

Patterson Companies (PDCO) EQ Review

Current EQ Rating*	Previous EQ Rating
3-	na

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "-" sign indicates deterioration

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

We initiate earnings quality coverage with a 3- (Minor Concern) rating

Patterson has helped its cash flow in over the years by selling receivables. That cash was spent to reduce debt. However, it now faces a problem that it is near the limit of raising cash from those programs and receivables are paying more slowly. Thus, as business picks up after COVID, PDCO may see cash flow pressure from rising receivables on the balance sheet.

We believe recent earnings beats do not have much quality in them. Fiscal 4Q20 saw forecasts plummet before the quarter ended with COVID news. The animal business actually grew, PDCO slashed pay, hours, and travel, and it benefited from selling more PPE units. Plus, it booked 12-16 cents in EPS from a gain on selling receivables which looks out of the ordinary. Fiscal 1Q21 saw PDCO beat by 9-cents but picked up 15-cents in temporary cost savings management does not see as sustainable.

- **PDCO is adjusting its EPS to a greater degree. A few years ago, GAAP and Adjusted EPS had a 5% difference. It is now more common to have a difference of 30%. Even the adjusted figure has dropped from \$2.47 to \$1.55 in recent years.**
- **We think ROI is still very weak. It fell from 16%-18% to a low of 9.2% in fiscal 2019. It rebounded to 16.6% in fiscal 2020. However, a huge write-off of goodwill added over 500bp to ROI by cutting the equity figure. Selling receivables to pay down financed debt by \$200 million helped ROI by another 200bp.**
- **Cuts to marketing and bad debt expense added 2-cents and 4-cents in fiscal 2020. Those are included in both GAAP and Adjusted EPS.**
- **PDCO is still adding back integration and restructuring charges as one-time events even though the last acquisition was in 2015! At what point are those finally considered recurring. That added 12-cents back to 2020 earnings.**
- **PDCO also adds back the amortization of acquisitions each year and that added 30-cents to 2020 earnings. The problem we see is the deal was a cash outlay and they amortize internal assets over much shorter periods. Also, they assigned more of the deal's price to goodwill without amortization. Along with adding back transaction costs, integration, and restructuring – PDCO is essentially saying the acquisition was free.**
- **In 2020, PDCO wrote off all the goodwill for the animal unit where that large acquisition was placed. They blamed it on having COVID hit at the time they were doing the annual test – yet the unit was actually performing better at that time. This was a \$675 million write-off.**
- **More amazing to us is the animal unit had been faltering for years with no impairments taken. Plus, at the time they wiped all the goodwill out, they didn't see any impairments for the other intangible assets. It looked like a big-bath charge to us and it reduced the equity balance which makes ROI look better.**
- **A prior impairment in 2017 involved amortizing the cost of a 10-year deal over a period longer than 10-years. This was considered a one-time item also. We viewed that as the prior income was overstated by not matching the expensing to the term of the deal.**

- PDCO has been selling finance contracts on equipment it sells to banks for many years. The banks pay a discount on the contracts by giving the company cash and essentially a 10% residual piece of the deal that pays last called a DPP (Discounted Purchase Price).
- When these receivables are sold, PDCO books a gain on the sale. Normally this is about \$15-\$20 million per year. In 2020, it was \$44 million, with half occurring in the 4Q. We did not see a level of receivables sold to support this surge in the gain. This added at least 12-cents in 4Q EPS by our estimate and it appears unlikely to repeat. 1Q21 already posted a loss in this area.
- There is a max that PDCO can sell of \$625 million in this area. It has \$617 million outstanding there now. As business picks up after COVID, it may not be able to sell new receivables which will rise on the balance sheet. Also, the DPP residual amount is rising too as some customers had their payments deferred. This DPP is now over \$250 million compared to a normal level of about \$120 million. Those will become cash flow to PDCO in the future, but as of now they are still building and consuming cash.
- The last two years saw a new securitization program for trade receivables as well which has a max of \$200 million. It operates the same way, and PDCO is at a \$200 million balance. It is not going to pull more cash out of that area either.
- Cash flow has already been weak in recent years and the money pulled out of those programs was spent. Accounts payable had been a tailwind for cash flow too and that reversed in 1Q21. Looking more closely we can see why the \$500 million share repurchase deal set up in March of 2018 has not seen a single share bought yet.
- Working capital overall looks like receivables and payables have helped cash flow in the last three years. 1Q21 saw all accounts decline and while payables will increase and help cash flow with business improving, the asset accounts appear likely to increase too. Until the DPP starts to pay down, PDCO may see cash pressure because they could be unable to sell the same amount of receivables y/y.
- The company also warns of some pressures on its ability to receive rebates from suppliers and its customers earning more rewards from it. We only point this out as an issue to monitor because the margins are so low here and 10bp of pressure is worth about 5-cents in annual EPS for a company with an adjusted EPS of \$1.55.

