BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Teva Pharmaceutical Inds. Ltd. (TEVA)
Earnings Quality Review

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

We are initiating 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 caught our eye because after years of horrible results following a debt-fueled acquisition binge, it had been working to correct the course and we noticed that net sales and non-GAAP EBITDA looked better in 2020. We also understand the basic case for TEVA that is focusing on debt reduction from free cash flow that should transfer value within the enterprise value from the debt to the equity.

Non-GAAP EPS jumped from $2.40 to $2.57 in 2020 as well, which is saying something for a $10-$11 stock. What we found were some significant issues in sales allowances that likely added as much as 70-cents that had some COVID issues and may not recur. There may be another 8-10 cents from reduced travel expenses in 2020 too.

While non-GAAP EPS ignores other recurring costs like litigation, contingent consideration on past deals, restructuring and regulatory costs – free cash flow does not. COVID closed court rooms and litigation that is often a $1 billion cost at TEVA came in at $60 million in 2020. Those expenses seem likely to return going forward. That could hurt Free Cash Flow and jeopardize the debt repayment goals expected to occur by the end of 2023. In the end, the stock is not as cheap as it appears on non-GAAP earnings, in our opinion, and its effective leverage is higher than it appears with the items being ignored in EBITDA as well.

What is strong?

- Even with many issues we have with not including litigation costs in adjusted earnings along with other recurring costs, TEVA still appears to have improved its situation considerably. It hit targets to reduce costs by $3 billion and it is producing free cash flow that can continue retiring the hefty debt load.

- The company has stopped making acquisitions too, which may mean future intangible asset write-offs could be less spectacular. That also lets it apply free cash flow to fix the balance sheet.

What is weak?

- The difference between GAAP and non-GAAP earnings is very wide. Forget the impairments as one-time items and it's still possible to see a very large part of the reported non-GAAP EPS of $2.57 as low quality or unsustainable.

- The sales allowance figures were helped by COVID issues and fewer customers hitting rebates in 2020. It looks like it added over $900 million to net sales and gross profit. That is 69-cents of the $2.57. Lack of travel expenses that should return are another 9-cents.

- TEVA ignores many recurring costs like contingency payments, equity compensation, restructuring costs, and costs to deal with regulatory changes. In most years, a conservative figure for those items is $300 million or 22-cents of the non-GAAP EPS.

- Most importantly, TEVA ignores litigation costs that it points to dozens of times as a key part of its business operation. In 2020, COVID closed courts and delayed the process and litigation was a mere $60 million. In other years it is a $1 billion item – which is as much as 74-cents of the non-GAAP EPS.

- Free cash flow of $2 billion per year is expected to pay off $8 billion in debt in three years. That free cash flow has been helped in the past with asset sales that may be difficult to repeat. It was also helped last year by the lack of litigation and sales allowances and still only came in at $2.1 billion. TEVA is moving toward that goal, but it may take longer to reach.

What to Watch?

- We almost rated this a '2 (Weak)' because many of the macro fundamental issues management has pointed to for weakness still appear to be having negative impacts on the business. That in turn has implications for the accounting such as weaker cash flow, effectively boosting the debt ratio, and asset write-downs. We would need to do more work on opioids contingencies and litigation issues as well as the pricing pressure in several of TEVA's markets and product lines before we want to let those fundamental factors influence the Earnings Quality rating. At this point, we have focused on earnings quality and accounting factors that we believe are unsustainable but drove 2020 results as well as the shortcomings of some of the non-GAAP definitions TEVA is using.

- Does this company keep shrinking due to the competitive pricing pressure it has faced for the last several years? Despite pulling $3 billion out of costs, EBITDA is still declining as net sales fall more than that. This analogy isn't perfect – but there were some offshore oil drillers who were making the argument that "our business is cyclical and in good times we make $7/share." The bears were countering, "that's true, but you were making $7 with 40 rigs and you only have 12 left – how can you get back $7 now in any market?"

- We think TEVA is more leveraged than the reported 4.7x ratio. Its cash balance of $1.7 billion is nothing for a company that often has $1 billion in litigation costs and $16 billion in sales allowances per year. If we simply do not subtract cash from the debt and make EBITDA a more realistic $1 billion less – considering legal bills often approach or exceed $1 billion and there could be that much more in headwind from sales allowances rising and travel returning – debt to EBITDA is closer to 6.4x.

Supporting Details

Revenue and Gross Margin Can Be Quickly Changed by Sales Allowances

TEVA deals with wholesalers and government health care rules. It has several sales allowance items relating to volume discounts, incentives, returns, and changes in pricing that impacts wholesale inventories. It charges these items off net of sales and sets up the allowance as a current liability. The reserve includes:

- **Rebates** – Volume incentives for customers who can hit sales targets. TEVA estimates this on historical trends and forecasted sales.

- **Medicaid and Government Allowances** – these are rebates also. They result from government programs negotiating best price levels and individual states have also obtained additional rebates.

