BEHIND
THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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AT&T (T) Updates Guidance for 2019 – Some Positives for American Tower (AMT) & SBA Communications (SBAC) Too

In general, we have been positive on AT&T in all areas except DirecTV and believe investors are missing some positive catalysts that we have discussed in previous issues. In the meantime, the stock trades for under 8x EBITDA, about 8x EPS and has a 6.75% yield. The debt load is forecast to be 2.5-2.6x EBITDA by the end of next year and drift below 2x EBITDA over the next 3-4 years. The dividend coverage is 54% of free cash flow and the company continually addresses its commitment to the dividend by talking about free cash after paying it.

Compare that to AMT and SBAC – who rely on AT&T for a huge part of their revenues: AMT is 54% domestic revenues with 16% from AT&T. SBAC is 80% domestic with 32% from AT&T. With AMT, investors get a 2% yield and 4.6x debt to EBITDA and SBAC is 0% and 7.5x. Although a case can be made that all three companies see some growth when AT&T grows, the tower companies largely get a one-time boost in revenues as AT&T pays more rent to install additional equipment on the towers. Adding the new equipment doesn't happen continually so revenues level off at the tower companies other than a contracted rent increase that often is paying rising property taxes and rising ground lease payments. AT&T can boost the use of that equipment and drive growth and income every year.

Recently, AT&T updated guidance for all its divisions and laid out a plan that should see strong growth at its wireless unit and capital spending that should start to decrease by mid-2019 and thus boost free cash flow. The DirecTV area still sounds like the improvements will materialize more in the second half of 2019. Looking at just that tree, we would be disappointed too. Looking at the full forest – AT&T looks attractive given the price and its potential:

- AT&T is guiding to $23 billion in capital spending in 2019 and Free Cash Flow of $26 billion. In 2020, free cash flow should rise with lower capital spending and new revenues from the completed infrastructure builds.

- The heavy spending is starting to pay off for AT&T Mobility and Mexico wireless. Growth in revenues and EBITDA are expected to accelerate. That's basically half the company seeing growing EBITDA.

- Installing 5G and spectrum at the same time as FirstNet is giving the tower companies more colocation growth and should enable AT&T to boost its wireless capacity by 50% from late 2018 to the end of 2019.

- FirstNet rollout is helping AT&T add more first responder agencies across the country – that helps it grow its Business Wireline unit which is about 17% of EBITDA and has been flat. Faster speeds from 5G and greater capacity should also be more attractive to other businesses and help growth at this division.

- DirecTV and TV overall are only about 7% of total EBITDA. Broadband is growing at 5% and is about 8% of the EBITDA and is coupled with TV in the Entertainment Unit.

- Guidance calls for TV to lose $1 billion in satellite customer EBITDA and $1 billion in higher accounting pressures and lost retail wireline phones. That will be offset by cost initiatives, higher profitability at broadband and new TV services, as well as higher advertising and retaining satellite customers at a lower price point.

- Everything looks conservative in that Entertainment forecast in our view and is already happening in many cases – except it will need to see a reacceleration of new customer sign-ups that exceed the number of satellite customers lost.

- Our view is that guidance for flat customer totals and about $10 billion in EBITDA at Entertainment may be doable. However, getting to flat may be backloaded as the easy comps will be in 3Q19 and 4Q19 and the building of new momentum in OTT customers may not be offsetting satellite losses until then.

AT&T's 2019 Guidance Calls for Ample Free Cash Flow

The negative focus for AT&T continues to be the Video portion of the Entertainment unit, which is only about 7% of EBITDA. We'll address this below. However, nearly every other unit is expected to grow EBITDA in 2019. Mobility is about 50% of EBITDA and is growing at 5%. WarnerMedia is 17% and growing about 7%. Business Wireline is 17% of EBITDA and has been consistently $2.6-$2.8 billion per quarter for years. Adding FirstNet alone should enable it to grow as well as offering faster speeds to businesses. The rest of Entertainment is Broadband, which is growing about 4%-5% and is about 8% of EBITDA. Latin America is only about 3% of EBITDA and is adding customers. FX is a wildcard here and the plan is to reduce costs which could grow the EBITDA.

