BEHIND THE NUMBERS
Quality of Earnings Analysis
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Patterson Companies (PDCO) Earnings Quality Update

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

We are reducing our earnings quality rating of PDCO to a 2- (Weak).

We also remind investors that we removed PDCO as a Top Sell on the Focus List on 6/23/2021. We are now adding PDCO as an On Deck Sell. As this report documents, we continue to have significant concerns with the company's earnings quality. The removal from the Top Sell list was a reflection of a reduction in the near-term downside following the 10%+ decline in the stock price after the company reported disappointing earnings. We believe the longer-term target price of $23 documented on our last Focus List update remains reasonable. 1Q will enjoy easy comparisons and a boost from inventory charges (discussed below). We will look to add back to the Top Sell list on a bounce.

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

Summary

PDCO missed adjusted EPS forecasts for fiscal 4Q21 by 14-cents. It further lowered guidance for fiscal 2022 from $2.10 to a range of $1.90-$2.05. The company is calling attention to an

incremental LIFO reserve of $12 million and an $11 million write-down of PPE inventory as reasons for the miss. These were 10-cents and 9-cents respectively. We have several issues with these items that we will discuss below – largely this sets up timing issues where COGS for 2022 are pulled into 2021 and should boost EPS going forward. Yet, PDCO still reduced guidance.

PDCO's 4Q21 EPS also benefited by a 340bp lower tax rate that added 1.6 cents. Lower stock compensation of $3.4 million added 2.7 cents to EPS. PDCO had a 4Q21 gain on interest rate swaps of $1.79 million vs. a loss of $12.66 million in 4Q20 – that swing added 11.7 cents to EPS. Higher investment income added another 0.5 cents y/y. Advertising occurs through the year but came in at only $134,000 in 2021 vs. $5.8 million in 2020 – that is 4.6 cents in EPS that happened over four quarters and should have helped 4Q21 too. All of this is probably 17-18 cents that benefitted 4Q21 results and could become headwinds in 2022. It also nearly offsets all the 19-cents PDCO is claiming for one-time inventory issues and confirms the miss.

What is strong?

- Dental equipment sales are rebounding. That helps sales and brings in software sales that are higher margin. Also, PDCO sells many of the finance contracts it sets up with equipment sales and books the gain/loss on the contract sales as part of income. In fiscal 2021, these sales were very low and produced a small loss of $2 million. But, in 2019, the gains were $16.9 million. At the start of Covid, PDCO had a $21 million gain in its 4Q20 that added 40bp to operating margin. There are easy comps for equipment sales and gains on contract sales for fiscal 2022.

- We questioned the drop in net PP&E after 3Q21 and the only explanation that made sense was more assets were fully depreciated. Net PP&E was down to $219 million at the end of 4Q21 vs. about $304 million at the end of both 2020 and 2019. PDCO is planning to spend $50 million in 2022 vs. $26 million in 2021.

What is weak?

- There are many costs that should return or increase in 2022 that helped 2021 margins: higher advertising, travel & entertainment, furloughs and salary cuts, and stock compensation. Just those four areas look like 50bp of margin headwind to us.

- Inventory levels look very low. That is problematic because PDCO may need to rebuild stocks when inflationary pressures and bottlenecks are high. Management believes some of these pressures will relax as the year proceeds – the 53-day figure for DSIs is

the lowest figure we've seen and given that inflation is higher now, the unit figure may be even lower than the dollar figure reported.

- The low inventory figure also may indicate that PDCO helped margins in late 2021 by liquidating LIFO layers of lower-cost inventory and sold those as inflation rose. Even with that, and higher sales growth in 2021 to leverage costs, and adding back the two inventory charges – gross margin fell noticeably in 4Q21 by 190bp.

- The LIFO charge taken in 4Q21 was $21 million not the $12 million pointed to by management as Covid pricing related. Given that inventory is 9% lower than 4Q20, the $21 million charge vs. the $8.4 million a year earlier points to significant inflationary cost pressures. Management is indicating it incorporated some of this into guidance but expects the pressure to reduce as bottlenecks are corrected.

- One quarter after touting that PPE would be a new permanent source of sales at Patterson, the company wrote off $11 million of PPE inventory due to pressure on selling prices and oversupply. We think this area could drop noticeably going forward.

