  - Stock Compensation fell by $0.9 million and added 6bp to margin
  - Operating expense fell as there was not a $2.3 million legal bill like in 3Q20. However, the remaining decline of $2.8 million was less travel expense offset by higher wages – that was 18bp.
  - That's 31bp of margin gain and we think the travel expense will bounce and the higher wages are here to stay.

- How dependant are margins on gains from selling receivables? This is still a low margin company in our view with an operating margin of only 4.6% in 3Q21, which added back amortization of acquired intangibles. PDCO has two deals set up to sell/factor receivables and it books gains/losses when the sales occur:

	3Q21	3Q20	9mths 21	9mths 20
Adj. Operating Margin	457bp	433bp	462bp	392bp
G/L on Securitization in Op Inc.	6bp	-10bp	-5bp	-12bp
G/L on sale of contracts in Sales	-10bp	77bp	0bp	53bp

On one hand, there is some positive here in that margins are higher in 2021 despite a much lower contribution from these gains. On the other hand, it is obvious that this is an area that can make or break any quarter.

What to watch

- The falling deprecation expense noted above has us concerned with the drop in capital spending and net PP&E:

	3Q21	2Q21	1Q21	4Q20	2020	2019	2018
Depreciation	$10.1	$9.7	$10.6	$11.0	$45.0	$44.4	$45.1
Capital Spending	$6.7	$8.0	$6.4	$8.9	$41.8	$60.7	$43.3
Net PP&E	$224.3	$298.5	$300.0	$303.7	$303.7	$305.8	$290.6

We did not see a reason given for the sudden drop in net PP&E other than some assets must be fully depreciated. Almost all PP&E is in the US so there's not an FX translation. PDCO did not report an asset sale on the cash flow statement or an impairment. For years, there was basically $11 million per quarter in depreciation and $11 million in CapEx. That changed in 2021, but not to the extent for net PP&E to drop $74 million in a quarter.

Let's see what happens going forward. It is possible that capital spending could become a net drain on cash flow as it may need to exceed depreciation in the future.

- **DPP – Deferred Purchase Price receivables have been helping cash flow too.** When new receivables are securitized or sold, there is a discount applied to give the bankers a cushion against non-collections that PDCO receives last. When sales are rising, the DPP grows and is a negative on cash flow. As sales fall, the reverse is true. Of late, the accounts receivable securitization has been growing and the DPP increasing which consumes cash. However, negative sales growth on equipment means fewer new contracts to sell to the bank – thus collections exceed new DPP:

	3Q21	2Q21	1Q21
DPP Out	-$179.9	-$366.0	-$139.5
DPP In	$225.6	$269.4	$139.5
Net cash Impact	$45.7	-$96.6	$0.0

Early in COVID, some customers were given payment deferrals as a result of their offices being closed. 3Q saw some of that snap back as payments were resumed. Equipment contracts have been producing cash this year – especially in 3Q as sales growth is still negative. If equipment sales rebound, there could be a negative cash flow situation as the DPP grows more quickly.

- **We have discussed in the past that rebates and incentives are a big part of PDCO's earnings. In fact, 3Q21 saw it hit some sales targets to achieve some rebates that likely played a role in margins improving along with sales.** PDCO continues to work on its own private label brands and called this out on the earnings call:

  *"**Our private label business, continues to grow at a faster rate than our dental consumables overall**. And certainly, private label makes up a large portion of the infection control and prevention products. So we view that as a good tailwind, both in terms of our revenue performance as well as our margin opportunity."*

  *"And **we're also incenting our teams to drive mix improvements and seeing the benefits in some of our higher-margin equipment and private label categories,** again, both of which are growing faster than our overall companion animal top line results."*

  Selling private-label could hinder PDCO's ability to earn rebates and incentives from suppliers. Also, PDCO has warned in its filings that consolidation among suppliers makes it tougher to earn rebates and that rebate targets could rise higher.

