BEHIND THE NUMBERS
Quality of Earnings Analysis

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# Teva Pharmaceuticals Industries (TEVA)
# Earnings Quality Update- 12/21 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 rating of TEVA at 3- (Minor Concern) and maintain our On Deck Sell rating.*

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

## Summary

TEVA posted non-GAAP EPS of 77 cents, beating estimates by 4 cents. The bigger news may be reaching some agreements to settle opioid litigation. Based on recent deals and proposals, TEVA believes it may reach a total settlement of $2.7-$3.6 billion to be paid over 15-years and one-third would take the form of providing free drugs for opioid treatment.

TEVA has $2.7 billion in litigation and loss contingencies accrued at this point. That would need to rise, in our opinion, given that the company has more than opioid litigation ongoing. But, we agree that perhaps being closer to at least defining the ultimate size of the resolution removes some of the issues facing TEVA.

We continue to have the same concerns regarding shrinking sales and adjustments to sales that reduce revenues by 46%. Sales allowances declined by $583 million during 2021, which added 44 cents to EPS this year when TEVA beat forecasts by a combined 1 cent over the year. We're also surprised that TEVA is the only company we have seen that reported its shipping costs went down by 10% in 2021. The heaviest lifting of cost-cutting appears to have run its course too. The spread between 38 cents of GAAP EPS and $2.58 of non-GAAP EPS remains

enormous and several recurring costs are being added back. Finally, debt retirement goals of being under 3x EBITDA still look tough to reach by 2023.

## What is strong?

- Recent deals on opioid litigation look tame compared to some initial forecasts. The CEO noted on the earnings call, *"I'm still optimistic that we can reach a nationwide settlement within the next 12 months. I've said that before. I'm still believing in that. And I think that the Texas settlement will be a good starting point for those ongoing discussions."* The Texas settlement terms call for TEVA to pay $150 million over 15 years and provide $75 million of its treatment drug over 10 years. TEVA had already reached settlements with Oklahoma and Louisiana and won a court case in California. There are other drug companies involved with looking for a national settlement that could be $26 billion. As noted above, TEVA's share could be approximately $3 billion +/- $500 million and paid over many years.

## What is weak?

- **EBITDA still looks overstated because TEVA adds back many recurring items. Free cash flow takes into account cash payments for litigation, restructuring, et.al and is less than half the level of EBITDA.** Moreover, free cash flow is already helped considerably by securitizing receivables and asset sales. All of this makes us believe EBITDA is not a realistic measure in determining how much debt TEVA can support:

| | 4Q21 | 4Q20 | 2021 | 2020 | 2019 |
|---|---|---|---|---|---|
| Adj. EBITDA | $1,373 | $1,277 | $4,911 | $4,912 | $4,685 |
| | | | | | |
| Cash from Ops | $456 | $331 | $798 | $1,216 | $748 |
| Cash from Securitiz. | $370 | $303 | $1,648 | $1,405 | $1,487 |
| Asset Sales | $43 | $13 | $311 | $67 | $343 |
| Capital Spend | -$153 | -$176 | -$562 | -$578 | -$525 |
| Free Cash Flow | $716 | $471 | $2,195 | $2,110 | $2,053 |
| | | | | | |
| Debt | | | $23,043 | $25,919 | $26,907 |
| Cash | | | $2,165 | $2,177 | $1,975 |
| Net Debt | | | $20,878 | $23,742 | $24,932 |

TEVA is carrying debt of 4.25x EBITDA and wants to be below 3.0x by the end of 2023- that's likely $6 billion in lower debt by then and they are not paying it down at that pace.

Plus, free cash flow is running $2.1 billion per year with $300 million from recent asset sales, and their securitization level rose to $1.65 billion in 2021. Cash from operations may also fall to reflect some cash payments on litigation that increase too.

- **TEVA is drawing down its sales allowances**. These are rebates, chargebacks, returns, and Medicare rebates that are netted against sales. **As they draw the allowances down, TEVA is actually causing net sales to increase by booking a smaller addition than actual settlements:**

| | 2021 | 2020 | 2019 | 2018 |
|---|---|---|---|---|
| Starting Allowance | $4,824 | $6,159 | $6,711 | $7,881 |
| Additions in year | $13,426 | $14,415 | $16,767 | $18,899 |
| Usage in year | -$14,009 | -$15,750 | -$17,319 | -$20,069 |
| Ending Allowance | $4,241 | $4,824 | $6,159 | $6,711 |
| | | | | |
| Net Sales | $15,878 | $16,659 | $16,887 | $18,271 |
| Additions | $13,426 | $14,415 | $16,767 | $18,899 |
| Gross Sales | $29,304 | $31,074 | $33,654 | $37,170 |
| | | | | |
| Allowance % Gross | 14.5% | 15.5% | 18.3% | 18.1% |
| Allowance % adds | 31.6% | 33.5% | 36.7% | 35.5% |

It is important to remember that these allowance items are not necessarily impacting costs very much beyond taxes. It is still manufacturing and shipping product represented by the gross sales. When a customer hits volume targets, it earns rebates from TEVA which reduce TEVA net sales. Medicare and other government buyers often get the lowest price and earn a rebate credit too. Chargebacks happen when prices fall in the marketplace and TEVA adjusts the prices down on what customers already hold. Also keep in mind, when prices fall or more generic drugs are sold – the level of rebates and chargebacks tends to decline too.

