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BTN Earnings Quality Review

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Medtronic (MDT)

A review of MDT's 1/18 results turned up a few items that are not overly-alarming but do warrant tracking in upcoming quarters.

Cash Flow Growth Should Improve, but Continuing to Watch Receivables and Inventories

At first glance, MDT's operating cash flow declined significantly in the twelve-month period ended 1/18 to $4.3 billion from $5.2 billion in the year-ago period. During this same time frame, EBITDA increased. This would ordinarily be a point of concern, but the company provided the following explanation in its 10/17 10-Q:

> "The $1.4 billion decrease in net cash provided was primarily driven by an increase in cash paid for income taxes of $416 million, funding of our retirement benefit plans of $170 million, cash paid for divestiture-related expenses of approximately $100 million, an increase in certain litigation payments of $96 million, net cash outflows for collateral related to our currency exchange rate derivative instruments, a decrease in cash collected from customers, and an increase in cash paid for inventory. The increase in cash paid for income taxes was primarily a result of tax payments related to the intercompany sale of intellectual property and sale of the Patient Care, Deep Vein Thrombosis, and Nutritional Insufficiency businesses as well as settlement payments for U.S federal income taxes for fiscal years 2012 to 2014 and audit settlements outside of the U.S. during the six months ended October 27, 2017.
>
> The decrease in net cash provided by operating activities related to the funding of our retirement benefit plans is due to timing of contributions; we made a contribution of $170 million in the second quarter of fiscal year 2018 whereas the prior year contribution was made in the second half of fiscal year 2017. *The decrease in cash collected from customers is partially attributable to reduced sales due to the July 29, 2017 sale of the Patient Care, Deep Vein Thrombosis, and Nutritional*

Insufficiency businesses. The increase in cash paid for inventory is partially attributable to higher inventory in the Cardiac and Vascular Group and Minimally Invasive Therapies Group related to new product launches and in Diabetes due to sensor supply constraints."

The company had already predicted in FY 2017 that timing issues would result in a spike in FY 2017 cash flow followed by a dip in FY 2018. Original guidance was for a high single-digit increase in free cash flow from FY 2016 to FY 2018, and the company is on target to deliver on this.

The main concerns raised by the explanation in the 10/17 10-Q was the lower cash collected from customers and the higher inventories. Both of these issues seem to have begun to resolve themselves in the recently-reported 1/18 quarter, although continued monitoring seems warranted. The following table shows accounts receivable days of sales for the last six quarters:

	1/31/2018	10/31/2017	7/31/2017	4/30/2017	1/31/2017	10/31/2016
Sales	$7,369	$7,050	$7,390	$7,916	$7,283	$7,345
Accounts Receivable	$5,775	$5,752	$5,784	$5,591	$5,453	$5,661
Sales YOY growth	1.2%	-4.0%	3.1%	4.6%	5.0%	4.1%
Accounts Receivable YOY growth	5.9%	1.6%	8.0%	0.5%	12.1%	12.2%
Sales Seq growth	4.5%	-4.6%	-6.6%	8.7%	-0.8%	2.5%
Accounts Receivable Seq growth	0.4%	-0.6%	3.5%	2.5%	-3.7%	5.7%
Accounts Receivable DSOs	**71.5**	**74.4**	**71.4**	**64.4**	**68.3**	**70.3**

MDT divested its Patient Care, Deep Vein Thrombosis and Nutritional Insufficiency Business on 7/29/2017, the first day of the 10/31 quarter. We can see the sequential decline in sales, but there is not a corresponding decline in receivables, which led to the observed increase in days of sales on both year-over-year and sequentially. Given that the divestiture took place on the first day of the quarter, we would not have expected a significant movement in DSOs unless the DSOs at the divested business were significantly different that the rest of the company, which appears to be the case. MDT disclosed in its 10/17 10-Q the assets and liabilities of the divested business as of 4/28/17, and while it showed $371 million for inventories, there is no amount disclosed for any other current asset account, implying no receivables at that time. This is somewhat puzzling given management's comment above that cash flow was hurt by the lack of collection of receivables related to that business. Regardless, if receivables at the divested business were unusually low relative to sales, it would have the impact of increasing DSOs in the 10/17 quarter. Therefore, observed reduction in year-over-year increase in DSOs in the 1/18 quarter of 3.2 days from the 4.1 days seen in the 10/17 quarter indicates that there is not a problem with receivables.

