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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Perrigo Company plc (PRGO) Earnings Quality Update 12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We maintain our earnings quality rating on PRGO of 3- (Minor Concern)

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

Summary

PRGO missed earnings expectations in the 12/20 quarter by 7 cps. This was largely driven by much lower-than-expected sales of cough and cold treatments as COVID-related social distancing and mask mandates resulted in an almost non-existent 20/21 flu season.

Our main concern with PRGO remains the extent to which it has relied on the acquisition of the rights to new products and ANDAs to provide much of its growth but adds back the amortization of these rights to non-GAAP earnings. Goodwill and intangibles amount to 60% of the assets on the balance sheet and exceed the company's shareholders' equity, but there is no cost for this reflected in the non-GAAP numbers. Also, the tax overhang remains, but management hopes this will be resolved favorably in the next 18 months.

What is weaker?

- PRGO continues with its acquisitions. Some of the larger deals done include buying Steripod, a maker of toothbrush protectors for $26 million. Almost all the deal price was

allocated to brand-name intangibles and is being amortized over 25 years. The oral care assets of High Ridge Brands (Dr. Fresh) were acquired in April for $113 million and are being amortized over 17.8 years. Three Eastern European OTC dermatological brands were acquired for $62.3 million and are being amortized over 18.8 years. In December, it acquired the ANDA for a generic gel for $16.4 million which was all capitalized and is being amortized over 20 years.

- We believe these amortizable lives are unrealistically long, but this become irrelevant when the company adds back the amortization to its non-GAAP results. This add-back amounted to more than 40% of non-GAAP pre-tax earnings in 2020. In our mind, these expenses represent development costs the company would have had to expense on the income statement had it not acquired these rights.

- Our contention that the acquisition costs should not be ignored is further borne out by the fact that the company incurred $347 million in goodwill impairment charges in 2020, following $184.5 million in 2019 and $224.4 million in 2018- this is not a pandemic problem. The company also warned in the 10-K that its BCS segment and Oral Care International reporting units' fair values exceeded their carrying values by less than 10% which puts them at risk for future writedowns.

- Inventory DSIs jumped to 141 in the 12/20 quarter from 108 a year ago. The company attributed this to a buildup to improve customer service levels, lower than anticipated sales, and preparation for new product releases. Cough and cold sales were much lower than expected and we see no reason for a rebound in demand in the 3/21 quarter. This could lead to a situation where the company must discount some of this inventory to move it which could eat into gross margin.

- The effective non-GAAP tax rate fell to 18.2% in the 12/20 quarter from 19.5% last year. This was impacted by the geographic earnings mix and the release of a valuation allowance. This added about 1.5 cps to earnings in the quarter.

What to watch

- Chargeback allowances fell to 63 days of Rx sales for the year ended 12/20 versus 88 a year ago. We see no explanation for this and would ordinarily be more concerned. However, the company has announced that it will finalize the sale of its domestic generic Rx business in early 2021, so the status of the company's chargeback allowances will become the acquiring company's concern.

- The upcoming sale of the company's final prescription pharma business to Altaris for $1.55 billion will complete its portfolio alignment to a pure consumer self-care business and leave it with $2 billion in cash on hand. The company will release more detail on capital allocation plans but indicated it will focus on M&A activity in the future.

- A key overhang for the company is its outstanding potential tax liabilities with both the IRS and Irish Revenue. These potential liabilities are connected with multiple issues over several periods with the potential negative outcome totaling over $2 billion. The company remains confident it will prevail in these matters and expects to see resolutions over the next 18 months.

- The 2020 threshold sales level to trigger the final milestone payment of $400 million related to the *Tysabri* royalties was not reached, prompting the company to write off the value of the related financial assets in a $95 million charge.

- Interestingly, in June the company entered the cannabidiol (CBD) market with its strategic $50 million investment and long-term supply agreement with Kazmira.

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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