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BTN Earnings Quality Review

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ResMed (RMD)

ResMed (RMD) is a leading provider of equipment and software for the treatment of breathing-related sleep disorders. Currency-adjusted revenues rose by 11% in the 9/17 quarter and adjusted EPS rose by 6%. Overseas growth and anticipation of new product releases has propelled the stock to all-time highs, resulting in a premium valuation of 28 times next year's earnings. We have not done any recent work on the company's markets and prospects for new products. However, an analysis of recent results turned up several signs we believe investors should be aware of and pay attention to in the upcoming quarterly results to be announced on 1/22.

Accounts receivable DSOs have been rising the last few quarters

RMD's accounts receivable have been rising noticeably faster than sales for the last few quarters. The following table shows information on sales and receivables and the calculation of accounts receivable days of sales outstanding (DSOs):

	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Sales	$524	$557	$514	$530	$465	$519	$454
Accounts Receivable	$431	$451	$414	$384	$347	$382	$358
Sales YOY growth	12.5%	7.3%	13.3%	16.7%	13.1%	14.5%	7.4%
Accounts Receivable YOY growth	24.3%	17.9%	15.5%	15.7%	6.1%	5.4%	3.7%
Sales Seq growth	-5.9%	8.3%	-3.1%	14.0%	-10.3%	14.3%	-0.1%
Accounts Receivable Seq growth	-4.3%	8.9%	7.7%	10.6%	-9.1%	6.7%	8.0%
Accounts Receivable DSOs	**75.2**	**73.8**	**73.4**	**66.1**	**68.1**	**67.2**	**72.0**

While reported sales grew by 12.5% in the 9/17 period, receivables increased at twice that pace, resulting in DSOs jumping to 75.2 days in the 9/30 quarter compared to 68.1 in the year-ago period. A similar disproportionate increase was seen in the 6/17 quarter. RMD did acquire Brightree in the 6/16 quarter, but the impact of the acquisition would have already been factored into the 9/16 quarter. Management noted the sequential increase in DSOs in its 10-Q, but gave no explanation for it. The subject was raised briefly on the conference call. When asked about the increase in DSOs and DSIs (which we will discuss in the next section) the company gave the following explanation:

> "Sure, yeah. Last year's cash flow was, if you compare that to the year before, it was very strong cash flows. And we're working through getting some good improvements in working capital balances.
>
> So this year I think on the receivable side, we've seen good revenue growth. So that's been driving on the receivables. And working capital – working balances around inventories and so on just looking to really rebuild through with a lot of new product launches and so on has been happening. So, yeah, I think it's sort of a little bit of a building in working capital level what was a pretty low base I guess the year before."

It is possible for an increase in sales towards the end of a period to result in an increase in DSOs as revenues are increased, but there is not time to collect the receivables by the end of the period. The concern is whether the company could have driven such an increase by offering special terms to its customers, (medical products distributors, hospitals, nursing homes, etc.) to pull sales into current periods at the expense of the next. RMD has been posting sales growth numbers that are exceeding expectations, meaning revenue manipulation does not appear necessary on the surface. Nevertheless, such a distinct increase in receivables bears watching going forward. We estimate that the increase in accounts receivable could have added in excess of $0.05 per share to earnings in the last couple of quarters. We will be alarmed if DSOs do not show signs of moderation in the next quarter as management has promised.

Inventory DSIs jumped with a concentration in finished goods

Inventories also increased out-of-line with sales in the last two periods, as seen in the below table:

	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Gross Profit	$306	$324	$300	$309	$269	$301	$260
Inventory	$300	$268	$260	$253	$254	$224	$233
Gross Profit YOY growth	13.5%	7.4%	15.3%	16.0%	12.8%	16.2%	3.4%
Inventory YOY growth	18.4%	19.5%	11.6%	6.6%	-1.8%	-9.1%	3.4%
Gross Profit Seq growth	-5.6%	8.0%	-3.0%	14.8%	-10.7%	16.0%	-2.5%
Inventory Seq growth	12.0%	3.3%	2.7%	-0.3%	13.1%	-3.6%	-1.9%
Inventory DSIs	***89.7***	***75.6***	***79.1***	***74.7***	***86.0***	***67.9***	***81.8***

