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ResMed (RMD) EQ Update-12/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	3-

We maintain our EQ rating of 3- (Minor Concern)

We noted last week that RMD's 12/18 quarter earnings beat of 7 cps was muted by a roughly 9 cps boost from a lower than expected tax rate. In addition, our review of the 10-Q turned up a couple of other items to note:

- The accruals for warranties fell from $4.6 million in the 12/17 quarter to $3.9 million in the 12/18 quarter. This was not material by itself, adding less than half a cent to EPS. However, the warranty reserve now stands at 3% of quarterly sales compared to 3.5% a year ago. To increase the reserve to the higher level would require about a 2 cps charge- not huge, but a potential minor earnings headwind going forward.

- RMD invested $25 million in equity investees in the quarter which was up from a historical run rate in the $2-3 million range. This amount relates to the company's JV with Alphabet's Verily unit. The investment is accounted for under the equity method as RMD has significant influence but not control, and it is not the primary beneficiary of the JV's activities. As we noted in previous reviews, the company has other investments in privately-held research institutions. The amounts invested in these joint ventures do not initially flow through the income statement. While common in the medical device and pharma industry, we view payments such as this as understating R&D expense to the extent RMD benefits from research conducted by these companies. The company recorded a $3.3 million loss associated with its equity investments in the quarter which we assume is largely related to the Verily equity investment.

- Receivables financing arrangements remain under control.

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 recent 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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