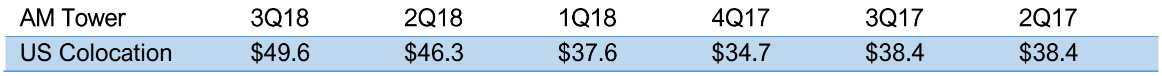
Overall – 90% of EBITDA is growing now and the path for that to continue is laid out and working. The company sees cash flow of $49 billion with $23 billion in capital spending. That remaining $26 billoon amply covers the $14 billion for the dividend – about 54% free cash flow coverage on the dividend. The remaining $12 billion will retire debt. After 2019, the capital spending should decline and improve the dividend payout ratio further. Also, debt repayment should continue as well to eventually push the ratio of net debt to EBITDA under 2x.

AT&T Mobility and Mexico Have been Seen Heavy Spending Some of Which Helps Tower Companies and Lays the Groundwork for More AT&T Growth

AT&T has been building out the FirstNet system for first responders in the US. As it has added that equipment, they have also been adding 5G equipment and other upgrades needed to use more of its spectrum. **On top of that, they have built out an entire LTE system in Mexico that has grown from 9 million customers to 17 million in three years and now**

covers 100 million people. Next year, free cash flow should rise in Mexico via lower capital spending and adding more customers.

We talked in both the American Tower and SBA Communications reports about colocation, which is adding more equipment to existing towers. This is a key source of growth for the tower companies, as they get paid more rent. American Tower shows these numbers better and there has been a bump in the last two quarters:



AM Tower	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
US Colocation	$49.6	$46.3	$37.6	$34.7	$38.4	$38.4

We think some of this is AT&T aggressively adding new equipment and turning it on. One-third of FirstNet's buildout was completed by 3Q18. It should all be finished in 2019. So, colocation growth in 2019 may also be stronger than normal for the tower companies. After 2019, it may drop off again. AT&T's Randall Stephenson is noting that the spectrum they are now setting up to turn on and enjoy means less spending after 2019,

> *"And so, you think about the spectrum that we've accumulated. When you buy spectrum, a lot of people don't realize this, but your business case is generally how much capital can you avoid if you own spectrum. So, rather than building more cell towers, you have spectrum.*
>
> *As we put this spectrum up over 2019, we begin to realize what I'll call a spectrum dividend, meaning our capital requirements – once this spectrum is deployed, our capital requirements for the foreseeable future drop dramatically."*

AT&T is seeing mobility revenues rising about 5% and it believes this will continue as it turns on more 5G and spectrum. **They expect to see a 50% increase in the capacity of its mobility unit by the end of 2019.** That is some sizeable growth potential for the largest unit now and that has implications for more wireless solutions to help other areas grow in Warner Media, Entertainment, and Business.

AT&T sees 400mb per second speed going nationwide and some areas will have 1gb speed. That should drive more business to AT&T by adding more smart-phone customers, better pricing, more business customers, and more first responder customers. It also makes it possible to offer customers the ability to access AT&T and entertainment via wireless, broadband, or traditional means. What is key is Mobility is half their EBITDA now. Adding equipment to towers is largely over in Mexico now and should start to drop off in 2019 in the US. Much of the spending for AT&T will be on software and marketing as capital expenditures should start to decline in later 2019 and beyond.

That's all a positive for AT&T's free cash flow and dividend. However, the tower companies are charging rent on the equipment, not how much data is being transmitted. Therefore, the colocation growth that comes from service carriers deploying new equipment may slow after a nice pop in late 2018 and 2019 even though AT&T may continue to see rising revenue and EBITDA for several years on the same equipment.

