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BEHIND THE NUMBERS
Quality of Earnings Analysis

December 2, 2021

Patterson Companies, Inc. (PDCO)
Earnings Quality Update- 10/21 Qtr.

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

We are maintaining our earnings quality rating of PDCO at 2- (Weak) and maintaining our Top Sell rating.

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

Summary

PDCO's 2Q22 beat adjusted EPS forecasts of 50 cents by 8 cents. That is after beating 1Q22 forecasts by 6 cents. It didn't raise full-year guidance after 1Q and boosted it only 5-cents after 2Q. Full-year guidance is now $2.00-$2.10 for adjusted EPS for a year that includes a small acquisition and an extra week vs. the $1.91 PDCO posted with all the Covid shutdowns in fiscal 2021. A mere 5%-10% y/y gain.

It's worth noting that EPS was lower y/y in 2Q too by 5-cents. PDCO attributed all of the 5-cent decline y/y to having lower travel costs and furloughed employees during Covid for the quarter ending October 2020. It also indicated that investors should expect a modest 3Q and strong 4Q next April. We noticed several unsustainable sources of EPS growth in 1Q, and 2Q saw some of the same:

- PDCO gained 6.1 cents from an insurance reimbursement payment of $8 million for expenses previously recorded.

- PDCO gained 1.1 cents from lower stock compensation y/y for 2Q22.

- PDCO gained 3.7 cents from having lower losses on the sale of receivables and finance contracts y/y for 2Q22.

- A higher tax rate was a 1.0 cent headwind.

This is 10-cents of what we would consider non-recurring adjusted EPS. It accounts for the entire 8-cent beat. What is interesting about the $8 million insurance reimbursement is PDCO announced it after 1Q, and we expected it to be backed out of adjusted EPS, but that didn't happen. It only added back the amortization of acquired intangibles and some restructuring charges. The $8 million wasn't mentioned on the 2Q call either, only in the 10-Q.

What is Weak?

- On the earnings call, management indicated that the entire 5-cent y/y decline in EPS was due to the higher travel and employee costs returning after Covid cutbacks and furloughs and reduced hours in 2Q21. 5-cents would be $6.6 million in higher costs. But it is interesting to note:

    - A full quarter of cutbacks like this was $20 million or 15-cents in 1Q21.

    - These costs were not fully restored in 2Q21 – August 2021 saw almost none of them, and hours and furloughs started coming back in September, but travel may have still been reduced too.

    - Given the potential for higher wages in 2Q22 plus full hours restored plus travel being back – this may have been more than a 5-cent headwind.

    - When discussing overhead costs rising in 2Q22 in the 10-Q, PDCO said, "*Consolidated operating expenses for the three months ended October 30, 2021 were $263.6 million, a 6.9% increase from the prior year quarter of $246.7 million. We incurred higher operating expenses during the three months ended October 30, 2021* ***due to higher personnel costs and higher travel-related expenses. These increases were partially offset by the receipt of $8.0 million*** *related to the Fiscal 2022 Legal Reserve."*

    - So total expenses rose $16.9 million and that was offset by the $8 million insurance repayment – and that's a one-time item. What happens next quarter without an insurance check? Maybe that's why PDCO told investors to expect a heavy emphasis on 4Q results to hit guidance.

- Gross margin declined by 80bp y/y in 2Q21. 20bp of this was due to higher interest rates causing a mark-to-market loss on the financing equipment portfolio. However, PDCO has interest hedges in place to offset this 20bp. The loss occurred in gross profit and the gain in "other income" below the operating margin line. The other 60bp decline was driven by selling more Animal Health products that have lower margins and other lower profit products. This runs counter to prior guidance:

    - On the 4Q21 call, the CEO noted, *"we don't believe there's a lot of gross margin compression, we think some of the things that we've outlined, really show up in the gross margin. And so* ***as we move forward, it's really a combination of stable to improving gross margin and continued OpEx leverage*** *as we expand the sales."*

    - On the 1Q22 call, the CEO said, *"Yeah, so on the inflation question, there's been some, but nothing that significant. I think that if you look at the trending of the gross margin throughout the year, typically first quarter ends up being again with a lot as with a lot of things, our most challenging quarter and volumes are generally at the lowest. We did have the benefit of the extra week, so that was helpful, but* ***I think if you look at how it may trend for the rest of the year, we expect there*** **to be some increasing gross margin as you look to the rest of the fiscal year."** Interesting too that 1Q margin was down 20bp y/y in what is considered the toughest quarter and 2Q margin was down 80bp.

    - On the 2Q22 call, PDCO noted that dental margins were flat y/y and the animal health unit saw higher margins. However, selling a higher percentage of animal health product mix reduced margins. The CFO added that animal margins came in higher than expected. He further indicated investors should expect more gross margin pressure going forward from the same issues. But, the tough comps kick-in for 3Q and 4Q:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Total Internal Animal Sales	$946	$946	$971	$899	$907	$816	$859
Total Internal growth rate	16.20%	16.50%	13.80%	10.00%	6.90%	-0.20%	-0.80%
Companion growth rate	21.00%	23.00%	29.60%	20.70%	12.00%	pos	down

  - Another issue is PDCO noted it boosted its private-label offerings for both dental consumables and animal health and that helped drive sales. Normally, private label products have lower selling prices but higher gross margins. To have gross margin decline amid that change should be another concern.

