BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Stryker (SYK) EQ Update- 3/19 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 increase our earnings quality rating to a 3+ (Minor Concern) from a 3- (Minor Concern).

SYK reported adjusted EPS of $1.88 in the 3/19 quarter which beat the consensus estimates by 4 cps. While the company's tax rate of 14.4% appears to been slightly below what may have been forecast due to the timing of stock option recognition, management noted that FX reduced EPS by about 2 cps more than expected at the beginning of the quarter so we consider that a wash.

We have the following observations regarding earnings quality trends in the quarter:

- The increase in inventories has begun to level out with DSIs rising only 6.6 days which was also likely elevated some by the acquisition of OrthoSpace in the last month of the quarter.

- Contract liabilities (deferred revenue) rose slightly on a sequentially marking the second straight sequential rise. We had expressed mild concern over the sequential decrease in the 9/18 quarter. We will continue to monitor this trend but our concerns are reduced at this point.

- Prepaid expenses and other assets have been gradually increasing for the last few quarters on a days-of-sales basis and as a percentage of total assets. There is no discussion of the cause in recent filings. While multiple factors could be at play, the possibility exists that income statement recognition of cash amounts spent have been

delayed which could be artificially benefitted results. However, given the lack of visibility into the issue, we are not ready to attach a high degree of concern to this trend.

While we are identifying a new concern with prepaid assets, the improvement in inventory trends and contract liabilities prompt the increase in the earnings quality rating.

Prepaid Assets Increasing

For several quarters, SYK's prepaid and other assets account has been gradually rising on both an absolute basis, a days-of-sales basis, and as a percentage of total assets as seen in the following table:

	3/31/2019	12/31/2018	9/30/2018	6/30/2018
Prepaid Expenses and Other Current Assets	$782	$747	$739	$664
Sales	$3,516	$3,796	$3,242	$3,322
Total Assets	$25,937	$27,229	$22,084	$21,570
Days of Sales	20.3	18.0	20.8	18.2
% of Total Assets	3.0%	2.7%	3.3%	3.1%

	3/31/2018	12/31/2017	9/30/2017	6/30/2017
Prepaid Expenses and Other Current Assets	$624	$537	$602	$547
Sales	$3,241	$3,471	$3,006	$3,012
Total Assets	$22,133	$22,197	$21,485	$21,292
Days of Sales	17.6	14.1	18.3	16.6
% of Total Assets	2.8%	2.4%	2.8%	2.6%

The company does not offer an explanation for the increase in its prepaid and other assets account in recent filings so we cannot pinpoint the cause. Other assets could contain such items as unbilled receivables. However, the company specifically states in its revenue recognition disclosures that it does not have contract assets. Generally, a prepaid asset is booked when the company has made a cash payment but has yet to recognize the expense on the income statement. Therefore, a rise in prepaids could indicate that a company has become more aggressive in reporting by delaying the recognition of expenses. The consistent, gradual increase does draw attention to the trend. However, given the lack of insight into the cause, we are not ready to attach a high degree of concern to the increase.

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.

Disclosure

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