AT&T expects to see lower capital spending after 2019 that boosts its free cash flow, improves its balance sheet via lower debt levels, and maintains and grows its dividend. In addition to having much of the tower equipment build-out slow in 2019, the fiber build-out program that has seen heavy investment over the last 3+ years will fall in the second half of 2019 too. As Randall Stephenson noted that capital spending should be much lighter for a while after mid-2019,

> *"As we get past 2019, you will see the capital requirements from just capacity lift. We'll still be investing heavily in 5G and fiber to the cell towers and to small cells for 5G. So, that will continue. But in terms of just broad macro capacity and coverage, the spectrum dividend is sizable as we get past 2019.*
>
> *So, this begins first part of 2019. It begins to improve throughout 2019. And 2020, the capital intensity really begins to lighten for the next few years."*

DirecTV's 2019 Guidance is for Flat Results

The way we interpret the projection, the results may remain weak in 4Q18 and even 1Q19 and then regain some lost ground. The company is forecasting total customers to remain at 25 million and EBITDA flat at $10 billion. Holding the line at 25 million customers is not a very aggressive forecast – it has been there for years:

AT&T Video Subs	3Q18	2Q18	1Q18	4Q17	3Q17	3Q16
Satellite	19,625	19,984	20,270	20,458	20,605	20,777
U-Verse	3,669	3,656	3,632	3,631	3,691	4,515
Over the Top	1,858	1,809	1,467	1,155	787	0
Total	25,152	25,449	25,369	25,244	25,083	25,292

What scared investors in 3Q18 was the first drop in total customers in the last several quarters. The price increases at Over the Top, which is DirecTV Now and Watch slowed the number of customers joining those areas where they did not offset the decay in traditional satellite. The company has rolled out many new package options and can offer it on multiple devices and bundle it with more high-speed broadband and faster speeds on mobile. We believe that 4Q18 and 1Q19 may still show more weakness where the number of satellite losses exceeds those who migrate to the new services or in the speed entirely new customers sign up. However, the marketing push will pick up during 2019 and reproducing results of 4Q17-2Q18 should be doable.

Holding the EBITDA flat at about $10 billion should be the bigger challenge. The company has been seeing double-digit rates of y/y decay. They do not break out just the video, EBITDA for the $10 billion includes video, broadband, and wireline phones. The wireline phone revenue is in decay and AT&T is pulling cost out of that business as it manages that decline. The broadband is growing but they have been investing in that area. Video is seeing $100 per month customers become more $50 per month customers and it is investing in marketing there. The rate of decay has slowed to about $2.5 billion per quarter and accounting changes for paying commissions have helped too by about $200 million per quarter in 2018:

AT&T Ent.	3Q18	2Q18	1Q18	4Q17	3Q17	3Q16
EBITDA	$2,209	$2,608	$2,408	$2,368	$2,663	$2,956
New Acctg	$2,434	$2,821	$2,620	n/a	n/a	n/a

The path to flat EBITDA in 2019 of $10 billion starts with losing $1 billion in video subscriber EBITDA as people cut the satellite. Another $1 billion is expected to be lost from retail voice lines being cut and some accounting changes. That pushes the total to $8 billion or a 25% drop. How does AT&T propose to make the $2 billion back?

AT&T expects to gain $0.4 billion back from Broadband growing – that does not sound aggressive at all to us given the fiber buildout and the recent growth rates. The company also forecasts $0.4 billion in cost cuts, $0.2 billion in better profits for DirecTV Now and Watch by offering more package choices and upgrades like DVR, Sports, Video on Demand. The remaining $1.0 billion comes from Xandr advertising gaining more (and it has been growing at double-digits), the opportunity to retain and reprice customers rolling off a 2-year price lock-up, and retaining customers leaving satellite in new systems.

On the $0.4 billion in cost cuts, there are two main items. First, signing up people to DirecTV Now and Watch is cheaper. There is no hardware to have a technician drive out and install – instead, it's downloaded software to activate a customer. Thus, fewer new satellite people reduces costs by itself. Also, the cost for entertainment is starting to be renegotiated to become more flexible and more tied to lower price point for the customers. The company noted that the last two content agreements that were signed reflect this and they expect to see this trend continue.

The $0.2 billion in better profits for DirecTV Now and Watch seem to be a reasonable forecast too. They are continuing to boost the number of package options and add-on services that boost demand. This also plays into some economies of scale. The growth forecast is small for an improving area and they have been boosting prices. This also plays into those units adding more customers and leveraging fixed costs.

