BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Perrigo (PRGO) 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 a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We initiate earnings quality coverage of PRGO with an EQ rating of 3- (Minor Concern)

We followed PRGO for many years, issuing multiple sell recommendations on the company. Our basic problem with the company was centered around the fact that its basic business model of buying the rights to OTC and off-patent drugs generated little in the way of organic growth. Newly-acquired products showed initial growth upon release, but quickly peaked and began a slow decline from pricing pressure as competitors caught up. In order to continue to represent itself as a growth stock, the company was forced to make a continuing string of acquisitions including its ill-fated Omega Pharmaceutical purchase and its 2013 pickup of the *Tysabri* rights through its $9.5 billion acquisition of Elan. Promised synergies never occurred and debt rose to alarming levels. Things came to a head when an activist shareholder pressured the company to sell the *Tysabri* rights and other non-core businesses to pare the debt load.

Today, the company continues to move in the direction of becoming a pure consumer self-care company and is pursuing plans of divesting its prescription pharmaceutical business. While we view the company as being in much better shape than it was in 2013 and the valuation is much more reasonable, we are concerned that the problem of a lack of internal growth remains.

We note that the following issues prompt us to initiate earnings quality coverage with a 3- (Minor Concern) rating.

- The company accrues for future expected chargebacks, government rebates, and retailer shelf stock allowances. The allowance has declined on an absolute and days of sales basis for the last three quarters. We would ordinarily be very concerned with such a decline, but we do note that the year-ago period was inflated by the introduction of new products which drives up the reserve as products are sold into the channel and have not yet generated payments to level the reserve out. The accrual level looks more normal when compared to 2017 level. Still, we note that the company continues to cite competitive pricing pressure which should have an elevating impact on both expected chargebacks and shelf stock allowances. We currently do not attach a high degree of concern to the issue, but this trend should be closely watched in future quarters.

- PRGO adds back amortization of acquired intangible assets to its non-GAAP results. We regularly criticize this practice and PRGO is in no way alone in doing it. However, we believe this is particularly distorting in the case of PRGO given the degree to which its model depends on the acquisition of new rights and ANDAs to release new products. In the 9/19 quarter, PRGO reported $1.04 in adjusted EPS, but this figure was boosted by an eye-popping $0.59 per share boost from adding back amortization. We also note that the company has been using a 20-year amortization period for recently acquired ANDAs which seems high, especially when compared to some competitors who are amortizing similar assets over 15 years or less.

- Further driving home the case of not ignoring the cost of acquisitions, the company reported goodwill and intangible impairments of $224 million, $48 million and $2.6 billion in the 2018, 2017 and 2016 fiscal year, respectively.

- PRGO's results are regularly impacted by the revaluation of its potential milestone payment from the sale of its *Tysabri* royalty stream. The company is still eligible to receive a $400 million payment contingent on the performance of *Tysabri* in 2020. The current carrying value of the related financial asset is $91 million. Should the company achieve its goal, it will report a gain of the difference between the carrying value and the milestone payment. If *Tysabri* falls short, it will result in a loss equal to the carrying value.

- The company has disclosed that it is exposed to several potentially negative outcomes related to claims by the IRS and Irish Revenue in the amounts of Euro $1.6 billion, $840 million and $200 million. Determining the likelihood of a negative settlement in any of these cases is beyond the scope of this report. However, investors should be aware of these items given their magnitude. We also remind investors that PRGO identified a material weakness in internal control in its financial reporting in the area of income taxes in 2016 and 2017. The matter was considered remediated in 2018.

