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BEHIND THE NUMBERS
Quality of Earnings Analysis

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Dentsply Sirona, Inc. (XRAY)
Earnings Quality Update- 12/21 Qtr.

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

We are reducing our earnings quality rating of XRAY to 3- (Minor Concern).

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

Summary

XRAY's adjusted EPS of 76 cents missed by 3 cents in the 4Q21. That even surprised us because the bar was set low for 4Q after 3Q's beat based on lower R&D spending and XRAY reducing guidance on the BYTE acquisition. We expected a y/y decline but not 11 cents. There are several sources of EPS growth we would consider low quality in 4Q21 too. XRAY said that 2022 will be backloaded given inventory problems and with adjusted EPS growth for the full year of only 6%-13%.

- XRAY reduced its tax valuation allowance from $287 million to $267 million. That included a $10 million credit. This is seen in the 10-K and we believe much of the change for this item happened in the fourth quarter. A $10 million credit is worth 3.6 cents in EPS.

- Inventory reserves fell $3 million since 3Q21 and bad debt reserves another $1 million. Declines have occurred for much of 2021, but with inventory levels dropping we think this source of income may be played out. These combined to add 1.5-cents to EPS in 4Q

- Stock compensation (which is included in adjusted EPS) was $54 million through September and finished at $48 million in December – a credit of $6 million, which added 2.1 cents to EPS. Y/Y the swing was $18 million or 6.4 cents.

- R&D spending is still worth monitoring. XRAY says it wants to spend 4% of sales on R&D. We noted that it was not hitting that figure through the first 9 months of 2021 – coming in at $112 million or 3.5% of sales. It hit the 4% figure on the nose for the year with $59 million or 5.4% of sales in 4Q21. However, it moved $10 million of SG&A costs already expensed in the first 9 months of the year into R&D for the 4Q. To us, it sounds like they were still $10 million light on the target, and EPS in the first 9 months already reflected the $10 million in expense. So in 4Q21, R&D increased by $10 million but SG&A declined by $10 million, which is a wash. This looks like another area where one could argue EPS was inflated by 3.6 cents.

- We also know that as part of the many restructuring charges that XRAY has taken in recent years, it was accelerating some depreciation into those charges. We noticed that depreciation expense turned flat in early 2021, but it dropped noticeably in 3Q and 4Q:

Depreciation	4Q	3Q	2Q	1Q
2021	$30	$30	$32	$32
2020	$38	$39	$33	$32

In 2020, XRAY recognized $14 million of accelerated depreciation. The $8 million drop in depreciation for 4Q21 added 2.9 cents to EPS. We think investors should also look at the adjusted gross margin of 57.7%, up 100bp for 4Q21. The drop in depreciation and decline in inventory reserve equals that margin gain. We also note that XRAY uses FIFO accounting, which should also be helping gross margin in the current environment.

- XRAY does seem to be very low on inventory. We were running DSIs based on net inventory, but the company boosted its inventory reserve so much in 2020 that the figures became skewed as the reserve fell. Using adjusted COGS which primarily adds back amortization of acquired intangibles – XRAY is at 100 days of inventory or 117 before the reserve. Those are the lowest figures for 2021, much lower than the 130 and 150 days the company normally carries. We believe it is likely that higher-cost inventory will start to make an impact by 2Q and pressure gross margins. We know 2Q20 was the period of many dentists being shut down, so that impacted those DSI figures due to low COGS:

Inventory DSI	4Q	3Q	2Q	1Q
2021	100	109	112	110
2020	91	115	176	143
2019	109	133	130	139

DSI w/o Reserve				
2021	117	127	131	131
2020	113	144	209	164
2019	126	152	153	163

- Lack of inventory could also cost XRAY some sales, especially in the early part of 2022. It already noted that 4Q21 margins came in at 20.0% vs. its goal of 21.0% due to lower sales volumes which meant the company didn't fully leverage fixed costs and there is less to sell now. They were warning that many dentists were canceling appointments due to sick customers or less staff.

- Guidance calling for a share count of 219 million vs. 220.2 million for 2021 would only produce 1 cent in EPS growth. The share count was 219.2 million for 4Q21. It does not sound as though XRAY is planning to retire much stock with the $1 billion authorization in the near-term either. The tax rate is expected to be a small headwind too for 2022 at 23.0-24.0% against the 23% of 2021. That's potentially 4 cents of EPS headwind.

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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