Earnings Getting More “Adjusted” and ROI still Falling

COVID certainly led to some additional items coming through results, but we think investors should be concerned that the spread between GAAP and Adjusted EPS at Patterson has been growing for years. From 5%-7%, the adjustments have become 30%-60% of reported EPS:

Fiscal year April	f2020	f2019	f2018	f2017	f2016	f2015	f2014
GAAP EPS	-\$6.25	\$0.89	\$2.16	\$1.82	\$1.90	\$1.81	\$1.69
Adjusted EPS	\$1.55	\$1.40	\$1.68	\$2.34	\$2.47	\$1.90	\$1.82
Adjusted % EPS	-124.80%	57.30%	-22.22%	28.57%	30.00%	4.97%	7.69%

COVID impacted the last few weeks of f2020, which we will discuss below – but the return on capital at PDCO has been falling steadily for years. These are on the adjusted figures and we can show several areas where ROI should actually be viewed as even lower:

Fiscal year April	f2020	f2019	f2018	f2017	f2016	f2015	f2014
Adj. Op. Income	\$236.7	\$204.2	\$267.0	\$372.4	\$408.0	\$316.8	\$390.1
Debt	\$587.8	\$749.3	\$1,014.6	\$1,072.0	\$1,058.7	\$722.5	\$725.0
Equity	\$836.4	\$1,480.5	\$1,461.8	\$1,394.4	\$1,441.7	\$1,514.1	\$1,471.7
Adj ROI	16.6%	9.2%	10.8%	15.1%	16.3%	14.2%	17.8%

A quick look shows that debt has been declining to help reduce the denominator. This is largely from securitizing receivables. Also, equity was impacted by \$675 million in goodwill impairments in 2020. Without those events cutting the capital figure, ROI would be about 9.5% still.

Looking at the last two quarters with COVID – PDCO has managed to beat forecasts handily. This has been a combination of first, COVID not closing production animal facilities early on and higher income in 4Q for that unit added 3-cents. PDCO also cut pay, hours, furloughed employees, stopped meetings and travel, and also enjoyed some expected bump from selling PPE equipment. It did not quantify this but the estimate also fell noticeably after COVID began and dentists shut down in late March and April. They announced that PPE sales were much higher than expected.

For 4Q20, Estimates fell from about 40-cents to 17-cents. PDCO then beat by 26-cents with an adjusted 43-cents. We know it added 3-cents from a surge in animal sales. We also know it slashed costs for about one-third of the quarter and had a jump in PPE sales. That looks like a case where the street expected the whole business to close and didn't happen.

For 1Q21, adjusted EPS came in at 33-cents, beating estimates by 9-cents. During that period, PDCO announced dentists reopened sooner than expected. More importantly, the COVID cost-cutting that it does not consider sustainable added 15-cents.

The Adjustments Include Several On-going Costs and Likely Short-Lived Items:

Looking at some easy ones to find from fiscal 2020 that helped results, PDCO cut marketing and bad debt expense:

	f2020	f2019	f2018
Bad Debt Exp.	\$2.0	\$7.3	\$6.3
Marketing	\$5.8	\$8.4	\$6.9

These are reported annually, so they do not drive quarterly earnings. It's worth pointing out PDCO gained 4-cents in EPS during 2020 from cutting bad debt expense and another 2-cents in EPS from cutting marketing. We know the bad debt allowance rose in 1Q21 from \$5.1 million to \$5.9 million. Those positive impacts on EPS were not added back. However, here is what PDCO is adding back:

