BEHIND
THE NUMBERS
Quality of Earnings Analysis

March 4, 2022

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Patterson Companies (PDCO)
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 maintaining our earnings quality rating of PDCO at a 2- (Weak).

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

Summary

PDCO's adjusted 3Q22 EPS of 55 cents beat forecasts by 5 cents. It was down y/y by 3 cents. Based on several accounting items, the beat was real and the y/y change could have been worse. PDCO called out the higher tax rate as a 3.3 cent headwind, we also saw its various losses on hedges, contract sales were worse y/y generating a 0.8-cent headwind, plus the share count was up representing a 0.9-cent headwind. Offsetting that 5.0 cents was a 2.8-cent tailwind from lower stock compensation. PDCO did raise guidance but still not much. Guidance rose from $2.00-$2.10 to $2.08-$2.13, so up 3 cents on the high-end.

We still do not think PDCO is projecting much growth vs. last fiscal year's $1.91. It is only calling for 17-22 cents of growth for the full year, and it beat forecasts in the first 9 months by a combined 19 cents already. Investors should not forget that PDCO already has 2.8 cents in the bank from an extra week in 1Q this year.

Also, in 4Q21 (April), PDCO took an extra $12 million in LIFO charges and $11 million in inventory write-downs. Those two items cost it 19 cents in adjusted EPS. If that simply doesn't recur – PDCO has two items that would generate 22 cents ahead of last year (the 3 cents from the extra week and the 19 cents from extra LIFO and inventory charges), which puts them at $2.13 - the high end of new guidance. Everything would seem to point to PDCO leaping over the current 4Q22 estimate of only 56 cents. Without inventory writedowns and excessive LIFO charges, it should clear that target easily. However, we believe the LIFO charge in 4Q22 may come in well ahead of last year's normalized amount that management gave investors in its commentary. This may prove to be a material headwind the market is not expecting.

Does a LIFO Charge Come in Higher than Fiscal 2021?

PDCO accounts for 83% of inventory under LIFO and 17% under FIFO. Because FIFO tends to have a lower inventory cost amid rising prices and thus often produces higher income, it would often result in a larger tax bill too. So, PDCO reports its GAAP income using both LIFO and FIFO. However, it reports its taxes by converting FIFO into 100% LIFO and has a deferred tax liability set up. The difference between the methods is the LIFO reserve. PDCO also believes that the difference between the GAAP inventory balance and the replacement cost for that inventory is approximately the same value as the LIFO reserve.

What happened in April 2021 (4Q21) when PDCO looked at this? The annual LIFO charge jumped from under $9 million in 4Q20 to $21 million in 4Q21. Inflation was already evident and the inventory they were purchasing was more expensive. Thus, the spread between FIFO and replacement cost was wider. The full $21 million impacted both GAAP and adjusted EPS, which (along with the inventory charge) helped drive adjusted EPS down to 38 cents:

	April 21	**April 20**	**April 19**	**April 18**	**April 17**	**April 16**
LIFO adjustment	$21.0	$8.4	$9.2	$4.3	$1.3	$3.1
LIFO reserve	$120.8	$99.7	$91.3	$82.1	$77.8	$76.5
Inventory	$736.8	$812.2	$761.0	$779.8	$711.9	$722.1

- In 2018, an inventory change reduced the adjustment and reserve level by $1.8mm
- The charge in April 2021 was $21.0 million, PDCO considered $12.0 million of it out of the ordinary and told investors to add back $12.0 million or 10-cents in Adj. EPS.

PDCO thought that the inflation seen in April 2021 was due to Covid as demand snapped back faster than supplies. The CFO told investors that this pent-up Covid mismatches in supply and demand would not recur and told them that $12 million of the $21 million LIFO adjustment should be viewed a one-time event.

At the end of January 2022, inventory was $868.7 million – 18% higher than April 2021. Let's not forget that PDCO wrote off $11 million of PPE inventory in 4Q21 and another $49 million in 1Q22 – so inventory is already $132 million higher and could be $181 higher without the $49 million write-off. DSIs were 63 for 3Q22, basically the same as 3Q21 – but inventory DSIs have been 7-8 days lower than before Covid. That could make the year ending inventory figure higher as well if PDCO rebuilds more stocks.

On its call this week, PDCO spoke about seeing higher prices for many products and manufacturers raising prices. That would seem to widen the gap between FIFO and LIFO further in addition to the higher inventory in dollar terms already. Also, the effective tax rate is increasing. A higher tax rate could impact the adjustment changes too as the primary reason for computing the FIFO/LIFO gap is to set up its deferred tax liabilities.