- There was a new lawsuit/investigation announced in the 10-Q. There are no monetary damages asked for, but it worth following:

  *"On October 27, 2020, Patterson's Board received a written demand from Matthew Davis to undertake **an independent investigation and take action to remedy alleged breaches of fiduciary duties by the following current and former directors and officers of Patterson:** John Buck, Scott Anderson, Stephen Armstrong, Ann Gugino, Mark Walchirk, Alex Blanco, Jody Feragen, Sarena Lin, Ellen Rudnick, Neil Schrimsher, Les Vinney, James Wiltz, Paul Guggenheim, David Misiak, Harold Slavkin and Tim Rogan. **The demand arises from the allegations that Patterson (a) conspired with Henry Schein and Benco over a multi-year period to boycott GPOs and fix dental supply prices; and (b) issued a series of materially false and misleading statements in connection with such scheme.** The demand seeks the institution of an action for breach of fiduciary duty and appropriate remedial measures, including obtaining damages from all persons unjustly enriched. Effective November 20, 2020, Patterson's Board adopted a resolution expanding the scope of the previously constituted special litigation committee to include this matter. Pursuant to the resolution, the special litigation*

committee has complete power and authority to investigate the demand, analyze the legal rights or remedies of Patterson, determine whether those rights or remedies should be pursued, and respond to Mr. Davis on behalf of Patterson."

Starwood Property Trust (STWD) Earnings Quality Review

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

We are initiating earnings quality coverage of STWD with a 5+ (Strong) rating.

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

We discontinue our BUY rating on STWD and initiate earnings quality coverage with a 5+ (Strong) rating. We are moving all our buy/sell ratings to earnings quality coverage and will use our quarterly Focus List to communicate top long ideas and sell recommendations.

Summary

STWD beat forecasts for 4Q20 by 2-cents with Distributable EPS of 50-cents. EPS was hurt by the company carrying excess cash of about $500 million. Every $100 million is worth about 3-cents in annualized EPS so $400 million is worth about 3-cent per quarter. STWD also announced a large Investor Day in March so we will focus this update on Earnings Quality issues. We believe STWD will discuss several areas of their normal continuation of blocking and tackling designed to realize higher asset valuations, boost ROIs, and limit risk including:

- Unlocking value in owned real estate where values have appreciated, but depreciation has lowered book value.

- Taking advantage of markets operating outside norms to sell weaker assets into a strong residential housing market or acquire strong assets in weak European, hotel, or office markets.

- Using its strong credit rating to refinance deals to lower cost of funds and boost ROI.

- Having its special servicing department find and lead the way on restructuring troubled loans in the market, earning fees, and perhaps buying or repackaging the assets.

What is strong?

- Unlike many mortgage REITs, STWD actually owns property. This does two things for it. It extends the duration of the portfolio because it cannot be called away or refinanced away like a loan. Plus, the depreciation rather than being a tax shield is a non-cash expense that reduces GAAP earnings. A REIT is required to pay out most of its income as dividends. With the income reduced, it would allow STWD to retain more of its internally generated capital to invest with.

- Commercial mortgage loans are primarily floating rate and at STWD it is 95%. With interest rates having been low, STWD has added LIBOR floors to a high percentage of its loans. Those loans are now on average about 150bp in the money. This protects income with low interest rates and if they fall, it still allows STWD to benefit from the upside to earnings if rates increase.

- Adjusted EPS vs GAAP EPS remains high-quality earnings. It approximates cash flow better and primarily adds back non-cash marks to the portfolio of unrealized gains and losses. Our biggest issues would be that the company adds back the management incentive fees, which do occur regularly and while depreciation on property is clearly a non-cash item, there probably should be a reduction from some maintenance capital spending. These two items were about 11-cents and 3-cents of adjusted EPS in 2020 of $1.98. Both should be completely offset post-COVID as STWD reduces its idle cash that cost it about 15-cents in EPS.

What to watch

- The biggest issue with STWD for investors is there is a considerable amount of “noise” in the structure. We say that because on the surface, investors see many things such as Variable Interest Entities, a changing share-count based on contingent events, and the long list of adjustments to GAAP earnings.

- A small amount of convertible debt and convertible equity issued in deal create tables that see GAAP earnings adding back the interest expense and a higher share count one year and then keeping the interest expense and a lower share count the next depending on thresholds in the price of STWD stock. For all this noise and investors seeing the effective share count change at times, the net impact of accounting for full conversion or not is actually immaterial to reported EPS. Running the figures under both scenarios does not change the EPS.

- The variable interest entities are primarily securitizations and CLOs which give STWD more diversification for funding and can recycle capital to generate more earnings. The fear is always that STWD will need to support these deals in the event of a crisis. We've now had a crisis in 2020 and a nuclear situation did not happen. The company cannot pool the cash flow from those structures into other deals – it must remain to support those trusts. But the amount STWD can lose is limited to its subordinated interests. In the case of deals where it is not the primary beneficiary, it is less than 1% of book value. In deals where it is the primary beneficiary and consolidates the VIE, the equity portion of those trusts provides a sizeable cushion of often more than 30%.

