

June 4, 2021

## Medtronic plc (MDT) EQ Update- 4/21 Qtr.

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

*We are raising our earnings quality rating on MDT to a 4+ (Acceptable)*

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

### Summary

MDT reported non-GAAP EPS of \$1.50, beating the consensus estimate by 8 cps. Despite some one-time benefits, the earnings beat remained intact.

#### What was weak?

- MDT's non-GAAP tax rate fell to 9.5% versus 12.6% a year ago. Management attributed this to a change jurisdictional mix and one-time benefits. Kudos to the company for prominently calling out the 6 cps non-operational benefit during the call.
- Lower bad debt provision as a percentage of revenue compared to the year-ago quarter added about a penny per share to growth. Comparisons will be favorable for the next couple of quarters. We will assess the allowance percentage when the K comes out.

## What to watch

- Like all the large medical device companies, MDT's past acquisitions have led to huge goodwill and intangible balances. Goodwill is not amortized, and the company adds back amortization of intangibles to its non-GAAP results. We believe this can be misleading when interpreting results as the company benefits from the acquired intellectual property with no cost while a company that developed the technology in-house would have to expense the associated costs. ***We recommend readers see the below industry discussion which compares how this impacts MDT versus its peers.***
- On the positive side, MDT has one of the lowest debt loads in the industry with net debt of just over 1x pre-pandemic EBITDA.

## Medical Device Industry Overview

### A Quick Look at Non-GAAP Adjustments of (BSX, MDT, SYK, and ZBH)

We currently cover four of the large medical device companies that compete in the high-end, technology-intensive areas such as defibrillators, heart valves, pacemakers, and joint replacements. These are:

- Boston Scientific Corporation- currently rated 3- (Minor Concern)
- Medtronic plc (MDT)- currently rated 4+ (Acceptable)
- Stryker Corporation (SYK)- currently rated 3- (Minor Concern)
- Zimmer Biomet Holdings (ZBH)- currently rated 3+ (Minor Concern)

While our ratings reflect various company-specific earnings quality factors, none of these companies receive our highest ratings for earnings quality, largely because they have all grown in the past through acquiring other companies in the space. This has led to sizeable intangible asset balances on the balance sheet. The goodwill is not amortized at all, and all add back the amortization of the definite-lived intangible assets to their non-GAAP results. We believe this erodes the overall quality of reported earnings for these companies.

The conventional response to our point is that amortization is a non-cash expense and therefore should not be counted in earnings-based valuations and return calculations. However, we believe that this misses the key point that the company's growth rate benefitted from the technology obtained from the companies it acquired. It otherwise would have needed to spend the cash on developing the technologies in-house. For some of these companies, these acquisitions have already resulted in sizeable debt balances. The following table shows net debt/EBITDA for all four using a pre-pandemic EBITDA figure:

Ticker	Net Debt/EBITDA
ZBH	2.7
SYK	2.6
BSX	2.5
MDT	1.2

ZBH, SYK, and BSX all are knocking on the door of a 3+ net debt/EBITDA which can limit their ability to make huge acquisitions in the future. All these companies are going to see near-term growth rates benefit as the pandemic subsides and there is a return to normal elective surgical procedures. However, growth after conditions return to the pre-pandemic norm faces the old headwind of lower reimbursement rates, pricing pressures, and intense competition.

Below, we will compare the degree to which these above factors impact each of these companies.

## Intangibles Amortization Add Backs

The most valuable asset of any medical device company is the intellectual property it develops through its R&D efforts or collects via acquisition. A company that spent hundreds of millions of dollars developing a new device and asked Wall Street to add back all the associated R&D expenses when calculating earnings or returns would be laughed at. However, if a company builds its intellectual property stable by acquiring other companies in the industry, it will inevitably build up sizeable goodwill and intangibles balances. Under GAAP, the company will not have to amortize the portion of the purchase price allocated to goodwill, so no cost will ever be recognized. The portion of the acquisition prices allocated to intangible assets may be amortized, but current practice is for the company to add back the amortization to its non-GAAP results which are used by analysts to value the stock and calculate returns. If those assets are deemed to be impaired in the future, the company will have to write them off. But again, industry practice is to add any impairment charges back to non-GAAP results. We argue that this practice has the same effect as perpetually adding back all R&D costs for a company that develops its intellectual property in-house.

