BEHIND THE NUMBERS
Quality of Earnings Analysis
December 1. 2021

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Teva Pharmaceuticals Industries Ltd (TEVA)
Earnings Quality Update- 9/21 Qtr.

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

We are maintaining our earnings quality coverage of TEVA at 3- (Minor Concern).

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

Summary

TEVA continues to make some progress on its goals in 2021 and potentially having some limits on its opioid exposure should be a positive. We find several areas of accounting concerns that may not be sustainable. For an $8-$9 stock with a history of earning $2.50+ we think sustainability (how much of the $2.50 is real?) and debt are still the primary concerns.

Lowering allowances against sales are at least 60-cents in our opinion for both GAAP and non-GAAP annual EPS and may prove to be headwinds as they started to reverse in 3Q21. The spread between GAAP and non-GAAP remains huge too – with GAAP of 3Q21 of 26-cents against non-GAAP of 59-cents. YTD, GAAP is only 52-cents vs. non-GAAP of $1.81. Several of the adjustments are recurring items in our view.

The potential for litigation payments remains a multi-billion item for TEVA. That can swiftly alter forecasts for earnings and cash flow.

What is strong?

- Free Cash Flow has continued at a pace in 2021 that enables TEVA to retire debt. The goal of fully reaching <3x EBITDA by the end of 2023 may be aggressive, but debt appears likely to keep declining.

Free Cash Flow	YTD 21	YTD 20	2020	2019
Cash from Ops	$342	$885	$1,218	$748
Securitizations	$1,278	$1,102	$1,405	$1,487
Asset Sales	$269	$54	$67	$343
Capital Spend.	-$409	-$402	-$578	-$525
Free Cash Flow	$1,480	$1,639	$2,112	$2,053
Net Debt Retired	$1,666	$1,756	$1,880	$1,863

The cash received from securitizations looks fine to us. TEVA sells receivables without recourse and pulls in cash more quickly. It accounts for it in the financing section of the cash flow statement rather than the operating section but it adds it back in its calculation of free cash flow. We like this definition of free cash flow used by TEVA because it includes payments made for restructuring and litigation in the cash from operations section.

What is weak?

- Sales are still declining despite continued declines in rebates (volume incentives) and chargebacks (reducing prices of inventory in the channel). Sales in the 3Q21 fell 2.3% ($91 million) and YTD by 3.5% ($428 million). TEVA attributes this to Covid still impacting customer stocking and traditional purchasing patterns. Also, it still sees lower volume from lower doctor and hospital activity.

- Rebates booked against sales fell from $3.649 billion to $3.060 billion YTD (down 16.1%). For 3Q21, rebates fell by $140 million or 13.2%. Sales would have been down in 3Q21 by 5.8% if rebates had simply been flat.

- We talked about these sizeable contra-accounts to sales falling noticeably in 2020 and expected to see them bounce back in 2021. By 3Q21, it appears this is starting to occur as it bounced up 60bp y/y. Remember, when these items increase – sales decline. TEVA could still be seeing pressure on sales growth going forward. Keep in mind, these allowances have a history of being over 400bp higher. That may remain a sizeable headwind for TEVA:

Allowances	3Q21	3Q20	YTD 21	YTD 20	2020	2019
Rebates	$921	$1,061	$3,060	$3,649	$4,703	$5,552
Medicare	$226	$132	$617	$566	$744	$976
Chargebacks	$1,954	$1,943	$5,949	$6,268	$8,438	$9,565
Returns	$64	$83	$207	$299	$459	$281
Other	$69	$5	$246	$55	$71	$394
Total	$3,234	$3,224	$10,079	$10,837	$14,415	$16,768
Reported Sales	$3,887	$3,978	$11,778	$12,206	$16,659	$16,887
Allow % Gross Sales	45.4%	44.8%	46.1%	47.0%	46.4%	49.8%

- Keep in mind – these lower rebates, chargebacks, etc. are also boosting reported gross profit margins and making results look better than they may actually be. We used the non-GAAP Cost of Sales which adds back acquired intangible amortization, stock compensation, regulatory actions, inventory writeoffs and accelerated depreciation. That Cost of Sales figure should be the same whether TEVA pays rebates, chargebacks, etc. Margin on gross sales has been declining but did increase in 3Q21. However, margin on net sales has been increasing for some time on the net sales as allowances decline. If these allowances to sales start to increase more like several began in 3Q21, then reported gross margin may come under pressure too:

