BEHIND THE NUMBERS
Quality of Earnings Analysis

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Patterson Companies, Inc. (PDCO)
Earnings Quality Update- 7/21 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 coverage of PDCO at 2- (Weak) and are moving it back to our Top Sell list.

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

Summary

Another quarter and more unimpressive results in our view from PDCO. The company beat reduced forecasts for adjusted EPS by 6-cents for fiscal 1Q22. It then only raised the low-end of guidance by 5-cents (after fiscal 2022 guidance was cut from $2.10 to a range of $1.90 - $2.05). Guidance is now $1.95-$2.05 so the midpoint only rose 2.5 cents vs. the 6.0 cent beat.

On the surface, several issues fully explain the 6.0-cents:

- Lower tax rate added 2.3 cents
- Less Stock compensation added 1.4 cents
- An extra week added 2.8 cents based on PDCO's adjusted operating margin
- Results were rounded up by 0.2 cents

The 10-Q is not available yet and we will need that to determine gains on the sale of equipment contracts and if that impacted margins and EPS as well as more closely see the components of DPP and receivables. Any inventory issues that were so prevalent in 4Q may have commentary in the 10-Q.

What is strong?

Inventory levels have increased. They rose to $770 million, allowing DSI's to rise to 57 up from 4Q's 53. That is still very low for PDCO, as normally 1Q ends with DSI's above 70 days. But perhaps this is moving in the right direction.

What is weak?

Adjusted Gross Margin was down to 20.2% in 1Q22. That is important because it was 21.0% in 4Q21 – after adding back the LIFO charge and the write-down of PPE inventory like PDCO advised. We noted last quarter that the inventory charges could have pulled future COGS into 4Q and help drive gross margin in 1Q. PDCO also had an extra week which could have leveraged some costs further. On the call, management said inflation is nothing significant – but it looks to us like that may be pushing down gross margins.

Cash flow looks weak despite a surge in DPP collections of previously sold receivables. PDCO adds the DPP collections into free cash flow and the figure is still negative at -$6 million for 1Q's FCF before acquisitions. That is with inventories still very low at 57 days vs. 70 and receivables are down to 48 days vs. 55 days. We could certainly see both accounts needing to increase further and be a headwind for cash flow. Plus, DPP collections likely will normalize at lower levels and further hurt cash flow.

We are also stunned at how poor the Protective Equipment (PPE) market results have become for the company so quickly:

- This market began in 4Q20 (ending April 2020) with a discussion that the market size could double and there could be an incremental $1 billion in PPE sales to dentists industry-wide.

- 1Q21 (ending July 2020) – PDCO said total PPE sales were less than 20% of dental consumable sales of $256 million – 19% of that would be $48.6 million. Actual growth was 7% of consumables or $21.5 million.

- 2Q21 (ending Oct. 2020) – PDCO said higher PPE sales were the cause for 12% of higher dental consumables sales – which was $36.5 million.

- 3Q21 (ending Jan. 2021) – PDCO said growth in PPE sales was $33 million of the reported $41 million of dental consumables growth.

- 4Q21 (ending April 2021) – PDCO said growth in PPE sales was only $13 million compared y/y to a period with likely little growth in PPE as dentist offices were shutting down in March/April 2020. PDCO also took an $11 million write-off of PPE inventory saying pricing has dropped in that market. **However, it assured investors on June 23 – just over 5-weeks before 1Q22 would end that it saw the PPE market stabilizing.**

- 1Q22 – **PDCO said consumables without the 53rd week were up 13.7% from pre-Covid 1Q20, with PPE 7.4% of that growth. That would translate to higher PPE sales of $22.5 million for 1Q22 vs. 1Q20. But remember, 1Q21 already had about $21.5 million in growth for PPE compared to 1Q20. That sounds like incremental PPE growth was only $1 million in 1Q22 y/y.** Also, PDCO took a $49 million write-off of PPE inventory, which it gave away to charity in the quarter.

Our conclusions on PPE sales for PDCO:

- PDCO's dental business has about a 4% operating margin. They picked up a total of $105 million in incremental PPE sales with Covid – generating an incremental pretax profit of $4-$5 million.

- At the same time, they managed to take $60 million in write-offs earning that incremental $4-$5 million – and this was a business they were already in!!

- Investors are supposed to add back all these charges – because they are non-cash and one-time in nature. The fact is they paid cash for these assets only a matter of weeks or months ago. The $49 million charge in 1Q tells us they didn't come close to valuing this inventory at the lower of cost or market after 4Q. Plus, EPS for 4Q was 38-cents which required adding back 9-cents in inventory charges. 1Q EPS was 43-cents which added back 38-cents.

- Look at the comps they have coming up in this area. They just topped last year's 1Q of $21.5 million in growth by only $1 million. Now they face lower selling prices in what sounds like an over-supplied market and comps of $36 and $33 million for 2Q and 3Q.

Plus when you look closely, PDCO has a history of huge charges and write-offs over several issues. Yet, the basics are PDCO makes 40-50-cents per quarter as non-GAAP EPS, which already requires it to add back 30-cents per quarter of acquired intangible amortization and often 1-3 cents in restructuring/integration charges:

- 1Q22 – Litigation settlements will be paid in cash – but PDCO added back 28-cents.
- 1Q22 – PPE inventory after prices drop donated – PDCO added back 38-cents.
- 4Q21 – PDCO takes a larger than normal LIFO charge – added back 10-cents.
- 4Q21 – PDCO writes down PPE inventory – added back 9-cents.
- 4Q20 – Goodwill impairments of $6.72 per share - $675 million only 5-years after making the acquisition.
- 3Q20 – Litigation reserves added back 2-cents
- 2Q20 – Litigation reserves were 62-cents of added back EPS.
- 1Q20 – Litigation reserves were 14-cents of added back EPS.

What to Watch?

Can Animal Division sales keep growing? PDCO saw early Covid cause livestock herds to drop and lockdowns led more people to get a pet. New pets need shots and some early vet visits. PDCO does not break down sales between companion and production animals in dollar terms, but it does discuss some of this on the call. For example, in 4Q20, they noted companion animal sales fell by double digits in April 2020. They have been increasing since. We think the easy comps are gone and animal sales appear to have turned down sequentially in 1Q21:

	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Total Internal Animal Sales	$946	$971	$899	$907	$816	$859
Total Internal growth rate	16.5%	13.8%	10.0%	6.9%	-0.2%	-0.8%
Companion growth rate	23.0%	29.6%	20.7%	12.0%	pos	down

The internal growth rate for the full division is in the press releases and it adjusts for acquisitions, the extra week, and accounting changes. We used that rate of growth to compute the y/y total dollar figure for internal animal sales. The company gives the companion animal growth rates on many of the calls. In 1Q21, they only said it grew and in 4Q20 it was negative.

Part of the growth in later 2021 was the rebuilding of livestock herds also. Just eyeballing this, it looks like a normal quarter is about $925-$950 million now. And, the comps get much tougher going forward. Internal growth could drop to 2%-5% and turn negative in 4Q.

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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