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ResMed (RMD) EQ Review Update- 6/18 Quarter

Current EQ Rating*	Previous EQ Rating
3-	NA

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

We initiate coverage of ResMed (RMD) with a 3- (Minor Concern)

Our review of the company's 6/18 10-K turned up several items investors should be aware of:

- RMD utilizes third-party financing institutions to offer certain customers financing for its products. While not a traditional factoring program, this should be monitored for signs of aggressive credit extension being used to fuel sales growth. The company's disclosures do not indicate this has been a problem in recent quarters.

- The company makes regular, material investments in "research and service" companies which it accounts for under the cost-method. While we are admittedly uncertain as to the nature of these investments, we are somewhat concerned that they could have the effect of capitalizing research and related expenses, thus keeping them off the income statement.

- RMD has received notice that it could have to pay up to $190 million in taxes, interest and penalties to the Australia Tax Authority (ATO) stemming from an audit of 2009-2013 and the ATO now has its sights on 2014-2017.

- The Office of Inspector General (OIG) has issued 3 subpoenas to the company since 2016 which appear to be related to an anti-kickback investigation. We have no indication of the likelihood of a negative outcome, but investors should be aware of the situation.

Third-Party Financing of Receivables

RMD utilizes third-party financing to offer some customers financing of its products. The company provides the following description in its 10-K regarding the program:

> *"We use independent financing institutions to offer some of our customers financing for the purchase of some of our products. Under these arrangements, if the customer qualifies under the financing institutions' credit criteria and finances the transaction, the customers repay the financing institution on a fixed payment plan. For some of these arrangements, the customer's receivable balance is with recourse, either limited or full, whereby we are responsible for repaying the financing company should the customer default. We record a contingent provision, which is estimated based on historical default rates. This is applied to receivables sold with recourse and is recorded in accrued expenses."*

This program is slightly different than a traditional factoring program when a company simply sells receivables to a third-party finance institution in order to collect cash up front as the financial institution appears to be directly involved with the customer in originating the loans. However, the fact that these receivables are sold with recourse indicates that RMD has more "skin in the game" than if the transaction was done entirely between the customer and the bank.

RMD does not disclose what the outstanding balances of receivables held by the bank are at the end of each period, so we can't adjust company receivables as accurately as we can with some companies. However, RMD does disclose the amount of receivables sold during the quarter, so we can get a feel for overall activity. These amounts are shown for the last eight quarters below:

Receivables Sold During the Period

	06/30/2018	03/31/2018	12/31/2017	09/30/2017
Full Recourse	$9.7	$6.2	$5.7	$4.2
Partial Recourse	$23.1	$20.3	$18.5	$17.4
Total	$32.8	$26.6	$24.2	$21.6
% of Sales	5.3%	4.5%	4.0%	4.1%

	06/30/2017	03/31/2017	12/31/2016	09/30/2016
Full Recourse	$10.1	$6.1	$7.0	$1.5
Partial Recourse	$21.8	$19.2	$18.0	$15.8
Total	$31.8	$25.3	$24.9	$17.3
% of Sales	5.7%	4.9%	4.7%	3.7%

We can see that while the level of sales activity as a percentage of sales has risen sequentially, it has actually declined on a year-over-year basis for the last 3 quarters. This does not indicate that sales have been driven by a rapid increase in the use of customer credit.

In addition, RMD discloses its maximum exposure on outstanding receivables at the end of each period which is shown in the below table:

Maximum Exposure on Outstanding Receivables Sold

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Full Recourse	$20.1	$18.3	$18.3	$18.3
Limited Recourse	$9.2	$9.4	$8.9	$11.1
Total	$29.4	$27.7	$27.2	$29.4
% of Sales	4.7%	4.7%	4.5%	5.6%

	6/30/2017	3/31/2017	12/31/2016	9/30/2016
Full Recourse	$18.1	na	na	na
Limited Recourse	$9.4	na	na	na
Total	$27.5	$22.6	$16.6	$14.4
% of Sales	4.9%	4.4%	3.1%	3.1%

Like the data on receivables sold during each of the last eight quarters, the company's total exposure to sold receivables also seems to indicate that there has been a significant uptick in financing activity to support sales growth. However, we do observe that the sequential increase in total exposure came from receivables with full recourse. We no not view this as a material item, but we will be monitoring this trend going forward.