The $1.0 billion is where there may be some aggressiveness. On Xandr growing – we think that is a reasonable forecast. It is starting at a low base and is growing at double-digit rates on revenues and AT&T doubled the spending in this area last quarter – this could become $100-$150 million of improvement. The company thinks that as they lose $1.0 billion from people quitting traditional DirecTV, it will be able to retain many of them by transitioning them to DirecTV Now and Watch. Thus, AT&T recovers part of the $1.0 billion in losses by adding back those customers to other products. As more customers roll-off with the price lock-up expiring – some switch to the lower priced services and the company recoups part of the lost EBITDA. Others may become a better revenue figure by renewing at a higher price point or getting bundled with higher priced broadband that is available and they stay. Overall, swapping more people from $100 per month to $50 per month is likely a net EBITDA loser. The rest of this $1.0 billion positive forecast will need to come from signing up more new people at the lower price point than are lost from the traditional satellite business. Until 3Q18, that was a strong positive trend for AT&T. It had quarters in 2018 where new DirecTV Now subscribers were 2x the number of those lost from satellite. So, this is not impossible, but may be aggressive.

In our view, the rate of decay in traditional DirecTV is well-established and likely to remain a bigger part of the negative before all the people churning off can be retained under the new DirecTV Now. The 3Q results showed this as AT&T boosted prices but reported much weaker customer gains for the newer technology. To the extent fast broadband becomes part of a bundle to entice people to stay or return later for broadband and TV – they are still building out more broadband and fiber in the first half of 2019. It would not surprise us is to see the $1.0 billion in lost EBITDA come largely in the first half of the year and the forecast gains in the other areas come in more in the second half. Looking at the EBITDA figures for 2018 YTD, the company is at $7.9 billion against a forecast of about $10 billion. That implies a 4Q18 below 3Q18's $2.4 billion. Thus, we do believe this until could have a more backloaded 2019 in this unit especially with easy comps in 3Q19 and 4Q19.

We are going to focus more on the bigger picture for the television part of Entertainment. First, it's only 7% of the company's EBITDA and is about the only area at AT&T not growing. Other parts are posting increasing growth rates and have the capacity to continue that. Second, we only see some aggressiveness and potential timing issues regarding a portion of $1.0 billion of expected gains that are forecast to offset losses at traditional DirecTV. Keeping customers at lower price points appears likely and so does Xandr growth. If AT&T is still light – it may only be $0.3-$0.4 billion. Third, the forecast is "about $10 billion" for both 2018 and 2019. That may mean $10.1 billion in 2018 and 9.95 billion in 2019 – so there is probably $100-$150 million of rounding wiggle room there on estimates. Fourth, the company has reiterated that it expects to see $700 million in synergies in 2019 – that would more than offset any weakness in the TV unit. That is baked into the rest of the company's forecasts so it would not create an upside surprise. However, if they are hitting on synergies in 2019, they have forecasts of reaching $2.0 billion in 2020 and $2.5 billion in 2021 – getting more confidence in those forecasts may offset a $300 million miss in entertainment. Fifth, interest rates have been increasing – that should raise the discount rate and lower pension costs at AT&T. That would also boost EBITDA and is not baked into forecasts. Sixth, the rest of the company is growing EBITDA overall before factoring in synergies and pensions – both of which should be able to offset any weakness at TV.

Conclusion:

We still believe the market will focus heavily on results at the Entertainment division and is missing the growth at Mobility which is half the company's EBITDA. The market is likely to still punish AT&T results if the TV unit does not show more stability in 4Q18 and 1Q19 against the company's forecasts for flat cash flow results in 2019. However, if mobility is going to add 50% to its capacity in the year and capital spending is dropping in the second half of 2019 as major projects are completed, the forecasts should reflect rising free cash flow in 2020.