Supporting Detail

STWD Reports GAAP and Distributable Earnings

As STWD has several portfolios of property, mortgages, and other investment securities – its GAAP earnings have a number of mark-to-market items reflecting unrealized gains and losses in valuations. Those are among the largest parts of the adjusted EPS along with non-cash equity compensation and incentive fees due to the manager. Here are the differences between GAAP and Distributable Earnings:

	2020	2019	2018
GAAP Income	$331.7	$509.7	$385.8
Depreciation/Amortization	$92.8	$113.2	$132.4
Reversed GAAP unrealized G/L	-$59.3	-$66.3	-$108.6
Reversed recognized G/L	$77.0	-$121.5	$50.8
Credit Loss Provision	$42.1	$7.1	$34.8
Noncontroll Int. in Woodstar	$20.4	$21.6	$17.6
Equity Compensation	$31.2	$36.2	$22.9
Mgt Incentive Pay	$30.8	$20.2	$41.4
Interest Income Adjustment	$14.2	$15.3	$16.0
Miscellaneous	$4.3	-$6.6	$14.9
Distributable Earnings	$585.3	$528.9	$608.0

- Distributable EPS was $1.98 in 2020 and the number of shares was 295.94 million. This compares to GAAP EPS of $1.16 with shares of 282.48 million.

- Depreciation is on real estate investments. We do not have a problem adding back this non-cash expense. Most of this is for the property segment. Adding it back makes earnings more focused on cash figures. To make this even more conservative, we would like to see the maintenance capital spending figure removed. Comparing net PP&E for the last two years and depreciation, we estimate that STWD contributed $16 million in new investment toward the properties. Some of that would be improvements more than maintenance in our view. Perhaps maintenance is $8-$12 million. Thus, depreciation is about 31-cents of D/EPS and maintenance may cost it 3-4 cents.

- Adding back marks to Fair Market Value and recognized gains/losses takes estimates and lumpy results out of the distributable EPS. We do not have an issue pulling these out of distributable earnings which are compared to the dividend payment.

- Bad debt expense is something STWD has been very good at avoiding. Over time, it has been practically non-existent. The new CECL rules have increased bad debt reserved based on required third-party models. STWD found that its own internal work was tougher than CECL on estimates and valuations. That is not to say that STWD does not book bad debt expense. It simply adjusts CECL back to its own standards. We do not have a problem with STWD adding back the CECL accrual. Per the 10K:

  "During the year ended December 31, 2020, we recorded a $42.1 million increase in the current expected credit loss, or CECL, reserve, which has been excluded from Distributable Earnings consistent with other unrealized gains (losses) pursuant to our existing policy for reporting Distributable Earnings. ***<u>We expect to only recognize such potential credit losses in Distributable Earnings if and when such amounts are deemed nonrecoverable upon a realization event. This is generally at the time a loan is repaid, or in the case of foreclosure, when the underlying asset is sold, but non-recoverability may also be determined if, in our determination, it is nearly certain that all amounts due will not be collected.</u>*** *The realized loss amount reflected in Distributable Earnings will equal the difference between the cash received, or expected to be received, and the book value of the asset, and is reflective of our economic experience as it relates to the ultimate realization of the loan."*

- We will discuss the non-controlling interests of Woodstar – which are two apartment communities in Florida – below. A quick summary is GAAP removes the non-controlling interest and Distributable earnings adds it back. However, the latter also assumes a greater number of shares as a result.

- Stock compensation and management incentive pay- In both cases these are lumpy. However, in both cases they are recurring. We are firm believers that recurring costs such as these should not be added back. We don't mind if a company quantifies them, they just shouldn't be operating on the assumption that these are discretionary and could be canceled at any time. In 2020, these were 11-cents and 10-cents of distributable EPS respectively.

- Interest income adjustments can arise from loans receiving interest expense deferrals for a few months, amortization of premiums/discounts, a non-accrual loan is moving back to current, and as a servicer of securitizations – STWD can be called on to forward payments of underlying securities for a few days. This appears to be the difference between contracted cash flows to be received and what actually is received at period end. It's a short term adjustment often measured in days. We do not see an issue here.

Our conclusions are that the Core or Distributable EPS of $1.98 essentially may be 3-4 cents inflated by not factoring in some maintenance capital spending on property investments. Another 10-cents are incentive fees paid to management and 11-cents are paid in stock. STWD is paying $1.92 in dividends.