Accruals for Customer Programs Declining

Given the nature of the business, PRGO must make several key estimates when recording sales. We will discuss each below:

Chargebacks- The company sells its prescription pharmaceutical products directly to wholesalers, distributors, and warehousing pharmacy chains. It also sells indirectly to independent pharmacies, managed care organizations and group purchasing organizations. PRGO will also enter into agreements with some indirect customers to set up contracted prices for specific products. The indirect customer then picks a wholesaler from which to buy the drugs at the price it contracted with PRGO and PRGO refunds the difference between the wholesaler's list price and PRGO's contracted price with the indirect customer. This requires PRGO to make an estimate of claims that have been incurred before the end of the reporting period but have not yet been made, as well as an estimate of future claims that will be made when the wholesaler eventually sells the inventory. Prescription drug chargebacks represent the largest sales-related accruals.

Medicaid Rebates- PRGO must estimate the amount of sales for which it will have to provide rebates to the government for purchases made under federal and state programs. As with chargebacks, this involves estimating incurred but not yet reported claims as well as an estimate for future claims that will be filed when the inventory is sold.

Returns and Shelf Stock Allowances- PRGO allows customers to return products within a certain time period and after the expiration date. In addition, shelf stock allowances allow customers to receive credits to reflect changes in the selling price of a product that the customer still has in its inventory.

The company discloses chargebacks, rebates and allowances for administrative fees and other incentive programs in the “Accrued Customer Programs” line item on its balance sheet. Sales return allowances and shelf stock adjustments are recorded as a reduction of accounts receivable. The company discloses the Accrued Customer Programs amount on a quarterly basis. This amount is shown in the following table on a days of sales basis for the last twelve quarters:

	9/28/2019	6/29/2019	3/30/2019	12/31/2018
Sales	$1,191	$1,149	$1,175	$1,195
Accrued Customer Programs	$359	$385	$380	$442
Accrued Customer Programs Days	27.4	30.5	28.8	34.4

	9/29/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$1,133	$1,186	$1,217	$1,283
Accrued Customer Programs	$416	$452	$438	$420
Accrued Customer Programs Days	33.4	34.7	32.4	30.1

	9/30/2017	7/01/2017	4/01/2017	12/31/2016
Sales	$1,231	$1,238	$1,194	$1,331
Accrued Customer Programs	$369	$370	$348	$380
Accrued Customer Programs Days	27.3	27.2	26.5	26.0

There was a noticeable buildup in the accrual in 2018 which has reversed in the first three quarters of 2019. Absent unusual factors, one should view a general decline in the accrual level with concern given it could represent a company overstating current earnings by underestimating the eventual amount of current and past sales it will eventually have to refund to customers. However, in practice, various factors can impact the level of accruals such as the introduction of new products in the period which results in a jump in the estimate of ultimate accrual related payments at the time the products are sold into the channel but before enough time has passed for refunds to customers to be paid and balance out the reserve. With that in mind, we will dig a little deeper into the changes in the account.

First, let’s go back to the 3/18 quarter which marked a spike in the accrual balance. The company stated the following in the liquidity section of its 10-Q for the quarter:

"…changes in accrued customer-related programs due primarily to new product launches, which resulted in higher customer related-accruals, pricing dynamics in the RX segment, and timing of rebate payments;"

As we described above, introductions of new products can temporarily inflate the program accrual and we actually do see the accrual level begin to decline throughout the rest of the year. Therefore, we believe we can consider the 2018 program accrual days as an unusually elevated level and the 2019 year-over-year declines as a return to normal as they are more in-line with the 2017 amounts. However, we do observe that the company's explanation for the decline in the accrual level in its last three 10-Qs is as follows:

"…$81.5 million change in accrued customer programs due primarily to pricing dynamics in our RX segment, as well as timing of rebate and chargeback payments"

In recent quarters, the company has prominently mentioned an increasingly tough pricing environment for its pharmaceutical segment. This increase both rebates offered to customers as well a reduction in prices which would potentially drive up shelf space allowances. An accompanying decline in the accrual in such a situation would indicate the company was inadequately accruing for future cash outlays which would overstate earnings. Unfortunately, the company only discloses the reserve components in its annual filings. The disclosure from the 2018 10-K is reproduced below:

