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Perrigo (PRGO) EQ Update- 3/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

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

PRGO received a huge tailwind in the 3/20 quarter as management estimated $90-$110 million in sales was pulled into the quarter from COVID-19 related demand. End-users of the company's products likely have their medicine cabinets stocked at this point, so consumer demand may be muted going forward. However, the next quarter could benefit from retailers restocking shelves. Now, investors are more focused on these issues than earnings quality items. Nevertheless, we continue to see a couple of red flags in the company's results.

- Accruals for customer programs continued to fall despite an increase in sales. Management has attributed the drain on cash flow by accruals for rebates, chargebacks, and shelf allowances to competition in the RX market. The fact that the allowances have declined due to more cash being paid out than accrued is an indication that earnings have received an artificial benefit from under-accruing. Customer programs were a smaller cash flow drain in the 3/20 quarter than the year-ago period as RX competition has reportedly begun to ease. However, we remain concerned that rebuilding these reserves may be a drag on earnings growth in upcoming periods.

- Amortization of acquired intangibles declined in the 3/20 quarter despite the addition of the *Prevacid* assets in November which we assume was due to older assets becoming fully amortized. Non-GAAP EPS growth was penalized in the quarter by the company's policy of adding back amortization to non-GAAP results. However, we remind investors that almost half of non-GAAP EPS disappears if intangible amortization is considered an expense. Given the company's reliance on acquisitions of ANDAs and brand rights for growth, we would argue the cost of these acquisitions should be considered an operational expense, and non-GAAP results are therefore misleading. Meanwhile, estimated useful lives remain at the high-end of ranges we usually see with the *Prevacid* assets being assigned a 20-year amortization period while recently acquired toothbrush accessory and oral care assets are being amortized over 25 years.

Customer Program Accruals Continue to Decline

We highlighted in our original review that the growth in PRGO's accruals for customer programs (chargebacks, rebates, shelf allowances) was lagging sales growth. His trend continued into the 3/20 quarter, as shown in the following table:

Table 1

	3/28/2020	12/31/2019	9/28/2019	6/29/2019
Sales	$1,341	$1,323	$1,191	$1,149
Accrued Customer Programs	$380	$394	$359	$385
Accrued Customer Programs Days	25.0	28.0	27.4	30.5
	3/30/2019	12/31/2018	9/29/2018	6/30/2018
Sales	$1,175	$1,195	$1,133	$1,186
Accrued Customer Programs	$380	$442	$416	$452
Accrued Customer Programs Days	28.8	34.4	33.4	34.7
	3/31/2018	12/31/2017	9/30/2017	7/01/2017
Sales	$1,217	$1,283	$1,231	$1,238
Accrued Customer Programs	$483	$420	$367	$370
Accrued Customer Programs Days	35.7	30.1	27.1	27.2

Accrued customer programs were higher in the 2018 time frame as a result of new product introductions. However, the year-over-year decline in customer program accruals days of sales in the 3/20 quarter marks the fifth straight year-over-year decline. PRGO only discloses the details of customer accruals in its 10-Ks. Following is the breakdown of the detail from the 2019 10-K:

	RX Chargebacks	RX Medicaid Rebates	RX Returns and Shelf Allow.	RX Adm. & Oth. Rebates	Rebates & Allow.	TOTAL
Balance at 12/31/2018	**$266.0**	**$36.4**	**$71.0**	**$44.5**	**$116.9**	**$534.8**
Acquired in Business Acquisition					$5.7	$5.7
Disposed of in Business Divestiture					-$4.1	-$4.1
FX					-$1.7	-$1.7
Provisions	$2,127.2	$47.9	$33.9	$116.5	$224.6	$2,550.1
Credits/Payments	-$2,157.4	-$56.7	-$33.4	-$126.3	-$227.3	-$2,601.1
Balance at 12/31/2019	**$235.8**	**$27.6**	**$71.5**	**$34.7**	**$114.1**	**$483.7**

**Note that shelf returns and allowances are recorded as reductions of sales rather than accrued programs so amounts do not compare directly to table 1.*

We can see that despite the increase in revenue in 2019, accruals for customer programs fell by almost 10% due to cash payments exceeding provisions. PRGO referenced the decline in accruals negatively impacting cash flow in the liquidity section of its 2019 10-K, stating that cash flow experienced *"$74.1 million decrease in cash due to the change in accrued customer programs due primarily to pricing dynamics in our RX segment, as well as timing of rebate and chargeback payments."* This essentially means that competition forced the company to lower the effective prices for customers by increasing rebates and chargebacks. Cash outflows to customers rose faster than accruals which implies that reported earnings were artificially inflated in the period. PRGO stated in the 3/20 10-Q that cash flow growth in the quarter benefitted from a decline in the consumption of cash by accrued customer programs in the current period. However, the accruals still consumed cash in the quarter as more was paid out than accrued.

Management noted that competition in the RX market is stabilizing, and we may see a reversal in the trend of the consumption of cash by accruals. However, the prolonged decline in accrual days may be an indication that there is still a need to boost the accrual reserves which could be a drag on future results.

Amortization of Acquired Intangibles Declined in the Quarter

Our original review documented how PRGO's non-GAAP earnings are highly dependent on adding back amortization from acquired intangibles. The following table shows acquired intangible amortization in net income, EPS, and the total non-GAAP EPS figure updated through the 3/20 quarter:

	3/28/2020	12/31/2019	9/28/2019	6/29/2019
Intangible Amortization in Net Income	$71.20	$79.80	$80.60	$74.40
Intangible Amortization in EPS	$0.52	$0.59	$0.59	$0.56
Non-GAAP EPS	$1.14	$1.06	$1.04	$0.86

	3/30/2019	12/31/2018	9/29/2018	6/30/2018
Intangible Amortization in Net Income	$76.50	$78.00	$85.50	$86.50
Intangible Amortization in EPS	$0.57	$0.57	$0.62	$0.62
Non-GAAP EPS	$1.07	$0.97	$1.09	$1.22

Intangible amortization rose in the 12/19 quarter, likely due to the addition of brand-named intangible amortization from the acquisition of the OTC rights to *Prevacid* in late November of 2019. PRGO is amortizing these rights over a 20-year period which seems somewhat long to us. While OTC *Prevacid* may still be on the shelf 20 years from now, new products will likely radically reduce its profit potential by then which makes for unrealistic cost-matching in our minds.

We assume the decline in amortization in the 3/20 quarter was due to older intangibles becoming fully-amortized. In the case of the 3/20 quarter, growth in non-GAAP EPS was penalized by excluding amortization expense. However, the table demonstrates once again that almost half of non-GAAP earnings disappear if the costs associated with acquisitions is considered. We believe this is very misleading given that acquiring OTC rights and ANDAs are a part of the company's growth strategy. With that in mind, we note that in the 3/20 quarter PRGO acquired toothbrush accessory company Steripod and silicon supplement brand Dexsil for $26 million and $8 million, respectively. Both brands are being amortized over 25 years. After the quarter-end, the company acquired the oral care assets of High Ridge Brands for $113 million. Amortization periods have not been disclosed.

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.

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