EPS Adjustments	f2020	f2019	f2018	f2017	f2016	f2015	f2014
Amortization of Deals	\$0.30	\$0.31	\$0.29	\$0.27	\$0.26	\$0.08	
Integration/Restr.	\$0.12		\$0.06	\$0.04	\$0.05		\$0.13
Transaction Costs					\$0.01	\$0.11	\$0.01
Impairments	\$6.74			\$0.24			
Legal Costs	\$0.78	\$0.22					
One time Gain	-\$0.27						
Accelerated Debt Cost	\$0.08				\$0.03		
Tax Items		-\$0.03	-\$0.82	-\$0.05	\$0.13		
Adjusted EPS	\$1.55	\$1.40	\$1.68	\$2.34	\$2.47	\$1.90	\$1.82

We are fine adjusting for a one-time gain and early amortization of debt costs for retiring debt early. We also know that the primary tax issues relate to the tax reform in 2017 that impacted nearly every company.

The legal costs relate to a \$58.3 million fine and settlement in 2020 for selling products the customers were not licensed to receive in the inventory. We consider that one time in nature. In 2020 and 2019 there were also legal costs of \$17.7 million and \$28.3 million to settle lawsuits the company acted in an uncompetitive way on pricing and allowing access to products. Those may also be one-time in nature.

The rest of the charges relate to acquisition accounting. We have several problems with this:

- There has not been an acquisition in five years (during fiscal 2016). Yet, PDCO is still reporting integration/restructuring charges for those businesses. During and just after the deals, PDCO reported 9-cents of charges in 2016 and 2017. It's now reporting 6-cents and 12-cents in 2018 and 2020.
- Long amortization leads to first write-off in fiscal 2017. In 2006, PDCO signed a 10-year exclusivity deal with Sirona Dental Systems and paid \$100 million for it. One would think that the \$100 million payment was amortized over the term of the deal. Instead, when the deal was not extended again – PDCO wrote off the remaining \$36.3 million (\$23.0 million after taxes or 24-cents) of the \$100 million. PDCO essentially inflated income by \$2.3 million annually for those 10-years by not matching the amortization term to the length of the contract. So, prior income was boosted – and then the write-off is considered one-time in nature and added back as though it didn't happen. It definitely was a cash cost.
- PDCO's largest deal was Animal Health International for \$1.1 billion in June 2015. It allocated \$518 million to goodwill and \$434 million to intangible assets. This deal was bought with cash and they are only expensing about 40% of the price. And yet, PDCO is treating this as both a one-time cost every year that it adds back the amortization. This is the first reason we think this should not be added back.
- We are again concerned that the amortization lives are too long. PDCO depreciates/amortizes computer hardware and software over 3-10 years and other equipment over 5-10 years. Many customers acquired organically would have had those costs expensed as incurred. Compare that to this amortization schedule:

Amortization Lives	Estimated Life	Amount
Customer Relations	15 years	\$291.9
Tradenames	10 years	\$111.4
Developed Tech	12.2 years	\$18.7

Doubling the rate of amortization would add \$32 million to annual expense. Suddenly, PDCO would be arguing that half their EPS is the result of ignoring that amortizations have any cost at all (adding back deal amortization, a higher level of that, plus integration costs) – even as they ignore the cost of 47% of the deal completely as goodwill. ROI would drop about 200bp by simply keeping the current amortization in place and another 200bp if it amortization tied more closely to other assets.

- We don't have to look too far back to see that long lives or eternal lives for these acquired assets was unrealistic. In 4Q20 (April), PDCO wrote off \$675 million of goodwill from acquisitions at the same time the division improved. The company noted that COVID was a big reason for lowering management forecasts for future revenues and cash flows for this goodwill and that led to the write-off. Given that they wrote off nearly all goodwill, it was glaring as the big-bath charge rather than let it become an annual charge. They seemed to get busted on it on the conference call too:

Kevin Caliendo

“One quick follow-up. So, the goodwill impairment, the \$675 million in Animal Health, it's your estimate of lost future cash flows due to COVID, yet Animal, the Animal Health business hasn't really been impacted as much as Dental. Was there any contemplation of taking any kind of charge or goodwill charge in Dental, or was this just a reflection of like lost business or a lost customer? Can you just sort of help reconciles that a little bit?”

Don Zurbay

“I think, you have to look at that. It's really an accounting calculation. And I think the COVID impact is – at the time when we do our annual impairment test, we

happened to be in the middle of COVID, so there was probably an outsized impact at that time.”