At some point, the overall company growth, the balance sheet deleveraging, the cash flow getting better should all outweigh weakness at 7% of the company. Investors are getting paid 6.75% in cash to wait for that to happen. The company intends to pay down $12 billion in debt with free cash flow. With 7.3 billion shares outstanding, that alone should add $1.64 to the share price assuming no change in the valuation multiples which is about 5%-6% capital appreciation for a total return of 12%.

The company gave guidance for $6-$8 billion in asset sales in 2019 that will also retire debt. Its debt is largely fixed as well with the company focusing on reducing the total. Thus, higher interest rates will not become a drag on income and cash flow like it could at the tower companies who are refinancing debt more than paying it down. With the rest of the company growing, earnings should also expand. With the Mexico build-out complete, fiber build-out ending in 1H19, and the FirstNet, 5G, spectrum buildout winding down in 2019; capital spending should be reduced and drive free cash flow higher in 2020 and 2021. That could allow AT&T to repurchase stock or grow the dividend faster.

We can see the growth in the tower companies. We just cannot justify buying those at over 20x cash flow with a 0% or 2% dividend and significantly higher debt levels – when a key reason for their organic growth is AT&T's heavy capital spending driving their results. AT&T offers a much higher yield with much better cash flow coverage, longer-term organic growth, an improving balance sheet, all for under 8x cash flow.

Zimmer Biomet Holdings (ZBH) EQ Review

Current EQ Rating*	Previous EQ Rating
3-	NA

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

We initiate coverage of Zimmer Biomet (ZBH) with a rating of 3- (Minor Concerns)

ZBH reported adjusted EPS of $1.63 versus the consensus targets of $1.60. However, we note meaningful one-time benefits and other red flags in the quarter that investors should be aware of.

- The effective tax rate for the 9/18 quarter was materially lower than forecasted. If the rate had remained consistent with the prior quarter, it would have taken 5 cps off of EPS. However, if we adjust for the full $16.9 million from the change in adjustments cited in the 10-Q, it would have reduced reported EPS by 8 cps. Either adjustment implies an earnings miss for the quarter.

- ZBH has been rapidly expanding its accounts receivable factoring program since 2016. While accounts receivable days of sales (DSO) growth adjusted for sold receivables remains in-line, factoring growth is providing a material boost to operating cash flow that will wane as the growth of the expansion of the program slows.

- The company took $305 million in goodwill and intangible impairments in 2017. While impairments fell to under $4 million so far in 2018, the company noted that a recent review indicated that fair value of $390 million of goodwill related to its Dental unit was only 5% above its carrying value. This indicates a reasonable risk of future write-downs.

- As is typical with any medical products company, ZBH is dealing with multiple litigation and regulatory issues. Items of note mentioned in the 9/18 10-Q include a warnings letter from the FDA received in August citing manufacturing violations at its Warsaw, Indiana facility and ongoing patent litigation with Stryker with a potential cost of $170 million.

The Quarter Was a Miss Without Lower-Than-Expected Tax Rate

ZBH's headline non-GAAP earnings per share of $1.63 topped estimate by 3 cps. However, the company stated in the conference call that the effective tax rate for the quarter was lower than anticipated due to tax planning initiatives:

> *"In addition, we have taken advantage of further tax planning opportunities,* ***which is primarily why you see the third quarter tax rate coming in lower than expectations.*** *Because of this, we now expect the tax rate for the full year to be below our prior guidance range."*

The effective tax rate was 16.5% in the 9/18 quarter, but it has been running closer to 19% in the last couple of quarters. We estimate that if the effective tax rate had remained level with the previous quarter's 18.9%, it would have shaved about $10 million or 5 cps off of non-GAAP EPS, leading to a 2 cps miss in the quarter. However, we also note that the company disclosed the following in its 9/18 10-Q:

> *"In the three and nine month periods ended September 30, 2018, we recognized tax benefits resulting from return to provision adjustments related to changes in estimated tax rates on deferred tax liabilities recorded on acquisition-related intangible assets.* ***The change in estimates from these adjustments resulted in tax benefits of $16.9 million in the three and nine month periods ended September 30, 2018."***

If we assume the full $16.9 million in adjustments was unexpected, it indicates a benefit of over 8 cps and implies a 5 cps miss in the quarter.

