BEHIND
THE NUMBERS
Quality of Earnings Analysis
September 14, 2021

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Patterson Companies, Inc. (PDCO)
Earnings Quality Update- 6/21 10-Q

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 coverage of PDCO at 2- (Weak) and keeping it on our Top Sell list.

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

Summary

PDCO released its 10-Q for its 1Q22 results and we wanted to update our review. We saw that PDCO picked up $2.1 million in earnings y/y from a smaller loss on the securitization of receivables and a gain vs. a loss on the sale of finance contracts. This helped EPS by 1.6-cents.

As a quick review, PDCO beat estimates by 6-cents. This was helped by:

- A lower tax rate adding 2.3 cents
- Lower stock compensation adding 1.4 cents
- This swing in losses adding 1.6 cents
- An extra week of sales at their operating margin adding 2.8 cents
- And rounding up results by 0.2 cents.

The 10-Q did not reveal any further issues with LIFO accounting. In terms of the sustainability of the gains/lower losses from selling finance contracts, the 10-Q did point out that coming into the quarter, PDCO had $50.6 million of contracts it had not sold, and finished the quarter at only $19.1 million. That could make the income level realized from selling contracts in 1Q22 difficult to maintain in 2Q22.

PDCO does expect to report an $8 million gain in 2Q22 reflecting an insurance deal in settling a lawsuit. That should be removed from non-GAAP EPS, which is customary for PDCO to do.

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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