BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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November 6, 2020 | www.btnresearch.com

Stryker (SYK) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4+	3-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are raising our earnings quality rating to 4+ (Acceptable)

SYK blew earnings estimates away in the 9/20 quarter with adjusted earnings of $2.14 which was 71 cps ahead of the consensus. Our previous concerns with SYK centered around rising receivables balances, rising inventories, and adding back amortization of acquired intangibles to non-GAAP EPS. We saw improvement in the former two issues which prompted the upgrade in rating.

What improved?

- Inventory balances ended the 9/20 quarter essentially flat sequentially. Management noted that gross margin took a mild hit from lower than normal production levels although manufacturing activity improved from the previous quarter. While DSIs of 249 days were ten days above the year-ago depressed level, they compare favorably with the pre-COVID trend. The company seems to be in a good position as elective procedure volume is already beginning to pick up.

- We had previously cited concerns with rising receivable DSOs which we were skeptical could all be attributed to acquisitions. However, DSOs settled back to just under 60 days. This was almost 3 days below the year-ago level and in-line with 2018 and 2019 levels.

What to watch

- Med-tech companies are starting to awaken from the COVID dormancy as elective procedures return. Like most companies, SYK has slashed discretionary spending such as travel, promotional activity, and hiring. Management noted in the call that R&D spending came in less than planned at 6.1% of sales on an adjusted basis. This was not a meaningful contributor to the earnings beat. However, the company is ramping up hiring and other spending again which will offset some of the benefit of re-leveraging a rising sales base. As such, the company still did not offer guidance for the fourth quarter.

- Like many companies in the med-tech field, SYK adds back amortization of acquired intangibles to its non-GAAP results. Amortization typically amounts to about 12% of non-GAAP operating income. With that in mind, the Wright Medical deal is expected to close during the fourth quarter. We will review the allocation of costs and amortization periods when data is available.

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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