BEHIND THE NUMBERS
Quality of Earnings Analysis
February 19, 2021

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Stryker Corp. (SYK) Earnings Quality Update 12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are downgrading our earnings quality rating of SYK to 3- (Minor Concern) from 4+ (Acceptable)

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

Summary

SYK reported EPS of $2.81 in the 12/20 quarter which was 26 cps above consensus. However, over 25 cps was traceable to the adjusted effective tax rate falling by half, a benefit the company does not expect to continue. We also see the rising add-backs of restructuring charges and amortization of intangibles from ongoing acquisitions eroding the quality of reported earnings. This prompts us to reduce our earnings quality rating back to 3- (Minor Concern.)

What deteriorated?

- Over 25 cps of the 26 cps earnings beat can be traced to the adjusted effective tax rate falling to 8.0% in the 12/20 quarter from 16.3% in the year-ago period. Management attributed this to "one-time operational fluctuations that arose due to the pandemic, with a mix of foreign losses related to lower foreign manufacturing activity, combined with reduced U.S. sourced income that resulted from the sharp drop in sales at the end of the year." The company does not anticipate a repeat of these factors and expects the 2021 effective rate to return to the 16% range.

- SYK added back $159 million in pretax "Restructuring-Related and Other Charges." On a trailing 12 basis, this brings total restructuring charges added back to almost 15% of adjusted profits. These sizeable and recurring charges reduce the quality of reported earnings.

	12/31/2020	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Restructuring and Other Charges	$159	$26	$170	$42	$58	$40

- In November, the company completed the acquisition of Wright Medical for over $4 billion. Of the $5.2 billion recorded as goodwill and intangibles, over 65% was recorded as goodwill which will not be amortized. The company does not give a specific estimated useful life over which it will amortize the Wright intangibles, but it does disclose that the average amortization period for all intangibles is 14 years. This comes to approximately $100 million in incremental annual pretax amortization. However, the company will add this back to its non-GAAP results along with any integration and restructuring actions thereby eliminating the cost of the acquisition from adjusted results. This is becoming more of a distortion as the company has made several sizeable acquisitions over the last few years and free cash flow after dividend and buyback regularly fails to cover acquisition spending. We estimate that the incremental amortization from the Wright deal will bring the total of intangible amortization added back to about 18% of adjusted profits.

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 Concern)- 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 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 upcoming quarters. 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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