- Using comments from earnings calls and percentages of growth, we believe we have created a picture where PDCO has seen PPE sales rise from about $109 million per year pre-Covid to about $212 million in 2021. That sounds like enormous growth, but we think much of it may have been price increases and those are now reversing. Also, pricing pressures won't hurt only the incremental $100 million in sales, it will hurt the whole amount.

What to Watch?

- PDCO continues to tout the sales of private label products. We think the same problems remain. If they buy less from other vendors, they are less likely to hit levels of sales to earn rebates. For a company with a 4% margin, the rebates are a big deal. Also, private label products often carry lower selling prices which makes it tougher to leverage some fix costs.

- There should be one more quarter of Covid tailwind for sales growth as 1Q21 was the period when dentist offices were largely closed for the first two months of that quarter. There may be some gross margin pop in 1Q22 too due to the two inventory charges taken in 4Q21. These should set up a mismatch of revenues and costs. The charges

don't mean PDCO won't sell the inventory going forward, it just means that part of the Cost of Goods sold was pulled into 4Q, and investors were told to ignore that as one-time events. When sales occur, there is less cost to match against the revenue and margins can get a quick bump. In the case of the LIFO charge, it may allow PDCO to report a smaller one in 4Q22 instead of the routine $9 million of the last 3-years.

Supporting Details

LIFO Inventory Issues and Gross Margin

For 4Q21, PDCO called out a LIFO inventory adjustment of $12.0 million that was incurred based on Covid issues. What investors should realize is the company takes a LIFO charge nearly every year. Here are the last three years and the 2021 charge includes the $12.0 million:

	f2021	f2020	f2019
LIFO Inv. Adjustment	$21.0	$8.4	$9.2
LIFO Reserve	$120.8	$99.7	$91.3

The basis for the adjustment is 83% of inventory is accounted for under LIFO and 17% is under FIFO. Because FIFO tends to have a lower inventory cost amid rising prices and thus often produces higher income, it would often result in a larger tax bill too. So, PDCO reports its GAAP income using both LIFO and FIFO. However, it reports its taxes by converting FIFO into 100% LIFO and has a deferred tax liability set up. The difference between the methods is the LIFO reserve. PDCO also believes that the difference between the GAAP inventory balance and the replacement cost for that inventory is approximately the same value as the LIFO reserve.

This is an annual charge at PDCO that is normally about $9 million, and it would have been $9 million in 2021 as well before the extra $12 million they are calling out as a one-time event. The reasoning is the $12 million came from Covid-related pricing dynamics which produced some sizeable rates of inflation due to tightness in the supply chains as well as shortages of raw materials and computer chips. PDCO believes these bottlenecks and shortages will be resolved in fiscal 2022 and remove some of the inflationary pressures. We see many issues at play here that should be considered before just adding back this $12 million as a one-time event on the notion that will not repeat. First, look at total days of inventory outstanding:

Inventory DSI	4Q	3Q	2Q	1Q
fiscal 2021	53	62	56	64
fiscal 2020	75	69	64	71
fiscal 2019	62	70	65	73

- Inventory is very low at PDCO right now. Even adjusting Cost of Goods Sold and the reported inventory level for the $12 million charge and the $11 million charge for infection supplies that we will discuss in the next section – the DSI would only be 54 days.

- We know 4Q20 ended in late April after the first 6-weeks of Covid. So, dentists were closing, and orders were disappearing, which is why the DSI was 75 last year. We know in 2Q21 as restrictions started to relax, pent-up demand hit, and that lowered inventory. Maybe a more realistic view of 4Q20 is about 70 days and the excess inventory was quickly cleared the next quarter, but PDCO ended 4Q21 at a lower figure than even 2Q when pent-up demand cleared the stock on-hand.

- The first question is – if inflation in 2021 resulted in a much higher charge, why didn't deflation in 2020 result in no charge or even a credit instead of being basically flat at about the same $9 million for 2019-2021? Part of inventory includes shipping costs – we remember oil being $10-$15 in PDCO's 4Q21. We remember big manufacturing plants being closed and less demand for plastic, aluminum, and steel lowering prices too in April 2020.