On the positive side, the company is sitting on excessive liquidity due to COVID. That is a drag on Distributable EPS too. STWD is likely carrying about $500 million too much cash and based on current rates of return – every $100 million is worth about 3-cents. So, they are light by about 15-cents in the 2020 numbers. That alone covers the maintenance and incentive fees. Then, STWD simply has considerable other liquidity. 1-cent in EPS is $3 million. STWD has $7 billion in liquidity. On top of that, it has $3 billion in unencumbered assets. Plus, another $4-$6 billion of investments recycle on average every year. So there is considerable cash flow to support a few cents of dividend and the Distributable EPS appears understated by 15-cents already.

Changing Share Counts are Due to Convertible Bonds

STWD has a $250 million convertible bond that matures in April 2023. The conversion price is $25.91. The company no longer asserts that these will be settled with cash. That means that when the stock price is less than 110% of the conversion price, STWD's EPS reflects the interest expense on these bonds of $10.94 million but not the 9.65 million shares the bonds could eventually convert into. If the stock price is above 110% of the conversion price, then STWD's EPS removes the interest expense but uses the higher share count.

In 2020, the stock price was below $25.91 and these bonds were not dilutive. If we assume they were dilutive, here is the impact on EPS:

	no dilution	adj.	with dilution
2020 Diluted Income	$326.5	$10.9 Int Exp	$337.4
Fully diluted share count	282.5	9.6	292.1
EPS	$1.16		$1.15

The net impact on EPS is essentially nothing – the actual difference is less than 0.1 cents, rounding makes it look like a penny.

A Convertible Share Issued with a Property Purchase Also Has Minimal Impact on EPS

Woodstar assets the multi-family apartment villages that STWD bought in Florida. A portion of the purchase price was paid for Class-A shares and there was a contingent issuance of additional shares if milestones were reached and they were. The Class-A shares are convertible into STWD shares.

For the accounting of Distributable EPS – it is the same as the convertible bonds. STWD adds back the income from Woodstar represented by the non-controlling interest which inflates Distributable Income. It then divides Income by a higher number of shares to reflect the potential dilution of the Class-A shares. There is also some minor dilution from unvested stock awards:

GAAP shares	282.4
unvested stock	2.8
Woodstar Class A	10.7
Distributable Shares	295.9

The difference between EPS without the Woodstar non-controlling interests and a smaller share count, versus adding back the non-controlling interests and a larger share count is less than 1-cent in annual EPS.

As redemptions have occurred, STWD has been settling Class-A shares with a combination of common shares and cash. The net result at this point is the number of Class-A shares should decline going forward – all the contingent payments in additional Class-A shares have been paid. Also, as these Class-A shares are redeemed in cash or common shares, the Woodstar adjustment between GAAP and Distributable earnings should become smaller too.

The Variable Interest Entities Are Simpler and More Vanilla than They Appear

STWD uses securitizations or CLOs to remove loans from its balance sheet. These occur primarily with its commercial mortgage loans and residential mortgage loans. There are three primary goals:

1. They can often sell these assets for more than cost as part of a trust portfolio. So it is a source of income in the form of gains.
2. It recycles capital so that STWD can repeat the process or invest in new areas – again with the goal of generating additional income.
3. It diversifies its funding sources and moves a portion off the balance sheet and it also limits risk.

There are VIEs where STWD is considered the primary beneficiary. In those cases, STWD manages the trust and can participate in losses or gains based on its equity interest. These assets and liabilities can be consolidated onto the balance sheets of STWD because of the control aspects. It is important to realize that STWD has no obligation to support any of these deals and its downside is limited to the amount of its actual equity position. The debt is not recourse to STWD.

In the cases where STWD is the primary beneficiary – there is considerable equity as well:

VIE Primary Ben.	Asset	Liability	Equity
CLO	$1,105	$931	$174
Woodstar	$673	$444	$229
CMBS JV	$330	$85	$245
Miscellaneous	$100	$54	$46

On VIEs where STWD is not the primary beneficiary, losses are again limited to the carrying value in the deals. One set has a value of $19.5 million for STWD and the other $25.1 million. We should add that often STWD is a value player and it buys loans at a discount to its view of fair value. It then sells those loans at a premium into a securitization facility. That builds cushion as well. The two values at risk need to be compared to book value of $4.9 billion. The two figures given for maximum loss are under 1% of book value.

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.

