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Medtronic (MDT) EQ Update

Current EQ Rating*	Previous EQ Rating
3-	4-

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

We are lowering our earnings quality rating on MDT to 3- (Minor Concern) from 4- (Acceptable). We are not overly concerned by the company's earnings quality but given the meaningful jump in receivables and ongoing restructuring charges, we were compelled to lower the rating.

- MDT's restructuring spending increased in fiscal 2019. In the 1/18 quarter, the company announced its Enterprise Excellence plan with the goal of improving global manufacturing and operating models and optimizing certain commercial processes and systems. It estimates total pretax costs will run $1.6-$1.8 billion through 2022. Total charges in fiscal 2019 were $424 million compared to $96 million in 2018. We note that $193 million of these charges were labeled as "associated costs" and included the salaries of employees working on the program. The concern with large restructuring charges is that ongoing operating costs could be included in these charges thus benefitting current charge-adjusted earnings. Note that the Enterprise Excellence program was started in the same quarter the Cost Synergy program ended. While the company is no longer taking charges to earnings related to the Cost Synergy program, it is still making cash payments against the restructuring reserve which amounted to $57 million in fiscal 2019.

- Accounts receivable days were up by 2.6 over the year-ago fourth quarter. Management did not address the receivables increase in its conference call or financial commentary in its filings, but the CFO did make the following comment in the call:

> *"We expect our first quarter growth rate to be lower than normal on the heels of a better than expected fourth quarter…"*

This statement seems to imply that sales from the fiscal first quarter (1/19) were pulled into the fourth quarter (4/19) and the increase in receivables could be a symptom of that.

- Days payable jumped to 72, almost 10 days over the year-ago fourth quarter. The company attributed this to a "decrease in cash paid to suppliers… due to our continued progress in extending supplier payment terms." Management specifically noted its higher than forecast cash flow conversion rate for the year. Days payable actually declined on a year-over-year basis in the previous two quarters so this quarter represented somewhat of a "catch up" period likely due to timing.

- The company reduced its contingent consideration liability by $66 million as results at acquired operations missed the top end of expectations. However, this was adjusted out of non-GAAP results.

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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 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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