- The next question is – suppose PDCO is correct, and the various bottlenecks and shortages are not an issue by April 2022. If costs moderate, will they even need to take a LIFO charge this year? PDCO was taking an annual $9 million charge for several years now and they now added $12 million extra for fiscal 2021. Could this be a zero or only $4 million in 2022 and give PDCO an extra $5-$9 million in gross profit and 4-7 cents in EPS next year? Remember – they cut their guidance even though this tailwind may be present.

- Shouldn't investors still be concerned at the size of both the standard $9 million charge and the extra $12 million given how low inventory is? It is down considerably in DSIs and is down almost 10% in dollar terms despite higher sales and inflation boosting the inventory figure. The reason for both the $9 and the $12 million is cost inflation. They just took a $21 million charge on inventory of $737 million vs. $8.4 million on inventory of $812 million in fiscal 2020. It would seem inflation is a large issue. Asked about this cost pressure going forward on the earnings call, management said, *"**we've built a little***

bit of that into the [guidance] numbers *that we laid out today. I think that obviously, this is an area we are watching carefully."*

- Did PDCO eat into LIFO layers that helped margins in 2021? LIFO is designed to have Cost of Goods Sold be largely representative of current replacement cost for inventory at the time of sale which means margins would not see much benefit from inflation. Yet, when inventory costs are rising and DSIs are falling – it can mean that some older inventory is being sold that did cost less. To illustrate this, let's say the company stocks 100 units and sells 130 in a week, then the next week the same thing happens- stock another 100 units and sell 130. Now they have sold 200 units with costs close to replacement and another 60 units were bought earlier that cost less. That is eating into LIFO layers, and it often boosts gross margin and profit via lower cost of goods sold while lowering inventories. That incremental margin is tough to duplicate unless the company continues to lower inventory levels – which already appear very low.

- Another potential problem for 2022 – even if inflation does moderate as management believes, when do they need to rebuild inventories? Right NOW! With LIFO, that may boost pressure on gross margin.

PDCO reported gross margin of 19.5% for 4Q21 vs. 22.9% for 4Q20- down 340bp. They want investors to add back both the additional $12 million LIFO reserve charge and the $11 million write-down of PPE inventory. Those are 150bp added back to make the adjusted figure 21.0% vs 22.9%. The 21.0% figure may have been helped by liquidating LIFO layers that may be tough to duplicate. It should be helped by higher sales leveraging fixed costs. There's one more easy comp for 1Q22 when consumable sales fell 15.4% last year and it will have more wages as workers were furloughed in 1Q21. Sales growth looks like it is low-single-digit without easy comps and pent-up demand. It could be tougher to leverage costs on much lower sales growth than 54% in 4Q21. 3Q21 was less than 3% y/y growth for dental consumables without PPE.

PPE Inventory Write-Down May Portend the End to that Growth

We have always been skeptical that selling additional PPE could be a permanent growth story and at worst hold PDCO sales at elevated levels. Long before Covid, dental workers already wore gloves and masks. The offices were already cleaned repeatedly. Thinking back to the early days of Covid as their offices were reopened – there was incremental demand for PPE for hand sanitizer and masks for other office workers and patients. It wasn't long after that when

all the patients acquired their own bandana masks to wear and didn't need one from the dentist's office. The office staff also wore their masks for longer periods. So, demand spiked, then dropped back as the need fell, and then fell further as mask mandates ended.

Also, remember that some of the initial demand for PPE at PDCO came from a shortage of products in the traditional channels. We have had anecdotal conversations with a few dental offices who use Patterson. They said that before Covid the office already bought sanitizer and cleaning products as well as some of their masks and gloves from Amazon and big-box retailers. When those channels were out of supply, they bought it where they could and as patients do not need this stuff anymore from their office, they have ample supply now. The places who make all these products have met demand and then some at this point. The shortages simply do not exist anymore.

PDCO has been reluctant to directly answer questions about how much PPE they were selling. They would give percentages about the amount of growth from PPE and non-PPE in the consumables of dental supplies. With the new 10-K and some comments from the last several earnings calls, we believe we have pieced together a picture of how much business PDCO has seen from PPE.

