BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Perkin Elmer (PKI) 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

Our biggest concern with PKI is the trend of rising accounts receivable which management which the company has admitted is at least partly due to extending payment terms. Note that this was a pre-COVID development and not related to helping struggling customers. Acquisitions are also a key contributor to growth and consume large amounts of cash but the company adds back its growing amortization expense to non-GAAP results. Acquisitions will likely play a key role in the future as organic revenue growth fell from 8% in 2018 to 5% in 2019.

- PKI's accounts receivable days posted year-over-year increases ranging from 5-9 days in each of the last five quarters. The company admitted in its 9/19 10-Q that this was partly due to "increased terms" which indicates the company could be artificially boosting revenue by extending more generous payment terms to customers. We estimate a 5-day increase in DSOs represents an approximate 5 cps in earnings boost for a quarter. This material tailwind could disappear or even reverse in upcoming quarters.

- The company has made several acquisitions over the last three years. On the positive side, PKI is not dependent on acquisitions to drive the majority of its growth. For fiscal 2019, reported revenue growth was 4% which included only a 1% impact from acquisitions and divestitures and a 2% decrease from currency implying a 5% organic growth rate. Likewise, in fiscal 2018, reported sales rose by 16% with 8% still intact after adjusting out acquisitions and currency. However, free cash flow has not covered spending on dividend, buyback, and acquisitions for any of the last three fiscal years.

- Given the ongoing nature of the company's acquisitions and their impact on cash flows, we take issue with the company's practice of adding back the amortization of acquired intangibles to its non-GAAP results. Acquisitions have led to a buildup in goodwill and intangibles which now amount to 67% of PKI's total assets. Amortization of intangibles amounted to 27.6% of non-GAAP operating income in fiscal 2019, up from 25.8% in 2018 and 17.5% in 2017. Pretax ROIC on adjusted operating income was a little over 13% in fiscal 2019, but this falls to 9.5% if amortization is considered. These figures are similar for industry peer TMO but nonetheless indicate the degree to which returns are overstated by the exclusion of a key expense.

- The company does not give a range of useful lives for its intangible assets in its discussion of accounting policies. However, based on the mix of intangible assets and weighted-average useful lives disclosed for specific acquisitions, we estimate the company is using approximately 10-11 years to amortize its customer lists and acquired medical technology assets. While we often criticize amortization periods of longer than 3-5 years for information technology assets, 10 years is not unreasonable for medical-related technology assets. For reference, industry peer TMO has used 13 years for medical technology assets and 14 for customer lists in recent deals.

Accounts Receivable Are Rising

PKI has seen a steady rise in its accounts receivable days of sales for the last five quarters as shown in the following table:

	4/05/2020	12/29/2019	9/29/2019	6/30/2019
Sales	$652	$805	$707	$723
Trade Receivables	$626	$725	$646	$654
Trade Receivables Days of Sales	94.1	81.9	83.2	82.4

	3/31/2019	12/30/2018	9/30/2018	7/01/2018
Sales	$649	$756	$674	$703
Trade Receivables	$624	$633	$551	$564
Trade Receivables Days of Sales	87.5	76.1	74.4	73.0

	4/01/2018	12/31/2017	10/01/2017	7/02/2017
Sales	$644	$642	$554	$547
Trade Receivables	$576	$552	$441	$440
Trade Receivables Days of Sales	81.4	78.3	72.3	73.3

We can see that the YOY increases started in the 3/19 quarter. Late in the 12/17 quarter, the company acquired EUROIMMUN for $1.4 billion. While the company does not disclose the amount of the purchase price allocated to receivables, it does indicate that $121 million was added to current assets with much of that likely being comprised of receivables. An addition to receivables with only a few days of sales recorded in the quarter would have lifted the DSO calculation in the 12/17 quarter. Consider the company's explanation for the increase in receivables from the last several liquidity sections of its SEC filings:

From the 3/19 10-Q:

> *"The decrease in accounts receivable was a result of accounts receivable collections during the first three months of fiscal year 2019"*

-Keep in mind that this is referencing the sequential decrease in receivables from the 12/18 to the 3/19 quarter. PKI typically sees a sequential decline in receivables in the first quarter. Still, receivables were noticeably higher relative to revenue compared to the year-ago quarter.

From the 6/19 10-Q:

> *"The increase in accounts receivable of was a result of higher sales volume during the first six months of fiscal year 2019"*

This explanation seems a little lacking considering sales growth was less than 3% in the quarter. The 6/19 quarter was the second full quarter of EUROIMMUN results. Our DSO figure is calculated using annualized quarterly sales so neither the 3/19 nor 6/19 figures were distorted by sales not reflecting a full period of revenue from acquired operations. The year-over-year comparisons at that point would be impacted only to the extent that EUROIMMUN's operations inherently carried a higher level of receivables. If that were the case, we would have expected the company to mention that as a factor for the 9-day year-over-year increase in DSO in the 6/19 quarter.