Cost-Method Investments

RMD has substantial investments that it accounts for under the cost method. There is little description of these in the company's financial filings other than the following from its 6/18 10-K:

> *"We periodically evaluate the carrying value of our cost-method investments, when events and circumstances indicate that the carrying amount of an asset may not be recovered. We determine the fair value of our cost-method investments to evaluate whether impairment losses shall be recorded using Level 3 inputs.* ***These investments include our holdings in privately held service and research companies that are not exchange traded and therefore not supported with observable market prices.*** *However, these investments are valued by reference to their net asset values which can be market supported and unobservable inputs including future cash flows. We have determined that the fair value of our cost-method investments exceed their carrying values."*

The following table shows the development of the company's cost-method investments balance over the last six quarters:

Cost-Method Investments Balance

	6/30/2018	3/31/2018	12/31/2017	9/30/2017	6/30/2017	3/31/2017
Beginning Balance	$41.1	$39.8	$40.6	$38.3	$39.7	$37.5
Investments	$8.1	$2.7	$0.5	$3.2	$0.0	$2.6
Impairment	-$8.0	-$1.4	-$1.3	-$1.0	-$1.4	-$0.4
Ending Balance	$41.2	$41.1	$39.8	$40.6	$38.3	$39.7

Our main concern with these amounts is that these are cash expenditures made to "service and research" companies about which there is little description. If the company is receiving any benefit from research or services conducted by these companies, this could effectively be capitalizing these expenses and keeping them off the income statement. We have not had a chance to speak to the company about this yet but will likely be doing some follow up work on this in the future.

Australian Tax Overhang

The company recently received a notice from the Australian Taxation Office (ATO) asserting that the company owes $151.7 million in additional income tax and $38.4 million in accrued interest related to the ATO's audit of the company's 2009-2013 tax years. RMD is contesting the assessment and agreed to pay half of this amount up front and the remainder if it is unsuccessful in defending its position. In June, it received another notice from the ATO that it is seeking a penalty of 50% of the additional income tax assessed, which is another $76 million. In addition, the ATO notified the company it now intends to audit 2014-2017. We do not have any insight into the company's chances of success in contesting ATO's assertions, nor the possibility of a negative development from the new audit. Nevertheless, the amounts in question are quite material and investors should be aware of the possibility of a materially negative outcome.

OIG Subpoena

RMD noted in its 10-K that it has received three subpoenas from the Office of Inspector General (OIG) since 2016:

> *"Federal and state enforcement bodies have recently increased their scrutiny of interactions between healthcare companies and healthcare providers, which has led to a number of investigations, prosecutions, convictions and settlements in the healthcare industry. For example,* ***in July 2016, we received a federal administrative subpoena from the Office of Inspector General, or OIG, of the Department of Health and Human Services. The subpoena contains a request for documents and other materials that relate primarily to industry offerings of patient resupply software to home medical equipment providers. In November 2016, we received a second subpoena, requesting documents and other materials regarding discounted sales and leasing to sleep labs, samples, and other promotional programs. In August 2018, we received a third subpoena requesting documents and other materials relating to diagnostic devices and masks provided to medical providers and diagnostic auto-scoring functions. In addition, the government has informally requested information about our leasing arrangements with customers****. We are cooperating with the government's subpoenas and request s for documents and information. Responding to investigations can be time-and resource-consuming and can divert management's attention from the business. Additionally, as a result of these investigations,*

> *healthcare providers and entities may face litigation or have to agree to settlements that can include monetary penalties and onerous compliance and reporting requirements as part of a consent decree or corporate integrity agreement. Any such investigation or settlement could increase our costs or otherwise have an adverse effect on our business."*

This appears to be related to anti-kickback rules that do not allow medical supply companies to offer free or discounted products or services to medical care providers in exchange for them buying their products. We note that one of the company's competitors, Philips Respironics, lost a $34 million lawsuit in 2016 for providing free customer support through its call centers for suppliers who bought its products. We do not know if the OIG investigation is of a related matter and we do not have any reason to expect a negative outcome, let alone the potential size of any fines. We simply believe this is a matter that investors should be aware of.

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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