From the 10-K we know that consumables had growth of 15.2% or $173 million for all fiscal 2021. That puts total 2021 consumables sales at approximately $1.31 billion, up from $1.14 billion a year ago. Of the 15.2% in growth, 9% was from PPE, or $103 million. From the 1Q21 call, PDCO said PPE sales were less than 20% of the total consumable sales. Consumables were $256.6 million, and we used 19% of that as PPE or $48.8 million. PDCO said the year before, PPE was less than half that percentage. However, sales were also higher at $303.5 million. We used 9% as the figure there to estimate the base PPE sales were $27.3 million in 1Q20. From comments on the 2Q and 3Q calls about the percentage of growth from PPE, we created the following picture:

PPE and Consumable Growth	4Q21	3Q21	2Q21	1Q21
Total Consumable y/y Growth	54.3%	13.6%	17.5%	-15.4%
non-PPE growth	48.5%	2.7%	6.0%	-22.5%
PPE growth	5.7%	10.9%	11.5%	7.1%
non-PPE $ growth	$112.3	$8.1	$18.3	-$68.3
PPE $ growth	$13.3	$32.9	$35.0	$21.5

- Information about 4Q20 is still sketchy with little data available on the call. Even PDCO was talking anecdotally about what PPE sales levels could be. During that quarter, the

dentist offices were normal in February and early March and then many were closed, and consumable sales fell 26.1% y/y.

- Based on the comment about 1Q20 sales, we think PDCO had sales in this area of about $109 million for the full year of fiscal 2020. From the growth comments in the 2021 10K, we think 2021 sales of PPE were about $212 million.

We think this source of sales growth is essentially gone now. Only one quarter after saying that it expects to keep this source of revenues permanently, the rate of growth fell to almost one-third of what was seen in the prior two quarters. Lockdowns have eased more, mask mandates have gone away, and PPE and cleaning products simply are not in short supply anymore – in fact, they may be in oversupply as demand is now going down. For 4Q21 ending in April, PDCO took an $11 million write-down in PPE inventory:

> "Limited supply of the personal protective equipment (PPE) necessary for dental practice and veterinary care of companion animals followed by related inventory write down. Supply chain disruptions for PPE and an increased demand for these products initially resulted in backorders of PPE and a potential scarcity in raw materials to make PPE, causing substantial price increases. We had to prepay suppliers in order to obtain PPE for resale to our customers, and **as manufacturing caught up to increased demand for PPE, prices dropped, impacting our margins and requiring us to write down certain inventory."**

This description of what caused the inventory write-down raises a very important question – how much of the PPE growth in fiscal 2021 is not due to higher demand volume at all, but simply raising prices? Much of the discussion about PPE implies that demand has been so high – it came solely from volume.

Now that PPE volume demand is going down and there may be oversupply, PDCO may have a situation where the move from $109 million in sales to $212 million was 20% due to higher prices. As the situation continues to normalize, PDCO could see a price cut on the whole amount of PPE sales, not just the incremental Covid gain. Suppose they lose 10% volume and 20% in pricing - $212 million becomes $148 million very quickly. And it likely comes at lower margin than was seen in 2021.

We do believe they will get some tailwind in 1Q22 because of the $11 million impairment. That simply pulled some of Cost of Goods Sold into 4Q21 before the revenue occured just like the LIFO charge. PDCO will still sell that PPE inventory at a lower price. However, the COGS will be $11 million lower giving it one last quarter where it may retain some higher margin on those lower sales. After that, we expect sales growth and margins to decline in this area.

Margin Headwinds May Be Tough to Overcome

As a distributor, PDCO isn't expected to have huge margins. It is supposed to work on operating leverage by putting more items in a single box that has essentially the same packing and shipping costs.

Adj. Operating Margin	4Q	3Q	2Q	1Q
fiscal 2021	3.1%	4.6%	5.3%	3.8%
fiscal 2020	5.6%	4.3%	4.0%	3.4%
fiscal 2019	3.9%	3.9%	3.6%	3.2%

When we consider some of the issues facing PDCO and its $6 billion in sales, it is obvious that fairly small changes in costs or pricing quickly impact operating margin in a meaningful way:

Some of the highest margins seen at PDCO came with Covid and there are big reasons for that:

- It cut advertising to almost zero last year:

Advertising	2021	2020	2019
Advertising spent	$0.1	$5.8	$8.4
Revenues	$5,912.1	$5,490.0	$5,574.4

Here is 10-15bp of margin gains in 2021 that likely will not recur.