From the 9/19 10-Q:

> "The increase in accounts receivable was a result of higher sales volume **and increased terms during the first nine months of fiscal year 2019."**

Here is where it gets interesting. DSOs in the 9/19 quarter increased by 6 days versus the 9/18 quarter (down from the 9-day YOY increase in the 6/19 quarter) **but the company admits for the first time that the increase in receivables for the first nine months was partly a result of increased payment terms most likely extended to customers to spur revenue growth. The company gave the same explanation in the 10-K for the receivables increase for the full year.**

From the 3/20 10-Q:

> *"The decrease in accounts receivable was a result of strong accounts receivable collection during the first three months of fiscal year 2020."*

Accounts receivable did decline sequentially in the 3/20 quarter, but this was partly due to a sequential decline in revenue from the COVID-related slowdown. Still, receivables ended the quarter at a historically high level relative to sales.

The concern we have is the degree to which revenue growth over the last several quarters has been artificially boosted by the extension of more generous credit terms. To put this in perspective, 5 days of receivables represents about $40 million in revenue. Using a 20% operating margin and a 15% marginal tax rate, that implies a potential 5 cps boost to EPS for a 5-day jump in quarterly DSO. Extending terms has

likely been a very material tailwind to earnings growth in 2019 which could reverse in upcoming quarters.

Cash Flow After Acquisitions Is Regularly Negative

PKI has made regular acquisitions over the last few years including the following:

Fiscal Year 2019

Five acquisitions for a total of $433.1 million in cash. These included Cisbio Bioassays SAS, a French company acquired for $219.9 million and Shandong Meizheng Bio-Tech, Ltd, and Chinese company acquired for $166.5 million

Fiscal Year 2018

Four businesses for a total of $105.8 million with no details given by the company

Fiscal Year 2017

PKI purchased EUROIMMUN for $1.4 billion plus two other acquisitions including Tulip Diagnostics for $127.3 million

On the positive side, PKI does not depend on acquisitions to drive the majority of its growth. For fiscal 2019, reported revenue growth was 4% which included only a 1% impact from acquisitions and divestitures and a 2% decrease from currency implying a 5% organic growth rate without acquisitions or currency. Likewise, in fiscal 2018, reported sales rose by 16% with 8% still intact after adjusting out acquisitions and currency.

On the downside, PKI's acquisition string has more than consumed free cash flow after the dividend and buyback for the last three fiscal years, as seen in the table below:

	12/29/2019	12/30/2018	12/31/2017	01/01/2017
T12 Operating Cash Flow	$363.469	$311.038	$288.453	$350.615
T12 Capex	$76.331	$93.253	$39.089	$31.702
T12 Free Cash Flow	$287.138	$217.785	$249.364	$318.913
T12 Dividends	$31.059	$31.009	$30.793	$30.799
Dividend % of Free Cash	10.8%	14.2%	12.3%	9.7%
T12 Net Stock Repurchases	$6.313	$57.445	$3.834	$151.801
Cash Flow after Buyback	$249.766	$129.331	$214.737	$136.313
T12 Net cash for acquisitions	$405.405	$97.686	$1,527.183	$71.924
Cash After Buyback and Acquisitions	-$155.639	$31.645	-$1,312.446	$64.389

It has also led to a buildup in goodwill and intangibles which now amount to 67% of PKI's total assets. This is not dissimilar to many other companies in the medical diagnostics industry such as TMO. Also like most of its peers, PKI adjusts the amortization of acquired intangibles out of its non-GAAP earnings numbers. Amortization of intangibles amounted to 27.6% of non-GAAP operating income in fiscal 2019, up from 25.8% in 2018 and 17.5% in 2017. While omitting amortization from intangibles from non-GAAP results is typical, we believe it is nonetheless a distortion of the true earnings power of the company, especially considering the company has spent more than its excess cash flow on acquiring these assets over the years. If it had not done so, it would have had to develop these technologies and relationships in-house and incurred expenses that analysts would not have found acceptable to ignore. To put this in perspective, PKI's return on capital using non-GAAP operating income was a little over 13% in fiscal 2019, but this figure drops to 9.5% after subtracting amortization expense from the numerator.

While the company ignores amortization expense, we think it is still informative to look at the estimated useful lives of acquired intangibles it uses to calculate amortization expense. PKI does not give a range of useful lives for its intangible assets in its description of its accounting policies. However, it does give the weighted average useful lives used to amortize the intangibles assets picked up by acquisitions each year. For example, the 2019 acquisitions resulted in approximately $37 million of intangible assets being booked with 77% being booked as "core technology", 4% as "trade names" and 19% as customer relationships. The weighted average amortization period for all the 2019 intangibles was 11.0 years. The mix of intangibles acquired in 2018 was similar in mix and resulted in an 11.2-year average amortization period. In 2017, the EUROIMMUN acquisition resulted in 78% of

acquired intangibles being booked as “customer relationships” with 18% booked as “core technology” and the balance as “trade names.” However, the weighted average useful life for the 2017 acquired intangibles remained similar at 11.8 years, implying similar amortization periods for technology and trade names in the 11-year range. By comparison, TMO assigned useful lives of 13 years for product technology and 14 years for customer relationships in connection with its most recent 2018 acquisitions. As such, PKI’s amortization periods do not look out of line. It is important to remember that PKI’s technology is medical related and should, therefore, have a longer useful life than IT-related technology for which a 3-5 year time frame is more appropriate.

Explanation of EQ Rating Scale

Rating	Description
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.

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