- We think investors should be asking two questions. The first is this business has been getting weaker for years, but there was never an impairment until now?

Animal Unit	f2020	f2019	f2018	f2017	f2016
Sales	\$3,336.5	\$3,354.5	\$3,242.6	\$3,159.8	\$2,862.2
Op. Income	\$102.9	\$81.5	\$78.1	\$88.1	\$94.3
Margin	3.1%	2.4%	2.4%	2.8%	3.3%

Second, if essentially all the goodwill was considered impaired after 5-years, why wasn't any of the other intangible assets impaired?

- We believe that this \$675 million write-down became a \$640.6 million reduction to the equity balance. That alone had a huge positive impact on ROI. We showed above that the adjusted results for fiscal 2020 posted an ROI of 16.6%. Without the goodwill write-off, ROI would have been 11.5%. As noted above adding back the amortization is helping ROI by another 2.0% also.

Sales of Receivables – Impact for Earnings and Cash Flow

PDCO sells consumable products for dentists and vets like porcelain products for fillings or heartworm medicine for vets. Those are smaller in price, but customers buy them more frequently. PDCO also sells equipment products like X-Ray machines or the machines that make new crowns for teeth. Those are more expensive and it will finance customers for those sales with interest over time.

For many years, PDCO has been selling a large amount of the equipment financing contracts. The way this works is they sell the receivable for cash. There are two banks it works with for a total of \$625 million in availability. In both cases, the banks pay less than face value for financing contracts and leave a PDCO subsidiary with a DPP – Deferred Purchase Price receivable. This is essentially a cushion for the banks that will be paid last. This DPP is based on the credit quality of the finance receivable and is a minimum of 9.5% at one bank and 11% at the other.

PDCO collects cash upfront on the sale of the finance contracts and recognizes a gain on the sale and that flows into revenues. Over time, it will collect additional cash as the contracts are repaid and the DPP amount is repaid as well. Let's look at where this program stands:

Sale of Contracts	1Q21	1Q20	f2020	f2019	f2018	f2017	f2016
Gain Recorded	-\$0.3	\$7.3	\$43.9	\$16.9	\$13.3	\$20.6	\$30.1
Amount Sold	\$50.1	\$66.3	\$357.6	\$279.6	\$312.7	\$358.0	\$359.6
O/S balance	\$617.5	\$565.8	\$613.6	\$577.2	\$617.6	\$613.6	\$601.0
DPP	\$252.2	\$110.8	\$228.0	\$121.7	\$150.4	\$119.8	\$108.8

- The amount that can be sold is \$625 million – PDCO has essentially been above \$600 million in Outstanding Balance for years. Therefore, **new receivables sales are replacing collected receivables at this point. This is not generating an increasing amount of cash flow as it would have in the early days when selling \$300 million one year against \$0 the prior year had a large impact on boosting cash flow.** Selling \$300 million each year results in a flat contribution to cash flow.
- **COVID relief allowed some customers to defer payments for three months. Thus, PDCO may have a period during 2Q21 and 3Q21 where they cannot sell as many new contracts because past contracts do not repay as originally planned.** Thus, the company runs into the \$625 million cap and sees fewer receivable sales – that could hurt cash flow in the near term. Basically, if they sell \$150 million this year vs. \$357 million last year – receivables would increase on the balance sheet and consume cash flow.
- **The DPP balance has ballooned for 4Q20 and 1Q21 – it is running double of other recent years.** That also shows that if customers are receiving deferrals on payments – they are using it and as the last to be paid, PDCO's deferred receivable is rising. **Eventually, this should represent a source of rising cash flow. The timing is simply not clear.**
- We also think investors should notice the size of the gain booked in fiscal 2020. The gains have been running \$15-\$20 million per year and suddenly in 2020, PDCO books \$44 million. The amount of receivables sold was a tad higher – but is \$20 million of that unsustainable? \$20 million would be 16-cents of EPS in 2020 generated

by an unsustainable source. **For just 4Q20 – remember that huge Adjusted EPS beat – the gain on sale was \$21.7 million vs. \$22.2 million for the prior 9-months.** The year before, the gain in 4Q19 was only \$5.1 million with \$11.8 million realized in the previous 9-months. Notice that the gain became a loss in 1Q21. Also, if PDCO is unable to sell the same dollar amount of receivables in the coming quarters as past receivables repay more slowly than planned – that should also push down the size of the gain reported.