- There was about $15-18 million in worker furloughs and reduced travel in 2021 – largely in 1Q and bled into 2Q. That is about 140bp of margin gain in 1Q and 30bp for the year that will not recur. These furloughs and salary cuts started in 4Q20. For the whole year of 2020, margins were up 65bp, with 170bp increase in 4Q helping that.

- Stock compensation fell by $6.9 million in fiscal 2021 – there's 12bp of margin gain.

- In 4Q20, PDCO sold a large amount of its equipment finance contracts at a substantial gain. This may have been due to falling interest rates and selling paper at a higher coupon. The gain on finance contracts was $21.7 million in

4Q20 vs. $22.2 million for the first nine months of 2020 and vs. $16.9 million in all of 2019. The $21.7 million was 40bp of margin for 4Q20.

- Pent-up demand from sales lost in 4Q20 and 1Q21 surged in 2Q and 3Q. In 2Q, sales were up 10% while costs rose only 8%.

- In 4Q21, there were the incremental $12 million in LIFO and $11 million in PPE write-offs that cut margins by 150bp. So, the argument is margins would have been 4.6% in the 4Q21 and the full year would have been 20bp higher at 4.6% vs. 4.2%.

We will accept that there is likely still a very strong revenue growth number coming for 1Q22. But that will be offset by the growth seen in 4Q21 by a weak 4Q20. So, if base sales are now $6 billion and the margin is 4.6% - here's how that changes:

- +/- $100 million in sales = 3.7 cents in annual EPS
- +/- 10bp of margin = 4.9 cents in annual EPS

Just looking at the obvious things, advertising seems likely to return and cut margins by 10bp, furloughs and curtailed travel are gone and that is likely over 30bp of margin, plus, stock compensation was more than 10bp of tailwind that may reverse too. There are over $200 million of PPE sales facing pricing pressure to push down revenues and create margin compression. We would argue that lower materials costs came through PDCO in 1Q21 and 2Q21 when fuel prices were very low as well as plastics and some metals. We know that situation has completely reversed now to the point PDCO took a $12 million charge related to inflation in the 4Q. Even if the rate of change there slows, the pressure seems likely to continue currently. The $12 million was 20bp based on $737 million of inventory. Inventory turns 6x a year so applying some basis point pressure on $4.4 billion in supplies adds up fast. 10bp on $4.4 billion adds up quickly – every 10bp is worth 3.7 cents in EPS. And remember, PDCO may have liquidated some LIFO layers in 2021 and sold lower-cost products into inflationary pricing and that would have boosted margins. Now the comps going forward should have higher-cost inventory.

The only positive we see is PDCO should sell more large equipment going forward and it sells those finance contracts. In 2021, the low volume produced a $2.1 million loss on the sale of contracts versus a $43.9 million in gains in 2020 and $16.9 million in 2019.

Macquarie Infrastructure Corp. (MIC) Update

We are ending coverage of MIC at this time as the company has announced the sale of all remaining units.

Summary

MIC announced a deal 10-days ago to sell its MIC Hawaii – the gas utility for Hawaii. The purchase price was $514 million with assumed debt and transaction fees. This came in lower than our forecast of $600 million for the valuation based on 10x pre-Covid EBITDA of $60 million. Instead it will be 8.6x. The lower multiple will lower our forecast for ultimate value by about $1 per share.

The lower figure means shareholders will receive $3.83 in cash per share from MIC Hawaii or $4.11 if the deal is completed after June 22, 2022. The difference is a $25 million bonus fee payable to management if the deal is approved by the Public Utility Commission of Hawaii and closed with the acquirer before that date.

With the Atlantic Aviation sale to KKR expected to occur no later than December 2021 providing $37.35 per share in cash and now the MIC Hawaii deal of $3.83 by June 2022 – shareholders are set to receive $41.18 with the bulk arriving within six months. The only issue for shareholders to still decide is if they want to earn the last 7% discount from the current market value of about $38.50.

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.

Disclosure

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