- PDCO touted that Free Cash Flow for six months was up y/y by $60 million. However, this was heavily influenced by collecting more of their deferred purchase price receivables when they sell/factor receivables and finance contracts. Also, we remember when dentists were closed, many were given the flexibility to delay payments which would have impacted the six months ending in October 2020:

	6 mths f22	6 mths f21
Cash from Ops	-$539	-$423
Cap Exp.	-$16	-$14
Collection DPP	$586	$409
Free Cash Flow	$31	-$28

- The problem with this source of cash flow is PDCO has been drawing down its deferred purchase price receivables and not replacing them at the same rate. There is simply less potential cash flow sitting here:

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
New A/R DPPs	$249.2	$267.5	$195.9	$186.5	$200.8	$185.4
Collected A/R DPPs	$230.5	$264.1	$175.6	$191.2	$188.1	$147.1
	$18.7	$3.4	$20.3	-$4.7	$12.7	$38.3
Net Fin. Contract DPPs	$13.9	$19.1	$45.0	$35.8	$34.7	$16.5
Collected Fin Con. DPPs	$40.0	$51.1	$23.9	$34.4	$66.1	$7.6
	-$26.1	-$32.0	$21.1	$1.4	-$31.4	$8.9

What to Watch?

- Who is correct on the supply chain – XRAY or PDCO? XRAY is a major supplier to PDCO and it reported earnings in early November. When asked about supply chain issues last month – here is what XRAY's CFO said:

> **Tycho Peterson – Analyst - "***Okay. And then* ***follow-up on supply chain, obviously topping issue or. I'm just curious what you're seeing in the channel in terms of inventory levels, our dealers starting to stockpile? Are you running into shortages?*** *Are you able to pass on higher shipping costs? Can you maybe just give us a little bit of a walk through on what you're seeing on the supply chain side right now?"*
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> **Jorge Gomez XRAY's CFO- "***In fact, I'll take that question. Yes. As I indicated in my remarks, there are challenges. So far -- I also said this. So far for us,* ***we have not been impacted in terms of our ability to manufacture products or to supply our distributors.*** *It is something that we are monitoring very closely. The supply chain team is doing a great job because the reality is, it is harder now to find certain components. It is more expensive in some cases to procure certain materials. We have managed all of that so far.*
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> *So with respect to what we're seeing in the inventory pipeline or channel, we haven't seen any major disruption or any changes, really, of material significant at this point. But as you know, this is a global situation and it's something that is hard to predict at this point.* ***But so far, we -- our financials are not -- have not been impacted by the supply and -- supply chain issues in a material way other than some elevated costs that we have been able to offset.*** *Or in some cases, for example, we did a price increase, we announced a price increase effective October first, some of that helps offset some of the incremental costs that we are all facing."*
>
> **PDCO's CFO said this week-** *"Internal sales of Dental equipment and software decreased 3.0% compared to 1 year ago.* ***Our performance in the equipment category in the quarter was impacted by the known supply chain challenges*** *in the core equipment category. However, sales of CAD/CAM products increased double digits in the second quarter of fiscal '22."*
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> **PDCO's CEO added this-** *"As we indicated in the prepared remarks,* ***we are seeing extended lead times from our manufacturers****, in particular, in the core equipment category. I think this is an industry issue that is widely known. And I think there is a number of factors that are impacting that, certainly supply chain elements, but really very strong demand from our customers. So, we are really*

*pleased with the backlog that we have. But as I indicated, **we are experiencing longer lead times than normal in this category in particular, and that certainly affected our overall equipment results in the quarter**."*

- PDCO just posted a quarter where dental equipment/software sales declined by 3% y/y. We think it's actually worse than that because on the call, PDCO said CAD/CAM sales were up double-digits in 2Q22. This has negative implications for the quantity of new finance contracts sold – which could impact cash flow on how many DPPs it collects. **But we have to ask – supply chain issues have been an issue for several quarters, at least a year – why didn't it impact PDCO's results in the last few quarters?**

	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Dental Equip/Soft Ware Sales	$193	$157	$183	$237	$198	$113	$111

  - In 1Q22, PDCO's equipment sales were up 28% and up 15% compared to 1Q20 which was pre-Covid.

  - In 4Q21, PDCO's equipment sales were about the same as 2Q22 and it had no problem filling surprisingly stronger orders. From the 4Q21 call, *"For some additional context, dental internal sales for the fourth quarter of fiscal 2021 are up nearly 10% compared to the fourth quarter of fiscal 2019. Our fourth quarter sales performance was driven by stronger than forecast growth in our consumables, equipment and software and value added service categories."*

  - PDCO did even higher sales of equipment in 3Q21, which also exceeded their expectations.

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.

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