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Medtronic (MDT) EQ Review Update-10/18 Quarter

Current EQ Rating*	Previous EQ Rating
4+	4-

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

We are raising our EQ Review rating to 4+ (Acceptable) from 4- (Acceptable).

MDT reported adjusted EPS of $1.22 in the 10/18 quarter. This was 8 cps ahead of the consensus estimate. However, management stated in the conference call that 5 cps of the upside came from better than expected foreign currency experience and another 2 cps came from a lower-than-expected effective tax rate. While still a beat, it was not as strong as the headline number implied. Regardless, we raise our *EQ Review* rating to a 4+ (Acceptable) from a 4- (Acceptable) due to improvement in inventory and payables trends.

- After several quarters of increases, year-over-year growth in inventory days (DSI) flattened out in the 10/18 quarter. Finished goods inventory as a percentage of total inventory rose a reasonable 80 bps over last year.

- Accounts payable days of sales (DSP) declined by 1.6 days. With DSPs at around 72, we are not overly concerned about a quick reversion to historical levels that would pose a meaningful heading to cash flow growth in upcoming quarters.

Growth in Inventory Days Has Levelled Out

We mentioned in our last review of MDT that inventory days (DSI) had shown a marked increase for the last several quarters. However, we also noted that finished goods as a percentage of total inventory was not rising materially which alleviated most of our concern.

In the 10/18 quarter, MDT's year-over-year inventory DSI growth has settled down as seen in the following table:

	10/26/2018	7/27/2018	4/27/2018	1/26/2018
COGS	$2,203	$2,204	$2,392	$2,191
Inventory	$3,763	$3,681	$3,579	$3,751
COGS YOY growth	3.8%	-6.3%	-1.8%	-3.4%
Inventory YOY growth	3.4%	4.0%	7.2%	0.8%
Inventory DSIs	155.9	152.4	136.5	156.2

	10/27/2017	7/28/2017	4/28/2017	1/27/2017
COGS	$2,123	$2,352	$2,436	$2,268
Inventory	$3,638	$3,538	$3,338	$3,720
COGS YOY growth	-8.7%	4.0%	3.1%	5.9%
Inventory YOY growth	-2.1%	-1.2%	-3.9%	5.2%
Inventory DSIs	156.4	137.3	125.0	149.7

Inventory composition likewise remains reasonable, as finished goods as a percentage of the total inventory rose by about 80 bps over last year.

Payables Growth Also Moderated

We had also noted that the company's cash flow was benefitting from a rise in accounts payable as it stretched its terms with suppliers. However, days payables (DSP), like DSI, also registered a year-over-year decline:

	10/26/2018	**07/27/2018**	**04/27/2018**	**01/26/2018**
COGS	$2,203	$2,204	$2,392	$2,191
Accounts payable	$1,742	$1,789	$1,628	$1,809
DSPs	72.2	74.1	62.1	75.3

	10/27/2017	**07/28/2017**	**04/28/2017**	**01/27/2017**
COGS	$2,123	$2,352	$2,436	$2,268
Accounts payable	$1,718	$1,759	$1,555	$1,557
DSPs	73.8	68.2	58.2	62.6

The current level of approximately 70 days seems reasonably sustainable and we are not overly concerned of a reversion to recent historical levels causing a significant headwind to cash flow growth.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's 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.

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