	3Q21	3Q20	YTD 21	YTD 20	2020	2019
NonGAAP COGS	$1,804	$1,894	$5,467	$5,799	$7,925	$8,185
Gross Sales	$7,121	$7,202	$21,857	$23,043	$31,074	$33,655
Net Sales	$3,887	$3,978	$11,778	$12,206	$16,659	$16,887
Margin on Gross	74.7%	73.7%	75.0%	74.8%	74.5%	75.7%
Margin on Net	53.6%	52.4%	53.6%	52.5%	52.4%	51.5%

- GAAP and Non-GAAP earnings benefit when the amounts for these allowances declines. If the company's results return to more normal levels in this area, there may be $800 million at least of headwind. That's 60-cents of EPS against the non-GAAP

What to Watch?

- Earnings adjustments continue to add back several recurring costs in our view. For example, TEVA adds back amortization of intangible assets, stock compensation, litigation costs, and costs to comply with regulations. All of those occur in almost every quarter. In addition, TEVA continues to take impairments of goodwill, acquired intangibles, or both annually for more than 5-years and it continues to add back material restructuring charges every year too. Some of that can include inventory write-offs, or step-ups as well as accelerated depreciation (these are in other non-GAAP items.)

	3Q21	2021 YTD	2020
Pre Tax GAAP	**$382**	**$833**	**-$4,406**
amortiz. Intang.	$199	$613	$1,020
restructuring	$28	$96	$120
legal fees	$3	$113	$60
impairments	$47	$401	$6,447
regulatory chgs.	$5	$17	$23
equity comp.	$26	$86	$129
contingent paymts.	$9	-$7	-$81
other non-GAAP	$103	$194	$151
other	$6	$104	-$85
Pre Tax non-GAAP	**$807**	**$2,452**	**$3,378**

  As we noted above, both GAAP and non-GAAP earnings are being helped by the lower sales allowances seen in 2020 and 2021 too. That may be helping earnings by more than 20% and may not be completely sustainable. It's also worth noting that litigation costs were only $60 million in 2020 and $113 million YTD in 2021. That compares to $1.2 billion in 2019 and 2018 which were added back.

- Debt Levels are declining, EBITDA remains a poor measure to review it though. TEVA's EBITDA adds back litigation and contingency costs, stock compensation, costs to meet regulatory requirements, and inventory write-offs. All of those appear to be recurring costs and several consume cash. Plus, EBITDA is computed from operating income – which is benefitting from lower sales allowances. This was a $2 billion help in 2020 vs. 2019 and nearly $800 million in 2021ytd vs. 2020. (See the table on allowances above).

	3Q21	3Q20	YTD 21	YTD 20	2020	2019
Adj. EBITDA	$1,170	$1,153	$3,538	$3,635	$4,912	$4,685

- TEVA is using Net Debt of $21.7 billion against trailing four quarters EBITDA of $4.8 billion to compute debt to EBITDA of 4.5x. It's goal is to pay it down to less than 3x by the end of 2023. That still looks aggressive as it would require Debt to fall by $7 million in in the next 2-years and free cash flow is not high enough to pay for that.

- Also consider that EBITDA is inflated by the declines in new sales allowances of late and that is showing signs of reversing. We think TEVA may be high by about 300-400bp in this area on gross margin just from the drops in allowances. That is more than $800 million to $1 billion in EBITDA. That is serious potential pressure compared to the $4.8 billion figure TEVA just reported. That alone could mean TEVA needs to retire almost $10 billion in debt in the next two years. Plus, free cash flow of $2 billion per year is also being helped by those lower allowances as the amount being charged is very close to what TEVA is settling each year.

- Netting the debt against cash is very common and cash of $2.0 billion is making the ratio 4.5x now instead of 4.9x. The reason we think investors should not necessarily view debt in this manner is TEVA has some hefty contingencies for legal issues that already has a $2 billion reserve. Also, TEVA is already pulling cash from receivables by securitizing them.

- Litigation is likely to remain a sizeable risk. As noted above, TEVA adds back its litigation expenses as one-time items in non-GAAP earnings. However, investors should remember that the litigation allowance is $2 billion. If the company has to pay a larger amount of claims going forward, it would not hurt non-GAAP earnings but would crimp the free cash flow figure TEVA touts as it would flow through cash from operations. There have been years such as 2019 and 2013 when litigation charges were at least $1.2 billion and 2015-17 when they were at least $500 million. In 2020, it was only $60 million. Plus, TEVA is getting sued on many fronts such as patent infringement, pricing, as well as issues with customers.

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.

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.