On the subject of inventory, the following tables shows the calculation of days of inventory for the last six quarters:

	1/31/2018	10/31/2017	7/31/2017	4/30/2017	1/31/2017	10/31/2016
COGS	$2,191	$2,120	$2,349	$2,436	$2,268	$2,326
Inventory	$3,751	$3,638	$3,538	$3,338	$3,720	$3,717
COGS YOY growth	-3.4%	-8.9%	3.9%	3.1%	5.9%	6.6%
Inventory YOY growth	0.8%	-2.1%	-1.2%	-3.9%	5.2%	5.7%
COGS Seq growth	3.3%	-9.7%	-3.6%	7.4%	-2.5%	2.9%
Inventory Seq growth	3.1%	2.8%	6.0%	-10.3%	0.1%	3.8%
Inventory DSIs	**156.2**	**156.6**	**137.4**	**125.0**	**149.7**	**145.8**

As with receivables, we can see the almost ten-day year-over-year increase in the 10/17 quarter brought on by the 2.8% sequential increase in inventory on a near-10% sequential decline in COGSs. In the case of inventories, we know that the divested business had $371 million in inventory as of 4/17 and can assume a similar amount at 7/17. Therefore, the 2.8% sequential increase in inventories in the 10/17 quarter, despite the exclusion of those inventories, does indicate something was out-of-line and corresponds with management's explanation that inventories were elevated from gearing up for new product launches in addition to sensor supply constraints. The increase in inventory relative to COGS seems to stabilize in the 1/18 quarter, plus management did mention in the call that inventories were pushed up some due to a currency impact towards the end of the quarter. Nevertheless, we would have intuitively expected a more pronounced decline as the new product associated with the inventory build in the 10/17 quarter began to sell in the 1/18 quarter and if the sensor supply issue had resolved. Given the possible impact from currency, we are not that concerned about the issue, but we will be tracking this going forward, starting with reviewing the inventory components when the 10-Q for the 1/18 quarter is released. If the buildup is focused in finished product, it will heighten our level of concern.

Restructuring Charges

During FY 2015, MDT acquired Covidien for $50 billion. This huge acquisition spurred a large restructuring/integration program that is just now winding down. The following table shows the one-time charges that MDT takes out of its adjusted profit numbers:

	9 mos 1/18	FY 2017	FY 2016	FY 2015	FY 2014
Inventory Step Up		$38	$226	$623	
Restructuring Charges	$62	$373	$299	$252	$88
Acquisition/Divestiture-Related Items	$216	$230	$283	$550	$117
Adjusted Operating Income	$5,893	$8,351	$8,126	$6,002	$5,177

These charges included such items as severance costs and headcount reductions, facility closures, charges for conforming to company accounting policies, and charges for the settlement of retirement plans. We are always skeptical of ongoing restructuring charges and their impact on earnings quality, but in the context of integrating a $50 billion acquisition, the size of the charges themselves are not that concerning.

However, management has now announced the beginning of a new plan called the *Enterprise Excellence Program* which is expected to cost another $1.6-$1.8 billion over the next several years and eventually cut $3 billion out of the company's cost structure. Most of the costs are expected to be incurred by the end of 2022. The company has yet to give much detail on the plan. We will be watching developments there closely as it is ongoing, open-ended restructurings that, in our opinion, carry much potential for abuse.

Prepaid Expenses and Other Current Assets

We noticed that the company's "other current assets" account on its 1/18 balance sheet increased out-of-line with both sales and with the recent trend:

	1/31/2018	10/31/2017	7/31/2017	4/30/2017	1/31/2017	10/31/2016
Sales	$7,369	$7,050	$7,390	$7,916	$7,283	$7,345
Other Current Assets	$2,645.00	$2,246.00	$2,000.00	$1,865.00	$1,792.00	$1,891.00
Other Current Assets Days of Sales	**32.8**	**29.1**	**24.7**	**21.5**	**22.5**	**23.5**

This account contains several unrelated items including the value of its derivative contracts. We were able to confirm from SEC filings that derivative contracts were not behind the increases seen through the 10/17 quarter, but the 10-Q is not yet available for the 1/18 quarter. We tried to contact management to get more color on the increase but did not hear back in time for publication. The concern with a rising other asset account is that expenses have been capitalized and therefore delayed in running through the income statement, thus overstating earnings. Given the lack of visibility into what is driving the increase, this needs to be taken with a grain of salt until we get more information on the increase.

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