Days sales of inventory (DSIs) rose to 89.7 in the 9/30 quarter, up from 86 in the year-ago period. What is more disturbing is that all of the increase was centered in finished goods:

	9/30/2017	**6/30/2017**	**3/31/2017**	**12/31/2016**	**9/30/2016**	**6/30/2016**	**3/31/2016**
Raw Materials days	21.4	21.3	25.1	22.1	22.2	20.3	25.7
In-Progress days	1.5	1.2	1.3	1.0	1.6	1.2	0.9
Finished Goods days	**66.9**	53.1	52.7	51.6	**62.2**	46.4	55.2
Other Inventory days	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Inventory DSIs	89.7	75.6	79.1	74.7	86.0	67.9	81.8

Finished goods DSIs rose by almost 5 days over the year-ago period while raw materials days actually fell. Ordinarily, such an increase would be very concerning, as it would indicate that there was an unexpected buildup of finished product that management will have to discount to move later. As noted above, management related the buildup to new product releases. It is plausible that the increase could be due to the current quarter's release of its new *AirMini* travel CPAP. As with receivables, we will be looking for a moderation in DSIs going forward.

Warranty expense benefitted the last two quarters

RMD accrues for warranty costs at the time of sale and discloses warranty reserve development in its footnotes. Warranty expense and total reserve balances are shown in the table below:

	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Sales	$523.66	$556.69	$514.20	$530.40	$465.45	$518.65	$453.88
Warranty expense	$3.80	$4.57	$6.39	$3.61	$5.24	$5.73	$4.11
Warranty expense % of sales	0.73%	0.82%	1.24%	0.68%	1.13%	1.10%	0.91%
Warranty Reserve Ending Balance	$19,956	$19,558	$20,187	$16,914	$17,578	$15,043	$12,283
Warranty Reserve % of T12 sales	0.94%	0.95%	1.00%	0.86%	0.93%	0.82%	0.69%

Despite the low teens sales growth in the last two quarters, warranty expense has actually declined. In the case of the 9/17 quarter, warranty expense as a percentage of sales fell by 40 bps, which was a material benefit to earnings growth and profit margins. The warranty reserve as a percentage of sales is actually towards the high end of recent experience, so it does not appear management is recklessly drawing it down to unrealistically low levels to boost results. Nevertheless, the decline in the expense as a percentage of sales added about 1 to 1.5 cents to earnings in the last two quarters and this benefit is unlikely to continue.

Rise in prepaid expenses

The following table shows prepaid expenses and other current assets for the last 7 quarters:

	9/30/2017	6/30/2017	3/31/2017	12/31/2016	9/30/2016	6/30/2016	3/31/2016
Prepaid exp. and other cur. assets	$115.02	$103.22	$104.57	$95.03	$92.23	$81.74	$90.50
Prepaid expense days	20.0	16.9	18.6	16.3	18.1	14.4	18.2

Prepaid expenses and other current assets can contain a broad range of items, and the company does not give a detailed breakdown of the account. The concern is that the company has spent cash on an operating item, but the expenditure has not been expensed on the income statement yet, thus artificially benefitting earnings. The prepaid balance is the highest it has been in at least three years, both on an absolute basis and on a days-of-sales basis. Given the uncertain nature of the account, we are not overly alarmed at this point, but this item bears watching as it could be an indication that the last quarter benefitted from artificially low expense recognition.

Conclusion

As the following table shows, RMD has been beating consensus estimates for the last few quarters by 1-3 cents per share.

Quarter	*Reported EPS*	*Zacks Estimate*	*Surprise*
9/17	$0.66	$0.65	$0.01
6/17	$0.77	$0.75	$0.02
3/17	$0.71	$0.70	$0.01
12/16	$0.73	$0.70	$0.03

While currency adjusted revenues rose by 11% in the most recent period, lower selling prices, unfavorable foreign currency exchange for expenses, and a rising share count cut the growth in adjusted EPS to just 6%. To be fair, the company experienced higher foreign currency and other losses in the 9/17 period that cost it about 1.4 cents in the quarter. However, we have identified as much as 5-7 cents per share in one-time benefits in the last two quarters. While growth may receive a boost from the release of new products, so much of the upside coming from non-operational factors increases the risks that the consensus view on the company is overly optimistic.

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