BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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ResMed (RMD) EQ Update-3/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

*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).

- The year-over-year decline in warranty expense continued to add about a half a cent to EPS. In addition, cash spending on warranty settlement is declining as well, so we do not see the company as being significantly under-reserved for warranties.

- RMD recorded $6 million in equity losses in other income for its share of the losses in the Verily joint venture. Management predicts that those losses will approximate $7 million per quarter for the remainder of the fiscal year and into 2020. As we have noted before, we view such investments in research ventures as capitalized R&D. However, in RMD's case, the recording of the losses each quarter does impact the income statement immediately and to the company's credit, it does not add back the impairments to its non-GAAP earnings figures.

- A metric we track for RMD is the amounts of receivables that are financed by the company's customers under arrangements with independent third-party financing institutions. Remember that this is not a receivables factoring program where the company sells receivables, but rather a way for the company to help its customers finance their own purchases of the company's products. The percentage of the company's total revenue financed by such arrangements rose to 5.9% in the 3/19 quarter from 4.8% th e quarter before and 4.7% in the year-ago quarter. This is not as much an earnings quality flag as it is an insight into the health and sustainability of the company's revenue growth. We still do not view the increase in use of external

financing by customers to be alarming yet, but there is a definite upward trend that should be monitored in future quarters.

- The company continues to make new acquisitions with Propeller Health being the most recent. Like many tech and medical companies growing via acquisitions, RMD chooses to add back amortization of acquired intangibles to its non-GAAP earnings. To put this in perspective, the company added back $17.6 million of amortization to its 3/19 quarterly results to arrive at a non-GAAP net income amount of $128 million. This was up from $8.5 million in the year-ago quarter. Growth in the company's software as a service business is coming largely from its recent acquisitions of MatrixCare and HealthFirst which drove the increase in amortization of intangibles. We are not fans of this practice as it serves to ignore the price paid for the acquisitions and cost of the growth strategy.

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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