In the last two years, PDCO has started selling normal receivables as well – those without a finance contract – representing smaller amounts per receivable. This is a securitization program with a maximum amount available of \$200 million. It also operates with a Deferred Purchase Price receivable that pays last to PDCO.

- The first transaction happened in fiscal 2019. PDCO sold \$237.6 million in receivables and received \$171.0 million in cash and a DPP of \$65.9 million.
- The second transaction in fiscal 2020 moved \$120.1 million in receivables off the balance sheet, gave PDCO an additional \$29.0 million in cash and maxed out the program. The DPP was \$117.3 million in April 2020.
- Much like the first program, the DPP is growing under COVID and was \$155.6 million at the end of 1Q21. So, while these receivables likely turn faster, they are maxed at \$200 million and the DPP growing should limit how much PDCO can run through this process and also cause receivables to increase on the balance sheet.
- Unlike the first program, PDCO is not recognizing gains on the sale but losses:

Sale of Contracts	1Q21	1Q20	f2020	f2019
Loss on sales	-\$2.3	-\$1.5	-\$7.2	-\$7.6

Our take-away from selling all the receivables is PDCO has already reaped the benefit of pulling cash out of these programs. The \$200 million pulled out of the more recent securitization program paid down fixed debt. If we look back at the first table in this report and assumed debt was \$200 million higher in 2019 and 2020 – this would reduce ROI from 16.6% to 14.6% - down by 200bp. And, we know from the discussion of the goodwill write-off reducing equity – that added 510bp to ROI. **We are going to say that even using the**

adjusted operating income and not backing out the super-sized gain on sale in 4Q20 for receivables sales, the cuts to marketing or bad debt – ROI in fiscal 2020 was closer to 9.5%. Then again, remember adding back amortization of intangibles is keeping ROI from being 7.5%.

The other issue is this one-time source of cash flow – seems likely to be a headwind on cash flow in 2Q21 and 3Q21 through a combination of not being able to sell as many receivables and having the DPP increase on them.

Is it any wonder why PDCO has had a \$500 million share repurchase plan in place since March of 2018 and has not bought a single share with it? You can blame COVID for the last two quarters, but they were not buyers in the two years prior to that either.

Cash Flow	1Q21	1Q20	f2020	f2019	f2018
CFO Reported	-\$229.8	-\$45.2	-\$243.5	\$48.2	\$178.9
Collected DPP	<u>\$139.5</u>	<u>\$105.7</u>	<u>\$540.9</u>	<u>\$402.4</u>	<u>\$49.7</u>
Adj. CFO	-\$90.3	\$60.5	\$297.4	\$450.6	\$228.6
Capital Exp.	<u>\$6.4</u>	<u>\$8.9</u>	<u>\$41.8</u>	<u>\$60.7</u>	<u>\$43.3</u>
Free Cash Flow	-\$96.7	\$51.6	\$255.6	\$389.9	\$185.3
Dividend	\$0.0	\$25.5	\$100.4	\$99.5	\$99.2

- The dividend in 1Q21 was paid after the quarter.
- The 2020 and 2019 figures include the \$200 million in cash received from the securitization that was used to repay debt.

If we look at other parts of working capital and refine this a bit more, we see that without selling the additional receivables and boosting payables, and inventory changes – cash flow looks even weaker:

Cash Flow	1Q21	1Q20	f2020	f2019	f2018
Free Cash Flow	-\$96.7	\$51.6	\$255.6	\$389.9	\$185.3
Cash From A/R	\$17.6	\$90.3	\$53.8	\$249.5	\$26.4
Cash from Inv	\$111.7	-\$48.6	-\$59.3	\$11.5	-\$60.5
Cash from A/P	<u>-\$312.4</u>	<u>-\$23.0</u>	<u>\$219.6</u>	<u>\$44.2</u>	<u>-\$12.1</u>
Adj FCF	\$86.4	\$32.9	\$41.5	\$84.7	\$231.5

- In fiscal 2019, the big sale of A/R drove cash flow
- In fiscal 2020, a surge in A/P drove cash flow

- In 1Q21, weak sales released Inventory, but also led to big payments on A/P and hurt cash flow.