- **Chargebacks** – Customers and wholesalers have inventories and when the prices for products decline TEVA will issue them a credit to reduce future invoices. This moves based on sales mix and inventory levels in the channel.

- **Returns** – these occur when product expires before it is sold by the customer. It can be returned for up to 1 year. This is an estimate.

- **Promotional** – These are offered on new product launches or targeted programs. This is an estimate too.

- **Shelf-Stock Adjustments** – This is like a chargeback; it allows retailers to lower prices on inventory when the wholesale price has declined.

This is a sizeable account; it is larger than net income and the cash on hand:

Allowances in $mm's	2020	2019
Sales Reserves/Allowances	$4,824	$6,159
Cash on Balance Sheet	$2,177	$1,975
non-GAAP Net Income	$2,830	$2,637

All these items are estimated, and the cash expenses are realized within a year. What investors should focus on is the size of these annual charges, which are much larger than the period end reserve:

Allowances exp. in $mm's	2020	2019	2018	2017	2016
Rebates thru year	$4,703	$5,552	$6,572	$6,435	$7,890
Government thru year	$744	$976	$1,284	$1,589	$1,911
Chargebacks thru year	$8,438	$9,565	$10,206	$12,408	$8,086
Returns thru year	$459	$281	$442	$280	$535
Other thru year	$71	$394	$417	$469	$398
Total	$14,415	$16,768	$18,921	$21,181	$18,820
Reported Net Sales	$16,659	$16,887	$18,271	$22,385	$21,903
Allowances % Gross Sales	46.4%	49.8%	50.9%	48.6%	46.2%

In dollar terms, these allowances have been declining with sales. Some of this is due to TEVA divesting some units in 2017 as part of its restructuring. The larger part of the sales decline is due to competition cutting prices on its key drug *COPAXONE* and other generic products. With lower prices – rebates and chargebacks decline too.

2020 may be a special case that is unsustainable. The allowance figure falling to 46.4% of sales from 49.8% was helped by COVID lock-downs. Doctor visits were lower which meant fewer new prescriptions. There were fewer sales calls on doctors too. Existing patients reordered early on in COVID, but then had gaps in stocking through the year as they had extra prescriptions on hand. This made it difficult for customers to hit volume targets to earn rebates and chargebacks may have been less frequent too.

Two things caught our eye when we started looking at TEVA – the revenue decay figure slowed to only 1% in 2020 and the non-GAAP adjusted EBITDA figure rose 5% vs. several years of decline. After looking in this area, where sales allowances fell over 300bp of gross sales in 2020, we think COVID was a big help. 300bp of gross sales in 2020 is $930 million in allowances that didn't cut reported net sales or EBITDA. Sales would have declined 7% and adjusted EBITDA would have declined 15% too if the allowance was 300bp higher. Remember, guidance for sales is for the net figure. For 2021, TEVA expects sales to start slow and be more back-loaded. We think that may be a case of the allowances as a percentage of gross sales rising to a more normalized rate in 2021 and reducing the net figure.

We also think investors should look at the impact on Gross Margin due to this issue. Cost of Goods Sold is determined by the production of enough supply to generate gross sales. It should be the same figure regardless of the amount of allowances netted against sales. TEVA uses several non-GAAP adjustments that we will discuss below. But at this point, we will use the company's non-GAAP Cost of Goods Sold figure:

in millions $	2020	2019	2018	2017	2016
non-GAAP COGS	$7,925	$8,185	$8,725	$10,351	$8,485
Gross Sales	$31,074	$33,654	$37,170	$43,486	$40,733
Net Sales	$16,659	$16,887	$18,271	$22,385	$21,903
Margin on Gross Sales	74.5%	75.7%	76.5%	76.2%	79.2%
Margin on Net Sales	52.4%	51.5%	52.2%	53.8%	61.3%

Pulling out the sales allowances and using gross sales, gross margin continued to decline in 2020 – another 120bp. However, on net sales, gross margin rose 90bp. Had net sales been $930 million lower if allowances had been 300bp higher in 2020, the net sales gross margin would have declined also to 49.6%.

The key point is investors should be aware of how large these sales allowance items really are and how much they influence sales growth and margins. It looks like it could become a sizeable headwind for 2021 compared to 2020 results.

Litigation Looks Like a Recurring Cost

TEVA's adjusted non-GAAP earnings and EBITDA add back litigation costs as being one-time in nature. We will agree they are lumpy. However, they occur every year and throughout the 10-K, TEVA makes repeated mention about how several parts of the business model involve litigation or risking litigation, along with 13 pages in the footnotes about specific litigation and contingencies:

- *We have a robust product portfolio, comprehensive R&D capabilities and product pipeline and a global operational network, which* ***enables us to execute key generic launches to further expand our product pipeline and diversify our revenue stream****. We use these capabilities to help overcome price erosion in our generics business.*

- ***We will challenge patents when appropriate if we believe they are either invalid or would not be infringed by our generic version.*** *We may seek alliances to acquire rights to products we do not have in our portfolio, to* ***share development costs or litigation risks, or to resolve patent and regulatory barriers to entry.***

