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Medtronic (MDT) EQ Review Update- 7/18 Quarter

Current EQ Rating*	Previous EQ Rating
4-	NA

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

We initiate coverage of Medtronic (MDT) with a 4- (Acceptable)

MDT reported adjusted EPS of $1.17 in the 7/18 quarter, $0.06 ahead of consensus expectations. However, the company pointed out that $0.03 came from a stronger-than-expected FX tailwind and $0.01 from lower-than-expected taxes.

We do not have much concern with the quality of the company's earnings, but do note the following minor red flags:

- Inventory days of sales (DSI) continued to increase. Management gave no explanation in the call or the 10-Q. This could have been due to rising raw materials costs along with new product introductions. Also, finished goods as a percentage of sales remained flat versus the year-ago period which does much to alleviate our concerns that there is an unexpected buildup of product which could lead to discounting or write-offs. Regardless, further increases will result in us lowering our rating.

- Regarding inventory, the company uses FIFO (first-in, first out) inventory accounting which matches older, lower-cost inventories against current sales. In addition, the company takes about 150 days to turn its inventory, meaning the impact of rising raw materials costs have been considerably delayed from hitting the income statement. This could lead to higher-than-expected cost of sales in the upcoming quarters.

- MDT is stretching payables to boost cash flow, with days payable up about 6 days from the year-ago period. Management is quite candid about this being a part of its strategy to boost free cash conversion. Our only concern is that with payable days now around 70 the "low-hanging fruit" is close to being picked.

- The company adopted ASU 2016-01 which requires equity investments to be marked to fair value every quarter with gains and losses recognized in net income. This will increase the volatility of reported results. To the company's credit, it has excluded these amounts from its adjusted EPS figures.

- Under ASC 606, the company has reported deferred revenue for the last two quarters. The fact that deferred revenue was flat sequentially is somewhat concerning at first glance, but two quarters is hardly enough to make an analytical conclusion. This will be a key account to monitor going forward.

Inventory Remains Elevated

The only real red flag in MDT's result that we consider to be somewhat concerning is the rise in inventory balances. The following table shows the calculation of inventory days of sales (DSIs) for the last eight quarters:

	7/27/2018	4/27/2018	1/26/2018	10/27/2017
COGS	$2,204	$2,392	$2,191	$2,120
Inventory	$3,681	$3,579	$3,751	$3,638
DSI	152.4	136.5	156.2	156.6

	7/28/2017	4/28/2017	1/27/2017	10/28/2016
	$2,352	$2,436	$2,268	$2,326
Inventory Composition	$3,538	$3,338	$3,720	$3,717
DSI	137.3	125.0	149.7	145.8

Management indicated in the 10-Q filing for the 10/17 quarter that increased cash spending on inventories was due to sensor supply constraints and a buildup in preparation for new product releases. However, two quarters later DSIs are still elevated versus the year-ago period. Management made no reference to inventories in the last two 10-Qs or conference calls. However, a close look at the components of inventory reduces our concern that there is an unexpected buildup in inventory:

	7/27/2018	4/27/2018	1/26/2018	10/27/2017
Finished Goods % of inventory	65.7%	67.3%	65.9%	65.1%
In-Progress % of inventory	14.7%	13.9%	13.9%	14.2%
Raw Materials % of inventory	19.5%	18.9%	20.2%	20.8%
	100.0%	100.0%	100.0%	100.0%

	7/28/2017	4/28/2017	1/27/2017	10/28/2016
Finished Goods % of inventory	65.7%	66.2%	64.0%	65.1%
In-Progress % of inventory	13.8%	13.7%	14.4%	14.3%
Raw Materials % of inventory	20.4%	20.0%	21.6%	20.6%
	100.0%	100.0%	100.0%	100.0%

Finished goods inventory as a percentage of total inventory was flat compared to the year-ago period after increasing slightly in the previous two quarters. If unsold inventory was accumulating and about to lead to large discounts or write-offs, we would expect to see a pronounced increase in the finished good percentage. Nevertheless, the trend in inventories should continue to be monitored going forward and a continued increase in DSIs could result in us lowering our rating on the company.

A more pressing concern we have regarding inventory is the slow speed at which the company turns its inventories coupled with the use of FIFO (first-in, first-out) inventory accounting. FIFO matches older, lower-cost inventory against current sales. In an environment of rising raw materials costs, this will boost profits as the more expensive, newly replenished inventories are delayed in hitting the income statement. It takes MDT over 150 days to turn its inventory, meaning the cost amounts on the inventory currently being expensed is about five months old. Steel and resin (a derivation of oil) are both important components in the company's products and the prices of both are higher than they were five months ago. This means much of that impact has yet to be felt in cost of sales which heightens the risk of higher costs than some analysts might be expecting over the next couple of quarters. If the company is able to increase prices to offset this, its margins will continue to benefit. However, if raw materials prices level off or decline and the company cannot push through price increases, FIFO accounting will actually turn against it when the higher costs are expensed.

Stretching Payables

MDT's accounts payable balances have also been on the rise. The following table shows accounts payable days (DSPs) for the last eight quarters:

	7/27/2018	4/27/2018	1/26/2018	10/27/2017
COGS	$2,204	$2,392	$2,191	$2,120
Accounts payable	$1,789	$1,628	$1,809	$1,718
DSPs	74.1	62.1	75.3	73.9

	7/28/2017	4/28/2017	1/27/2017	10/28/2016
COGS	$2,352	$2,436	$2,268	$2,326
Accounts payable	$1,759	$1,555	$1,557	$1,659
DSPs	68.2	58.2	62.6	65.1

Some of this increase is to be expected given the rise in inventories. However, the company specifically cited extending payment terms as being a boost to cash flow growth in the period, saying *"the decrease in cash paid to suppliers is primarily due to our continued progress in extending supplier payment terms*." MDT is focusing on its free cash flow conversion and has both extended payment terms along with improving receivables collections. We do not have an issue with this as management has been very forthcoming about the progress in those areas. However, we observe that with DSPs up about five days versus last year and already over two months, the company may have picked the "low-hanging fruit" in this area of cash flow improvement. Still, with lower expected litigation payments going forward, cash flow should still have some solid tailwinds.

Change in Accounting for Investment Gains

We note that the company recently adopted ASU 2016-01 which requires that equity investments (other than those being accounted for under the equity method) be measured at fair value and gains and losses be recognized in net income. As such, MDT now reports both realized and unrealized gains on its equity investments in "other non-operating income" on the income statement. This will result in more volatile results going forward. In addition, historical results have not been restated. Case in point, in the 7/18 quarter, the company reported $186 million in other non-operating income versus $99 million a year ago with the difference attributed largely to a $103 million ($0.06) gain from minority investments recorded in the quarter. To its credit, the company excluded this gain from its adjusted EPS figure and we assume it will continue to do so.

Deferred Revenue Flat Sequentially

MDT has adopted ASC 606 for revenue recognition which has resulted in the company now disclosing deferred revenue balances in its footnotes for the last two quarters. Historical periods have not been restated. Deferred revenue was $288 million in the 7/18 quarter, essentially flat with the 4/18 quarter's $289 million. While it is somewhat concerning that deferred revenue did not increase sequentially given the strong sales performance, two sequential quarters is hardly sufficient information to make much of an analytical conclusion. Nevertheless, this will be an important account to monitor going forward.

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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