	RX Chargebacks	RX Medicaid Rebates	RX Returns and Shelf Allow.	RX Adm. & Oth. Rebates	Other Seg Rebates & Allow.	TOTAL
Balance at 12/31/2016	$217	$25	$77	$35	$131	$484
FX	$0	$0	$0	$0	$0	$0
Provisions	$1,564	$45	$44	$114	$281	$2,048
Credits/Payments	-$1,551	-$33	-$45	-$105	-$286	-$2,020
Balance at 12/31/2017	$230	$37	$76	$43	$126	$512
FX	$0	$0	$0	$0	-$4	-$4
Provisions	$1,754	$58	$17	$100	$270	$2,200
Credits/Payments	-$1,718	-$59	-$22	-$98	-$276	-$2,174
Balance at 12/31/2018	$266	$36	$71	$45	$117	$535

We see that in 2017 and 2018 the company did a good job of matching its provision expense to its cash payments. However, this does not help us get visibility into the first three quarters of 2019.

Overall, we view the decline in program accruals in the first three quarters of 2019 with a mild degree of concern. On one hand, it appears to be a return to normal from an elevated

2018. One the other hand, a tough pricing environment in the pharma segment should be exerting an upward force on the accrual level. This disclosure should be reviewed carefully when the 2019 10-K is released.

Amortization Expense and Impairments

We regularly criticize the practice of companies adding back the amortization of acquired intangibles to their non-GAAP earnings figures as it ignores that in many cases a company is choosing to effectively buy its R&D rather than spend to develop products in-house. It is no surprise that PRGO chooses to follow the industry norm of adding back the amortization of acquired intangibles, but we believe the resulting distortion for PRGO is particularly large.

First, amortization is a very large expense for PRGO. For the quarter ended 9/19, the company reported $1.04 in adjusted EPS. However, this includes an adjustment for $0.59 per share in amortization of acquired intangibles meaning EPS would be almost 60% lower if amortization is considered a "real" expense- and we believe there are compelling arguments to consider it a real expense for PRGO.

PRGO's reported R&D expense runs in the mid-3% range which is very low for a company in the medical products industry. This is because PRGO's medical products are largely over-the-counter (OTC) formulations of products that were previously protected by patents, or generic versions of prescription drugs which have recently gone off patent. In the case of prescription drugs, the company typically purchases the ANDA (abbreviated new drug application) from the pharmaceutical company which holds the now-expired patent of the original drug. PRGO then commercializes the generic version of the drug. For example, in July of 2019, the company paid $49 million for the ANDA for a generic gel which it launched on the market in the third quarter. As is typical, it capitalized the purchase price as a developed product technology intangible asset which it is amortizing over 20 years. Our issue is not with the choice to capitalize the asset- that is consistent with GAAP for the company to capitalize a research asset that has a definite commercial use at the time of purchase. Our concern is that adding back the amortization expense to adjusted profits ignores the expense associated with developing the asset in the first place. We also note that the company has used an estimated useful life of 20 years for most of its ANDA acquisitions which seems somewhat long. For reference, Lannet Company, another developer of generic and OTC products, amortizes its acquired intangibles over 10-15 years.

As an example in the OTC segment, PRGO announced in the third quarter that it will be acquiring the OTC rights to *PrevAcid*, the popular antacid remedy, from GlaxoSmithKline in the fourth quarter for $61.5-$65.0 million. It expects to allocate almost all of the purchase price to brand name intangible assets. The amortization period has yet to be announced.

Finally, another case to be made for including amortization in ongoing expenses is the regular occurrence of material goodwill and intangible amortization impairments. The following table shows impairment charges for the last three years and the nine months ended 9/19:

	9 mos-9/19	2018	2017	2016
Impairments of	-	$0	$0	$0
Goodwill	-	$137	$0	$1,093
Indefinite Lived Intangibles	-	$28	$0	$850
Definite-Lived Intangibles	-	$50	$20	$666
Assets Held for Sales	-	$2	$7	$16
IPR&D	-	$9	$13	$4
PPE	_	$0	$8	$4
	$43	$224	$48	$2,631

Acquisitions Are Key to Growth

Another structural reason that intangibles amortization should be considered operating in nature is the degree to which the company's business model depends on acquisitions for growth. PRGO acquires its innovation by buying it from other companies. New products are released which drive sales growth initially, but sales for the new products quickly peak and then begin a slow decline due to competitive price pressure. This is why PRGO's results seldom cite "growth from exiting products."