**Look at what is happening. In 2021, net sales dropped by 4.7%, or $781 million. However, the allowance account fell by $583 million. That's equal to 44 cents in EPS for a company that just reported $2.58 in non-GAAP. That $583 million would have hurt GAAP earnings of 38 cents by 44 cents too and net sales would have declined by 8.2%.** We arrive at that by starting with gross sales of $29,304 and subtracting $14,009 in allowances used and assuming TEVA matched that same $14,009 for new additions.

These allowance figures and the size of the chargebacks and rebates are material items. **TEVA has cut the allowance in half since 2018 and it is helping earnings. Investors should note that the decline in 2021 was much smaller than in recent years and the allowance was flat for 3Q21 and 4Q21 so this may be less of a source of earnings going forward.**

Also, Covid had an impact. In 2020, fewer people went for normal doctor visits and that helped reduce the size of rebates and chargebacks. That helped drive the allowances down so heavily in 2020. That didn't fully correct in 2021, but it did not have as large an impact as 2020. Investors should remember that allowances charged against sales were only 46% of gross sales in 2021, but were 49%-50% from 2017-19.

- **It is also important to focus on these lower sales allowances boosting net sales as a source for gross margin gains.** TEVA has been rationalizing its operating footprint and consolidating offices, labs, and manufacturing. Costs have come down. But look at margin if the decline in sales allowances doesn't happen. Cost of goods would be the same based on gross sales or net sales. Gross margin is not rising on gross sales. It was 75.2% in 2021, lower than both 2019 and 2018.

  It is rising on net sales that are inflated via lower allowances. For 2021, had net sales been $583 million lighter if the total allowance used was equal to the amount netted against sales – gross margin on net sales would have been 52.5% - basically flat y/y. With the lower allowances, gross margin jumped 180bp.

| | 2021 | 2020 | 2019 | 2018 |
|---|---|---|---|---|
| Gross Sales | $29,304 | $31,074 | $33,654 | $37,170 |
| nonGAAP COGS | $7,266 | $7,925 | $8,185 | $8,725 |
| Gross Profit % | 75.2% | 74.5% | 75.7% | 76.5% |
| GP on Net Sales % | 54.2% | 52.4% | 51.5% | 52.2% |

  **We think it is important to also look back at EBITDA of $4.9 billion. That calculation starts with GAAP operating income of $1.7 billion. We know that figure is inflated by drawing down the sales allowances too**. As we showed above, net debt to EBITDA is 4.25x right now. If EBITDA was lower by $583 million, that debt ratio increases to 4.82x.

- Impairments continue on intangible assets. TEVA has not made a meaningful acquisition since 2016, yet the "one-time" charges keep coming. The rationale behind much of this

comes from more generic drugs and TEVA revising its forecasts down for pricing and volume for the assets it acquired. We wonder if higher interest rates mean higher discount rates when TEVA is determining the present value of these intangible assets going forward, which would reduce the estimated value.

| | 2021 | 2020 | 2019 | 2018 | 2017 | 2016 |
|---|---|---|---|---|---|---|
| Goodwill Impairmt | $0 | $4,628 | $0 | $3,027 | $17,100 | $900 |
| Intang. Impairment | $424 | $1,502 | $1,639 | $1,991 | $3,800 | $746 |

We think it's important to remember that TEVA has a leveraged balance sheet from making acquisitions with still over $23 billion in gross debt. The entire market cap for the stock is under $10 billion. And they have written off $36 billion in assets in recent years due to weaker cash flows. In our view, TEVA spent real cash on all these deals and still has $20 billion in goodwill and $7.5 billion of other intangible assets. We believe the risk of additional write-offs could still be high. We think this also points to TEVA using an amortization period for definite-lived intangibles that is too long.

- Non-GAAP earnings continue to be significantly higher than GAAP because TEVA still adds back many recurring items:

| GAAP to non-GAAP | 2021 | 2020 | 2019 | 2018 |
|---|---|---|---|---|
| Pretax GAAP income | $658 | -$4,406 | -$278 | -$195 |
| Amortization Intang | $802 | $1,020 | $1,113 | $1,166 |
| Impairments | $584 | $6,546 | $1,778 | $5,518 |
| Legal Fees | $717 | $60 | $1,178 | -$1,208 |
| Regulatory Chgs | $23 | $23 | $45 | $14 |
| Stock Comp. | $118 | $129 | $123 | $152 |
| Contingency Pymts | $7 | -$81 | $59 | $57 |
| Restructuring | $133 | $120 | $199 | $488 |
| Other | $429 | $59 | $87 | $239 |
| Pretax NonGAAP Inc. | $3,471 | $3,470 | $4,304 | $6,231 |
| | | | | |
| GAAP EPS | $0.38 | -$3.64 | -$0.91 | -$2.35 |
| NonGAAP EPS | $2.58 | $2.57 | $2.40 | $2.92 |

The amortization of intangibles is getting smaller as TEVA has taken so many impairments since the last acquisition. It is still providing over 20% of adjusted income by adding it back. Legal fees, regulatory changes, and stock compensation happen all the time. For 2021, adding these back helped non-GAAP EPS by 54 cents, 2 cents, and 9 cents. Those are all recurring items.

“Other” includes amortization of financing costs – that is largely from refinancing debt and we’re fine with that. It also includes removing some marks to fair market value for derivatives like currency hedges and we’re fine with that. It also has times it includes accelerated depreciation and inventory items. Those do not meet the smell test as they frequently involve taking a write-off of future expenses – then adding it back as though it didn’t occur – followed by claiming that the restructuring actions boosted profitability. In reality, the ongoing cost was pulled forward and didn’t need to impact future results.

# 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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