Management expects that a higher than expected FX drag will offset the benefit from lower taxes on the year:

> *"Because of this, we now expect the tax rate for the full year to be below our prior guidance range. While the points I just discussed will likely move some specific line items in your models, we do not expect dramatic changes to 2018 earnings.* ***In other words, the positive effect of tax and interest will largely offset the negative FX impact that we are seeing in 2018."***

We also note that management cited the timing benefit of certain contract tenders boosting revenue growth in the quarter:

> *"But before I do that with the idea of being fully transparent on the quarter our results actually look a little better than they actually are for a couple reasons. First of all and I think this is probably pretty clear to everyone, we had a pretty easy third quarter comp, which buoyed revenue growth in the quarter obviously and unfortunately, that will not continue in the fourth quarter. We have a much more challenging comp in the fourth quarter.* ***In addition to that, we experienced notable timing benefits in the quarter with regard to both tenders and capital sales on the tender front that happened both ,in Asia-Pacific for us as well as EMEA and on the capital side it was mainly in our S.E.T. business, either way that those buoyed the third quarter results and will come as a result of that with some pressure to the fourth quarter.*** *Good news is we have banked the revenue, which is the most important thing. So even though you are going to move those between quarters, I would much rather have the sale. So as much as we are happy with the third quarter, I believe it's important to highlight these factors, because I think very importantly, I don't want my team or you to get too excited that we appear to be at a weighted average market growth for the business."*

We appreciate the company's candor and investors should take the beneficial timing of revenue into consideration when forecasting growth in upcoming quarters.

Receivables Sales Boosting Cash Flow Growth

Like several companies we have been following, ZBH instituted a receivables factoring program two years ago and it has been increasing its scope rapidly in the last several quarters. Receivables are sold to third-party financial institutions and the company retains no interest or servicing liability. It guarantees the factored receivables and purchases insurance on them to limit its exposure. Receivables are removed from the balance sheet when sold.

The following table shows the receivables remaining on the balance sheet, factored receivables, and an adjusted DSO calculation. In addition, the company discloses the face value of outstanding factored receivables at the end of each quarter, the year-to-date amount of receivables factored during each period, and its estimate of how much incremental operating cash flow was provided by its factoring program.

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$1,836.7	$2,007.6	$2,017.6	$2,084.1
Accounts Receivable	$1,262.7	$1,335.3	$1,418.5	$1,544.1
Outstanding Derecognized Receivables	$341.8	$338.9	$323.4	$261.2
Adjusted Receivables	$1,604.5	$1,674.2	$1,741.9	$1,805.3
Adjusted DSOs	79.7	76.1	78.8	79.0
YTD Receivables Sold	$1,942.8	$1,260.7	$617.0	$1,456.9
Receivables Sold During the Quarter	$682.1	$643.7	$617.0	$406.4
Company's YTD Estimated Incremental Cash Flow Boost	$25.0	$30.0	$12.0	$174.0
YTD Operating Cash Flow	$1,367.9	$883.8	$490.5	$1,582.3

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$1,813.1	$1,949.5	$1,972.4	$2,013.1
Accounts Receivable	$1,318.5	$1,423.0	$1,600.1	$1,604.4
Outstanding Derecognized Receivables	$276.1	$228.7	$100.2	$65.5
Adjusted Receivables	$1,579.7	$1,651.7	$1,700.3	$1,669.9
Adjusted DSOs	79.5	77.3	78.7	75.7
YTD Receivables Sold	$1,050.5	$582.7	$208.7	$103.1
Receivables Sold During the Quarter	$467.8	$374.0	$208.7	$103.1
Company's YTD Estimated Incremental Cash Flow Boost	$273.0	$210.0	$50.0	$103.0
YTD Operating Cash Flow	$1,179.4	$715.9	$275.4	$1,632.2

We have several observations from the data above:

- For the last three quarters, adjusted DSOs have tracked steadily on a year-over-year basis. This alleviates concern that the factoring program is masking a buildup in total trade receivables.