The following table shows goodwill and intangibles as a percentage of total assets for each of the four companies for the trailing 12 months over the last three years as well as the amortization added back to non-GAAP earnings as a percentage of pre-tax non-GAAP income before taxes:

Table 1

	Goodwill % of Assets			Intangibles % of Assets			Add Back %*	3-yr. % Write-Off**
ZBH	38.4%	35.1%	39.4%	28.3%	27.7%	31.0%	42.8%	9.4%
MDT	45.1%	43.9%	44.6%	19.1%	21.0%	22.9%	26.1%	0.1%
BSX	35.2%	33.5%	34.4%	19.4%	24.6%	27.1%	47.5%	4.8%
SYK	38.3%	30.7%	33.6%	16.1%	14.0%	16.3%	16.4%	0.0%

\*Add Back % is the pretax intangible amortization added back to non-GAAP results as a percentage of non-GAAP pre-tax earnings.

\*\*3-yr. % Write-Off is total goodwill and intangible asset write-offs taken in the most recent 12 quarters as a percentage of the intangible asset and goodwill balances from three years ago.

We also believe it is informative to look at what results would be if the amortization is not added back and goodwill was amortized over 40 years (as it was in the past). The following table shows our reconciliation to non-GAAP pretax return on capital (operating income/debt+equity) to an adjusted return on capital which takes out intangible amortization and amortizes goodwill over

40 years. Note that we use operating income for the period ended 2019 to adjust for distortions from the pandemic.

Table 2

Ticker	Non-GAAP Op Inc	Debt+Equity	Non-GAAP ROI	Goodwill/40	Int. Amort.	Adj Op Inc	Adj. ROI	Difference
BSX	\$2,800	\$24,815	11.3%	\$272	\$773	\$1,755	7.1%	4.2%
ZBH	\$2,189	\$20,284	10.8%	\$231	\$605	\$1,352	6.7%	4.1%
MDT	\$9,171	\$78,986	11.6%	\$1,049	\$1,782	\$6,340	8.0%	3.6%
SYK	\$3,908	\$26,576	14.7%	\$320	\$535	\$3,053	11.5%	3.2%

Our quick observations on each company are below:

#### Zimmer Biomet Holdings (ZBH)

ZBH has the highest percentage of goodwill and intangibles as a percentage of total assets in the group. It also has the highest proportion of that booked as amortizable intangibles rather than goodwill which is not amortized. While this may be a positive for the quality of GAAP results, it is irrelevant for non-GAAP results which have the amortization added back.

In addition, ZBH has sustained multiple material write-offs of goodwill/intangibles balances over the preceding three years which amounts to almost 10% of the balances as of three years ago.

#### Medtronic plc (MDT)

MDT has the second-highest percentage of goodwill and intangibles to total assets. In the case of MDT, its add back of amortization is the lowest as a percentage of non-GAAP pretax earnings. However, this is partly a result of a greater proportion of its acquisition purchase prices being allocated to goodwill which is not amortized at all. When subtracting both amortization of intangibles and an estimate of amortization for goodwill, we can see in table 2 that MDT's adjusted ROI falls by a similar amount to its peers.

On a positive note, the company has not experienced any major write-offs in the last three years.

#### Boston Scientific Corporation (BSX)

BSX's goodwill and intangibles percentage of assets is the third highest in the group. However, it has also incurred write-offs in the last three years totaling almost 5% of the balances three years ago. Likewise, its adjusted ROI in table 2 falls by the largest amount (11.3% to 7.1%) which is partly due the company's faster pace of amortizing its intangibles.

#### Stryker Corporation (SYK)

SYK has the lowest goodwill and intangibles percentage of total assets. Its amortization add-back percentage is also the lowest but like MDT, this is partly due to a larger percentage of acquisition purchase prices being allocated to goodwill which is not amortized. When accounting for an estimate for goodwill amortization, SYKs adjusted ROI falls by an amount similar to its peers.

## 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.

## Disclosure

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