Overall, we think cash flow looks weaker than reported even before COVID. As business returns to normal, A/P will likely increase but so will A/R and Inventory. What else can they monetize out of working capital?

Working Capital Ratios in More Detail

PDCO is touts that's working capital management has improved DSOs on receivables significantly over the last three years. But we know they simply sold \$200 million of receivables and moved them off the balance sheet. When we adjust for that, DSO's have improved by 7-9 days. But, that's a far cry from PDCO's statement they dropped from 53 days to 29. Here are all the stats:

Working Cap.	1Q21	4Q20	<u>3Q20</u>	<u>2Q20</u>
DSO	59.7	59.0	51.6	56.5
DSI	64.4	74.7	69.1	64.3
DSP	50.6	79.3	64.0	62.6

Working Cap.	1Q20	4Q19	<u>3Q19</u>	<u>2Q19</u>
DSO	55.2	56.9	55.2	55.7
DSI	71.1	61.8	70.3	65.2
DSP	55.0	52.6	57.2	54.5

Working Cap.	1Q19	4Q18	<u>3Q18</u>	<u>2Q18</u>
DSO	55.5	62.7	65.4	63.2
DSI	73.3	64.1	71.7	67.9
DSP	51.0	50.1	55.3	54.1

The COVID shut-down did what we would expect, cause the stats to rise at the end of 4Q20 and then fall as working capital falls with sales in 1Q21. We think investors should be mildly alarmed that PDCO was growing its payable balance and cutting receivables over the last three years. Given that both those movements help cash flow and their cash flow has been getting weaker without sales of receivables, that is a red flag for us.

Going forward we know that payables should pop again and add some cash, but inventories need to increase too. These two accounts are likely to net positive for cash flow there with some return to normalcy. However, cash from receivables could well be a headwind for a few more quarters. They have little room to move new receivables to their banks until the large DPP balance pays down. But if they sell more equipment and supplies, receivables should rise on the balance sheet and consume cash.

It's not simply a matter of seeing sales recover. Higher sales will lead to building working capital and could make cash worse before these issues are worked through.

Rebates and Rewards May Pressure Margins Too

This is a longer-term issue and we just want to highlight these risks from the 10-K. Basically, PDCO earns rebates for buying higher volumes of inventory from its suppliers and that helps margins. Also, it offers rewards to its own customers for buying more volumes too and that can pressure margins. Keep in mind, their adjusted operating margin is only 4.3%. A 10bp change is worth about 5-cents in annual EPS, which was \$1.55 last year.

- PDCO customers are consolidating – which could lead to more qualifying for discounts from PDCO. These discounts would reduce revenues: *“In addition, in recent years there has also been **a trend towards consolidation in the industries that buy our products and services, including the consolidation of dental practices into larger clinics and dental service organizations, the consolidation of veterinary practices as well as producers, and the formation of group purchasing organizations, provider networks and buying groups designed to leverage volume discounts.**”*
- PDCO sees the availability of companion pet products to many other outlets that may not buy from PDCO. That may hinder PDCO's ability to earn volume rebates from suppliers of those products: *“Companion animal health products are becoming increasingly available to consumers at competitive prices from sources other than veterinarians, including human health product pharmacies, Internet pharmacies and big-box retailers, and consumers are increasingly seeking such alternatives sources of supply for their companion animal health products. Companion animal owners also could decrease their reliance on, and visits to, veterinarians as they rely*

more on online animal-health information and retailers that now offer basic veterinary services”.

- The rebate targets needed may increase as well as other distributors selling at lower prices or manufacturers selling directly: Industry consolidation has also adversely affected and may continue to adversely affect our margins and product availability. *There has been increasing consolidation among manufacturers as well as distributors, which could cause the industry to become more competitive as greater economies of scale are achieved by competitors, or as competitors with lower-cost business models are able to operate with lower prices and gross profit on products. We also face pricing pressure from branded pharmaceutical manufacturers. These competitive pressures could adversely affect our sales and profitability.*
- PDCO also sells its own exclusive private label products. Those could take share from branded products and hurt its ability to earn rebates or have suppliers turn away from PDCO.

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 Concerns"	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 may 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 the next quarter. 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.

Disclosure

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