Dentsply Sirona Inc. (XRAY) 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 maintain our earnings quality rating on XRAY of 3+ (Minor Concern)

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

Summary

XRAY beat 4Q20 forecasts by 23-cents with an adjusted EPS of 87-cents. We can see some areas where XRAY picked up some short-lived items such as cutting R&D in 2020 to only $115 million, which added 6-cents to 2020 EPS. Adjusted SG&A declined from $420 million to $362 million in the 4Q. That was 21-cents and would have included the R&D decline. It also included lower marketing, lower commissions, and travel. We don't have a break-out of all those costs. We would say that XRAY did beat forecasts as those items are unlikely to amount to more than half the SG&A decline.

We should also point out that XRAY is guiding to $90 million in higher SG&A in 2021 and is guiding to R&D recovering from $115 million to $160 million. That should create higher quality earnings but may pressure margins in 2021.

Where we are still negative on XRAY are its ugly history of acquisitions, its continual restructuring, and the fact that based on its best-case scenario the adjusted ROI is about 9% with a decent part of that coming from adding back amortization of acquired intangibles. We would urge investors to review our prior update from January 15 on XRAY that details how the company's goal is to restructure for years and end up at the same profitability as 2016.

What was stronger?

- Low inventories in the channel should help XRAY's near-term gross margin. It should boost sales, allow for greater leveraging of fixed costs during manufacturing, and perhaps help pricing remain firm. XRAY is only carrying 83 days of inventory, which is the lowest figure in four years. 102 days was the prior low in December 2018. Patterson normally carries about 70-days and is now at 62. Henry Schein is at 60 days vs. the normal 70. Even adjusting for the $31 million write-off of inventory by XRAY in 2020 would only add 5-6 days to DSI's and it would still be very low. A 1% boost to gross margin would add 14-cents to EPS in 2021.

- The inventory reserve figure is already declining. It peaked at $126 million or 44.5% of finished goods inventory in 3Q20. It hurt EPS in 3Q by over 8-cents. In 4Q, the reserve is down to $117 million and 44.3% of finished goods inventory. This ratio is normally 25%. Even assuming the DSI rises to 112-115, if the reserve falls to 25%, XRAY could see this reserve fall under $100 million and thus the expense could be $15-$20 million lower in 2021. That would be 5-7 cents in EPS tailwind.

- The SEC investigation into past accounting and disclosures is now complete. The final resolution included a minor civil payment of only $1 million. This was dealt with in 4Q.

What was weaker?

- As we feared, the acquisition of BYTE for $1.045 billion was essentially completely assigned to intangible assets. $631 million is going to goodwill, which will not be expensed. Another $416 million was added to intangibles with basically half being technology amortized over 10 years and the rest tradenames amortized over 20 years. Guidance is that BYTE will add 5-cents to EPS in 2021, which is about $14 million in adjusted pretax earnings. Amortization alone will be almost $34 million. That tells us that in reality, BYTE is going to lose at least $20 million. That also ignores that goodwill would be another $16 million in expense if it was amortized over 40 years. Plus, XRAY issued $750 million in debt at 3.3% last year and this is arguably where that cash went. It is paying $25 million in interest on that money. The ROI on the rough guidance is just over 1% adding back the amortization and ignoring the interest cost.

- XRAY has taken several impairments in recent years of intangible assets including more in 2020. They are using a discount rate as low as 9% in determining fair market value.

The repeated write-offs are evidence to us that there should be a faster amortization period and/or a higher discount rate. There is only $5.0 billion in equity here vs. $6.5 billion in intangible assets, with $4.0 billion not being amortized at all.

- The company still has an outstanding dispute with the IRS over a $546 million deduction from 2013. The IRS disallowed the deduction and XRAY is appealing. There is also a Swedish tax dispute involving $57 million for interest deductions that were disallowed. XRAY has not set up a reserve for either matter.

- XRAY has one of the longest auditor letters we have seen in a while. It is 5-pages long and excludes BYTE from the 2020 assessment of internal controls but does call out valuations assigned to intangible assets for BYTE as critical audit matters and highlights the large degree of judgment and high use of forecasts. It further notes that the huge amount of intangibles overall are critical to the audit as well as the tax issues.

Paycom Software, Inc. (PAYC) 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 maintain our earnings quality rating of PAYC at 4- (Acceptable)

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

Summary

PAYC reported adjusted EPS of $0.84 which was 5 cps ahead of the consensus estimate. The quarter appears to have faced meaningful headwinds from higher-than-expected stock compensation and taxes. Capitalized costs to obtain contracts spiked in the quarter but we are not overly alarmed given what is going on in the business.

What was stronger?