- Receivables sold on a quarterly basis rose rapidly from $103 million in the 12/16 quarter to $682 million in the most recent period. The sequential increase has slowed some in the last three quarters, but the year-over-year pace was still almost 50% in the 9/18 quarter. This dramatic rise in factoring activity has been a huge boost to reported cash flow growth. However, the growth is clearly beginning to level off.

- According to the company's 10-Q filing for the 9/18 quarter, ZBH estimated that *"the incremental operating cash inflows related to all of our receivables purchase*

> *programs were approximately $25 million in the nine-month period ended September 30, 2018."* We are not certain how the company defines that figure. We believe the analytically significant number would be the amount extra cash that was generated by the expansion of the factoring program compared to last year. We know that in the first nine months of 2018, the company sold almost $900 ($1,942.8 million - $1,050.5 million more in receivables than it did in the comparable year-ago period. We can also see that the amount sold each quarter gradually rose as well. In addition, outstanding factored receivables at the end of the 9/18 quarter were $66 million higher ($341.8 million -$276.1 million) than at 9/17. With all this in mind, it seems to us that the amount of cash collected in the nine months ended 9/18 that would not have been collected without the expansion of factoring activity is closer to the $66 million figure than to the company's $25 million. This would mean that about 35% of the increase in reported operating cash flow in the nine months ended 9/18 was a result of increased factoring.

It is also worth noting that operating cash flow growth for the nine months ended 9/18 received a boost from $30.5 million in penalty payments and an undisclosed amount of payments related to the Durom Cup settlement. Consider the quote from the 9/17 10-Q filing:

> *"Cash flows provided by operating activities were $1,179.4 million in the nine month period ended September 30, 2017, compared to $1,005.0 million in the same prior year period. The increase was driven by our sale of accounts receivable in certain countries in the 2017 period which we estimated provided an incremental $273 million of additional cash, partially offset by product liability payments related to the U.S. Durom Cup Settlement Program and $30.5 million in penalties paid to resolve previously-disclosed FCPA matters involving Biomet and certain of its subsidiaries as discussed in Note 15 to our interim condensed consolidated financial statements included in Part I, Item 1 of this report."*

We estimate that after the benefit from increased factoring in 2018 and the one-time penalty and settlement payments in 2017, operating cash flow for the most recent nine-month period was about 2%. To management's credit, it mentions all of these factors in its liquidity discussions in its 10-Q filings. We admit that the company would not have reported negative cash flow growth even with our higher estimate of incremental cash from increased factoring activity. However, it has clearly been a material tailwind to cash flow growth that has come from a dramatic expansion of the program that could fade or even reverse in the future.

Goodwill Write-Offs

ZBH has reported a consistent string of goodwill and intangible impairments over the last few years. During 2017, the company recorded $304.7 million in goodwill impairments including a fourth-quarter charge of $272 million related to its Spine reporting unit. So far in 2018, it has only recorded $3.8 million in impairments. However, it did disclose that disappointing sales in its Dental unit led to an assessment of goodwill in the third quarter. While it was determined that the associated goodwill was not yet impaired, the fair value of the unit was less than 5% greater than the carrying value, so further deterioration could very well lead to more write-downs. The carrying value of the goodwill in question was $389.1 million.

Lawsuits and Warnings Letters

A full analysis of legal and regulatory risks is beyond the scope of our *EQ Reviews*. However, we do want to point out recent developments noted in filings that investors should be aware of.

ZBH disclosed in its 10-Q for the 9/18 quarter that on October 2, 2018, the Belgian Court of Appeal of Mons issued a judgment in favor of Heraeus in its trade misappropriation complaint seeking past damages and an injunction preventing future sales of certain European cement products in Belgium. ZBH is currently appealing.

It is worth noting that the company is involved in a patent infringement case against Stryker which the company states could result in a charge of up to $170 million in the event of a negative outcome.

The company also noted in the 10-Q that it received a warning letter in August from the FDA related to "observed non-conformities with current good manufacturing proactive requirements" at its legacy Biomet manufacturing facility in Warsaw, Indiana.

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 recent 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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