PRGO is considered to be in a rebuilding phase. It sold its royalty stream from the sales of *Tysabri* in early 2017 for over $2 billion and used the money to reduce its debt load at the behest of an activist shareholder. The debt was a result of a string of ill-fated acquisitions the company made to drive top-line growth. New management has a goal of returning PRGO to a pure "self-care" company with plans to sell its prescription pharma business in place for over a year. We view these developments as a positive, but investors should still be wary of acquisition-fueled growth in the future and remain skeptical of ignoring the cost of that growth- the amortization of acquired intangible assets.

Tysabri Royalty

On January 1, 2017, PRGO sold its rights to receive royalties on the multiple sclerosis drug *Tysabri* to Royalty Pharma for $2.2 billion in cash plus the possibility to receive two milestone payments ranging up to $250 million and $400 million based on the performance of *Tysabri* sales. In 2016, the company began accounting for the *Tysabri* rights as a financial asset with a beginning balance of $5.3 billion. The fair value of the asset was reduced by $2.6 billion over the course of the year to reflect increasing competition for the drug.

In 2018, *Tysabri* met the sales target for PRGO to receive the first milestone payment of $250 million. The remaining milestone payment is based on *Tysabri* payments to Royalty exceeding $351 million. In 2018, payments were $337.5 million. PRGO currently records the potential to receive the milestone payment as a financial asset on its balance sheet at a value of $91.7 million. Changes in the value are driven by conditions in the market for *Tysabri* and are reflected as a gain or loss on the financial asset in the income statement. If the royalty payments in 2020 fall short of the target, PRGO will have to write off the value of the financial asset (currently $91.7 million) but if the goal is met, PRGO will recognize a gain equal to the difference between the $400 million payment to be received and the carrying value of the asset (currently $308.3 million.) *Tysabri* is facing new competition and expectations for the drug have been downgraded over the years. We believe it is possible that *Tysabri* could miss its targets, causing PRGO to incur a relatively minor loss and miss the opportunity to receive $400 million in cash. Neither one should impact PRGO to a huge degree.

Tax Contingency

PRGO has disclosed that it received a notice of proposed adjustment (NOPA) from the IRS related to transfer pricing on in-process R&D related royalties between Elan and Athena. The IRS has proposed a payment of $843 million and PRGO is strongly contesting. The company will not have to make any payments until the matter is settled. We do not have an opinion about the likelihood of a negative settlement, but the potential liability is substantial and deserves careful investor consideration.

In addition, the company has received a Notice of Assessment (NoA) from Irish Revenue related to contingent consideration paid by Biogen to Elan in the 2013 sale of the rights to *Tysabri* which assesses a tax liability of Euro 1.6 billion. The company has filed a judicial review to block the NoA and prevent Irish Revenue from continuing to pursue the matter. As with the above issue, we have no insight into the likelihood of a negative outcome. However, if the company loses its case in the judicial review and Irish Revenue successfully pursues its case, it would be a very material negative event.

PRGO also received a NOPA for fiscal years ended 6/14 and 6/15 related to the deductibility of interest on a loan made to a subsidiary related to the 2013 Elan deal. The company also expects the IRS to pursue similar adjustments for 2015-2019. The company estimates that the potential increase in taxes, penalties, and interest could run as high as $200 million.

We would note that the company identified a material weakness in its internal reporting in 2016 and 2017 related to the are of income taxes but the matter was considered remediated in 2018.

In addition, the company is the subject of price-fixing litigation along with several other pharmaceutical companies and also faces multiple security litigation matters.

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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