- PAYC gives detailed guidance for the next quarter in its quarterly calls which typically includes expected tax rates and stock-based compensation. Management forecasted stock-based compensation in the 12/20 quarter to be flat with the third quarter, or about $20 million. However, the actual figure for the 12/20 quarter was over $33 million. This difference shaved about 19 cps off earnings.

- Likewise, the company forecasted a tax rate of 29% for the 12/20 quarter but the adjusted effective rate came in at almost 30%. This would have cost the company about a penny per share in earnings.

What was weaker?

- There was a sizeable jump in capitalized costs to obtain contracts in the 12/20 quarter. Costs capitalized in the period rose to over 12% of quarterly revenue versus 9% in last year’s fourth quarter. We estimate that if the rate of capitalization had remained the same, it could have shaved about 10 cps off EPS. However, we are not especially concerned given 1) we are surprised the accelerated rate at which the company has signed new business has not pushed capitalized costs higher sooner and 2) the earnings beat is still intact after considering the one-time earnings headwinds mentioned above.

What to watch

- We remind investors that deferred contract costs exceed $430 million and the company amortizes this balance over the estimated useful client life of ten years. The company’s earnings are very sensitive to this assumption which seems unrealistically long to us.

- PAYC has benefitted from new business signups during the pandemic. However, this has been offset some by reduced headcount at existing clients. Management estimates this lower headcount is costing it about $2 million in weekly revenue. This could reverse if re-hiring resumes in upcoming quarters.

- A key part of PAYC’s model is collecting tax balances from clients and investing the balance prior to submitting to taxing authorities. Lower interest rates have been a key headwind which management has estimated to be $350 million per week. This could be another headwind that could reverse with a meaningful uptick in rates.

Supporting Detail

Jump in Capitalized Costs to Obtain Contracts

We noted in our initial review that PAYC capitalizes the cost to obtain contracts (such as commissions) as well as the costs to fulfill contracts (such as client training clients). It amortizes these costs over the estimated useful life of a client which is currently ten years. The combined capitalized balances of costs to obtain and costs to fulfill contracts currently exceeds $430 million, and we remind investors that the company’s reported earnings are very sensitive to the assumed life figure.

We track the trends in both balances quarterly. For the 12/20 quarter, we saw nothing out of line with capitalized costs to fulfill contracts. However, there was a significant jump in capitalized costs to obtain contracts in the period. The following table shows the trends in the balance for the last eight quarters:

Capitalized Costs to Obtain Contracts	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Beginning Balance	$213.920	$209.462	$208.960	$194.964
Capitalization	$26.809	$12.174	$7.982	$21.184
Amortization	-$8.146	-$7.716	-$7.480	-$7.188
Ending Balance	$232.583	$213.920	$209.462	$208.960
	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Beginning Balance	$183.439	$178.445	$172.655	$158.989
Capitalization	$18.156	$11.315	$11.811	$19.387
Amortization	-$6.631	-$6.321	-$6.021	-$5.721
Ending Balance	$194.964	$183.439	$178.445	$172.655

We can see the significant jump in amounts capitalized in the most recent quarter above. The size of the jump can be seen better in the below table which shows the amount capitalized as a percentage of quarterly sales for the last eight quarters as well as the amortization of the average outstanding balance:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Capitalization % of Quarterly Sales	12.1%	6.2%	4.4%	8.7%
Amortization % of Avg Outstanding Capitalized Balance	3.6%	3.6%	3.6%	3.6%
	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Capitalization % of Quarterly Sales	9.4%	6.5%	7.0%	9.7%
Amortization % of Avg Outstanding Capitalized Balance	3.5%	3.5%	3.4%	3.5%

Management stated in the conference call following the 6/20 quarter that the second quarter set a record for signing up new business as companies flocked to outsource HR functions in the wake of the pandemic. We noted in our review of the quarter that we were surprised not to see a jump in capitalized costs to obtain contracts given the uptick in activity as the company pays a one-time commission to its salespeople after the first month the new customer processes payroll. We did see a sequential increase in the capitalization rate in the 9/20 quarter, but it was still below the 9/19 quarter level. However, we finally saw an uptick in capitalized costs to obtain contracts in the 12/20 quarter as capitalization as a percentage of revenue jumped to 12.1% which was well ahead of the recent trend. Ordinarily, we would be very concerned to see such a jump in any capitalized costs, but given the new business activity, we are only surprised by the timing of the arrival.

For reference, even if the company artificially accelerated its rate of capitalizing costs, we estimate that it would have cost the company about 10 cps if the capitalization rate had remained the same as the year-ago quarter.

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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