BEHIND THE NUMBERS

EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

August 8, 2019 | www.btnresearch.com

Stryker (SYK) EQ Review-6/19 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 strong acquisition-volume growth across all of its product segments in the 6/19 quarter and topped EPS targets by 4 cps. Our overall level of concern for the company's earnings quality is not high, but there are still some minor points to take note of. A jump in receivables DSOs and a decline in contract liabilities constitute a decline in the earnings quality for the quarter, prompting us to reduce our rating to 3- (Minor Concern) from 3+ (Minor Concern).

- Accounts receivable DSOs in the 6/19 quarter jumped by 2.8 days over last year's second quarter. SYK's receivables generally stay very consistent and the DSO increase of more than 2 days is unusual. SYK had a strong performance in revenue growth in the quarter with the top line solidly beating the consensus estimates. Regardless, we are somewhat concerned that the jump in receivables could be signaling that disproportionate amount of sales could have fallen at the end of the quarter which could be a drag on revenue in the 9/19 quarter.

- The company discloses its contract liability balances in its footnotes which represents cash received from customers at the inception of contracts which is recognized as revenue over the contract term, typically less than a year. The balance fell to $321 million from $337 million last year and $331 million in the 3/19 quarter despite the increase in revenues. The year-over-year decline represents 1.2 days of sales. This looks out of place as the company experienced strong acquisition-adjusted volume

growth in all its product segments. While this could be due to the timing of contract signings in certain businesses, it could also be indicating an acceleration of revenue recognition in the quarter. For perspective, if contract liabilities had remained constant on a days of sales basis, it would have taken approximately $50 million off of revenue in the quarter.

- SYK continues to supplement its R&D spending by acquiring smaller companies. In March, SYK paid $110 million for OrthoSpace with another $110 million in future milestone payments possible. The company specializes in orthopedic biodegradable technology for the treatment of rotator cuff tears. The company booked $114 million in goodwill in the deal (which will not be amortized). This follows the November acquisition of K2M for $1.38 billion. Of that deal, $788 million of the purchase price was booked as goodwill (not amortized) with another $475 million booked as developed technology and patents with the related amortization added back to adjusted non-GAAP EPS. While the booking of the intangibles is the proper treatment under GAAP, we have always believed this overstates results since the company would have had to expense the R&D if it had developed the technology in-house. SYK's decision to add back the amortization of acquired intangibles to adjusted EPS is common in the industry but nonetheless leads to an unrealistic impression of the company's real earnings, in our opinion. For perspective, the company's adjusted EPS of $1.98 for the 6/19 quarters includes $0.26 per share of amortization of acquired intangibles expense added back.

- Growth in prepaid expenses days of sales leveled out in the quarter after several quarters of year-over-year increases in the 2-4 day range. We were uncertain of the source of increases in the past, but the moderation of growth in the 6/19 quarter alleviates concern that results benefitted from the increased capitalization of expenses.

- Inventory DSIs jumped by 9 days over the year-ago quarter, continuing a string of increases. We realize that medical device companies carry large inventory balances to facilitate the fulfillment of orders or various sizes and models of its products. We also understand that the release of new products requires a rapid buildout of inventory to prepare to provide the necessary sizes of products as needed. Nevertheless, the current DSI level of 230 compares with 221, 204 and 182 for the 6/18, 6/17 and 6/16 quarters respectively. We have seen similar trends with other medical device companies which may simply be an indication of a secular increase in working capital needs for the industry as well as rising raw materials costs.

Explanation of EQ Rating Scale

Rating	Explanation
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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