Our conclusion is PDCO could see its LIFO reserve rise by 12%-22% when it announces 4Q22 results. That is an increase in the reserve of $14.5 million - $26.5 million. That would show up as the LIFO adjustment. Looking at the charge for 4Q21 of $21.0 million, that doesn't sound too bad. HOWEVER, PDCO told investors in commentary on the 4Q21 quarter to ignore $12.0 million of the $21.0 million:

> *"Our fourth-quarter fiscal 2021 adjusted gross margin was 19.4%. During the period, we recorded two significant adjustments in our dental segments that negatively impacted our gross profit. The first was $11 million of COVID-related inventory adjustments [PPE charge] to account for higher amounts of certain infection control inventory, or prices have fallen as the impact of the pandemic is tampered in recent months.* ***<u>The second was our year-end LIFO adjustment, which negatively impacted our gross profit by $12 million in our dental segment; the significant LIFO adjustment was almost entirely due to the COVID-related pricing dynamics and variability in our infection control products during the year."</u>***

Remember – official adjusted EPS last year for 4Q21 was 38 cents. That 38 cent number expensed the full $21 million LIFO adjustment charge. It did not add back the $12 million of the LIFO adjustment management identified as unusual. They are asking investors to view 4Q21 not as 38-cents but as 57-cents which adds back the full $11 million of the PPE inventory write-off and $12 million of the $21 million LIFO charge. The estimate of 56 cents for 4Q22 looks very easy to beat viewed in the context that 4Q21 was actually 57 cents.

We agree – there is unlikely to be another inventory write-off. However, they are banking on a LIFO adjustment that will be $9 million or less in April 2022. From the current inflation issues, we think the adjustment could come in much higher than $9 million. That's where PDCO could miss forecasts.

We showed that a 12%-22% increase in the LIFO reserve would be $14.5 - $26.5 million. We think only $9 million is baked in the foecasts. So if the LIFO adjustment comes in $5.5-$17.5 million over that $9 million – it becomes a headwind to EPS of 4-13 cents for 4Q22. Would the company argue that the inflation is still not recurring and to adjust the adjusted EPS again?

Higher Priced Inventory and Receivables May also Hurt Cash Flow

As noted above, PDCO is running about 7-8 days below its normal inventory levels. Yet, higher costs are still making working capital a bigger cash drain. For the last seven quarters, PDCO reported negative cash flow from operations in each period and it is getting worse. The working capital impact is the primary reason and it is getting worse in our view, despite not being able to hold inventory at normal levels:

	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Working Cap	-$365.7	-$300.2	-$291.2	-$174.5	-$259.2	-$278.6	-$284.0
Cash Ops	-$295.1	-$225.6	-$313.4	-$125.6	-$181.9	-$193.2	-$229.8
Cap-Ex	$11.0	$7.8	$7.7	$4.7	$6.7	$8.0	$6.4
Collection DPP	$332.7	$270.4	$315.2	$199.5	$225.6	$269.4	$139.5
Free Cash Flow	$26.6	$q37.0	-$5.9	$69.2	$37.0	$68.2	-$96.7
Ending DPP	$316.4	$376.0	$383.4	$412.0	$370.5	$373.8	$407.7

PDCO securitizes receivables and factors financing contracts for equipment sales. These assets are sold for a combination of cash and a DPP (Deferred Purchase Price) receivable. The DPP is collected in arrears. It shows up in the investing section of the cash flow statement. PDCO nets it against cash from operations and capital spending to determine free cash flow.

As Covid began, many dentists were able to defer payments on equipment, which caused DPP to increase. The dentists then repaid the delayed payments along with current payments. The company has been collecting more DPP than it has been originating. Since April 2021, DPP is down almost $100 million, while free cash flow has only been $58.5 million. Without this excessive collection of DPP, free cash flow would have been negative in fiscal 2022. The company also had a small acquisition of $20 million that doesn’t show up in the table above as another cash drain.

On equipment sales, this has been the been the primary key to DPP collections exceeding new contract sales. That is just under $80 million of 2022’s cash flow through 9 months. That balance is down to only $149 million. Also, this is the area of sales where PDCO has seen the slowest rate of growth and the most supply chain issues. This may remain a source of free cash flow for a few more quarters, but the rate of change may slow. Inflation could continue hurting the cash flow situation by making working capital a larger drain.

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 he 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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