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January 31, 2020 | www.btnresearch.com

Stryker (SYK) EQ Review
Initial Look at 12/19 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 are maintaining our earnings quality rating of 3- (Minor Concern)

SYK reported adjusted EPS of $2.49 in the fourth quarter, 3 cps ahead of consensus estimates.

- We note that the company's accounts receivable days of sales jumped by almost 8 days over the year-ago quarter following an almost 4-day jump in the previous quarter. We are skeptical that acquisitions accounted for all of the increase. Organic sales growth has been strong, but the growth has been spread fairly evenly between US and international sales which seems to rule out a disproportionate growth in slower-paying international receivables. The fourth quarter DSO is also 7-8 days higher than the last three fiscal fourth quarters making it look very elevated historically. We find the increase to be concerning and worthy of attention, but given the strong organic growth and the earnings and sales beats posted in the quarter, we are inclined to keep our rating at 3- (Minor Concern) rather than reducing it to Weak at this point.

Accounts Receivables DSOs Jumped by More than Nine Days

The following table shows accounts receivable days of sales (DSOs) rose by almost 89 days over the year-ago quarter

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Sales	$4,131	$3,587	$3,650	$3,516
Trade Receivables	$2,893	$2,438	$2,408	$2,284
DSOs	64.4	62.5	60.0	58.5

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Sales	$3,796	$3,242	$3,322	$3,241
Accounts Receivable, Trade	$2,332	$2,076	$2,089	$2,108
DSOs	56.5	58.9	57.2	58.5

Note that the DSO of more than 64 compares to DSOs of 56.5, 58.3 and 57.3 for the 2018, 2017, and 2016 fourth quarters, respectively, making the current reading look very much out of place historically. Also, an examination of the year-over-year growth trends in receivables and sales provides more insight into the noticeable ramp up in receivables starting in the 6/19 quarter and accelerating thereafter:

	12/31/2019	9/30/2019	6/30/2019	3/31/2019	12/31/2018	9/30/2018
YOY Receivables Growth	24.1%	17.4%	15.3%	8.3%	6.1%	5.6%
YOY Sales Growth	8.8%	10.6%	9.9%	8.5%	9.4%	7.9%

The company acquired K2M Group Holdings in November of 2018 for roughly $1.4 billion. This likely would have inflated DSO in the 12/18 quarter as K2M receivables hit the balance sheet in full but the quarter had fewer than two months of K2M revenues in the ratio. It is also telling that DSO remained flat in the 3/19 quarter, the first full quarter after the deal.

SYK acquired OrthoSpace in March of 2019 for $110 million and made other minor throughout the rest of 2019. However, this acquisition was not material enough for the company to disclose an itemized purchase price breakdown showing how much was booked as receivables making it unlikely the deal had a very material impact on DSO trends.

On October 21st of 2019, SYK acquired Mobius Imaging and Cardan Robotics for $370 million. The size of the acquisition and the quarter containing over two months of Mobius sales to match against the acquired receivables balance makes us skeptical that this could have had a huge impact on DSOs. The preliminary purchase price allocation was not performed until the fourth quarter so we will not see how much was allocated to receivables until the 10-K is released.

It is worth noting that SYK has been posting strong revenue growth, with constant currency revenue growth of 9.4% and acquisition-adjusted growth of 8.0% in the fourth quarter. Sales growth has been evenly split between US and overseas, so a shift to international sales with longer collection times does not seem to be a significant contributor to the DSO jump. Strong revenue growth can cause a modest rise in DSOs, and it conceivable that an acquisition could have added another day or two. However, an 8-day jump is concerning and could be an indication that sales were pulled into the fourth quarter at the expense of the upcoming first quarter. To put this in perspective, one day of sales is approximately $45 million and the company posted a $335 million YOY increase in revenue in the fourth quarter.

We have seen no discussion of the receivables increase in the last two 10-Qs or conference calls. However, given the company's strong revenue growth and the fact that it beat both EPS and sales targets in the quarter, we choose to leave our rating at 3- (Minor Concern) rather than reducing it to Weak. We will update if warranted after the 10-K is released.

Explanation of EQ Rating Scale

Rating	Description
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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