- ***We have filed a lawsuit in the U.S. District Court for the District of Massachusetts alleging that Eli Lilly & Co.'s ("Lilly") marketing and sale of its galcanezumab product for the treatment of migraine infringes nine TEVA patents.*** *Lilly then submitted IPR (inter partes review) petitions to the Patent Trial and Appeal Board, challenging the validity of the nine patents asserted against it in the litigation.*

- ***One European patent protecting COPAXONE 40 mg/mL was found invalid*** *by the Board of Appeal of the European Patent Office in September 2020. Two additional patents expiring in 2030 are currently under opposition at the European Patent Office. In certain countries,* ***TEVA remains in litigation against generic companies on an additional COPAXONE 40 mg/mL patent that expires in 2030.***

- *In July 2018,* ***Eagle prevailed in its suit against the FDA to obtain seven years of orphan drug exclusivity in the United States for BENDEKA. On March 13, 2020, this decision was upheld in the appellate court.***

- *In September 2019,* ***a patent infringement action against four of six ANDA filers for generic versions of BENDEKA was tried in the United States District Court for the District of Delaware****. On April 27, 2020, the District Court upheld the validity of all of the asserted patents and found that all four ANDA filers infringe at least one of the patents.* ***Three of the four ANDA filers have appealed the district court decision***

- ***TEVA and Eagle filed suit against Hospira, Inc. ("Hospira")*** *related to its 505(b)(2) new drug application ("NDA") referencing BENDEKA in the U.S. District Court for the District of Delaware. On December 16, 2019, the Delaware* ***District Court dismissed the case against Hospira on all but one of the asserted patents, which expires in 2031. Trial against Hospira on that patent is scheduled to begin on November 15, 2021.***

- ***We consider the overall protection of our intellectual property rights to be of material value and act to protect these rights from infringement.***

- ***Efforts to defend the validity of our patents are expensive and time-consuming****, and there can be no assurance that such efforts will be successful.*

- ***We are currently subject to several governmental and civil proceedings and litigations relating to our pricing and marketing practices, intellectual property, product liability, competition matters, opioids, securities disclosure and corporate governance and environmental matters. These investigations and litigations are costly*** *and involve a significant diversion of management attention.*

- ***A number of state attorneys general, including a coordinated multistate effort, are investigating our sales and marketing of opioids, and we have received subpoenas from the DOJ seeking documents relating to the manufacture, marketing and sale of opioid medications****. In addition, we are currently litigating civil claims and administrative actions brought by various states and political subdivisions as well as private claimants, against various manufacturers, distributors and retail pharmacies throughout the United States in connection with our manufacture, sale and distribution of opioids.*

- ***We have been involved in numerous litigations involving challenges to the validity or enforceability of listed patents (including our own), and therefore settling patent litigations has been and will likely continue to be an important part of our business.***

- ***Our ability to introduce new products depends in large part upon the success of our challenges to patent rights held by third parties or our ability to develop non-infringing products. Based upon a variety of legal and commercial factors, we may elect to sell a product even though patent litigation is still pending, either before any court decision is rendered or while an appeal of a lower court decision is pending.***

- ***In large part as a result of the nature of its business, TEVA is frequently subject to litigation****.*

- *In addition, TEVA incurs significant legal fees and related expenses in the course of defending its positions even if the facts and circumstances of a particular litigation do not give rise to a provision in the financial statements.*

We believe that TEVA lays out the case that its business model and ability to launch new products depend on litigation. Without new products, TEVA would be continually subject to price erosion from more generic competitors – hurting sales, margins, and cash flows.

in millions $	2020	2019	2018	2017	2016	2015	2014	2013
Litigation, Settlements, Contingencies	$60	$1,178	-$1,208	$500	$899	$631	-$111	$1,524

Keep in mind that the effective tax rate is about 17%-18% of late with 1.1 billion shares. So, $500 million in legal costs is about 37-cents in EPS. TEVA is adding this back to adjusted EPS which was $2.57 and $2.40 in 2020 and 2019. Thus, this is a material part of earnings and is often an ongoing cash expense – it is 15%-30% of EPS.

COVID created an aberration in 2020 as courtrooms were part of the lockdowns and many legal actions were delayed and rescheduled. That resulted in litigation costs of only $60 million last year. That would only hurt EPS by 4-cents vs the normal 37-74 cents had it come in at $500 million - $1 billion. That could mean 2021 and 2022 see much larger costs as the legal process catches up.
TEVA will add back this cost to non-GAAP EPS and EBITDA, but it won't be able to add it back to free cash flow. Guidance is for flat free cash flow in 2021 vs. 2020. Is litigation going to come in at $60 million again? We think it could rise significantly this year and pressure free cash flow.

… So Do Restructuring Expenses

TEVA went through an extensive restructuring effort between 2017-19 with the goals of closing/consolidating manufacturing plants, reducing headcount by 14,000, optimizing the

portfolio of drugs to cull those losing money and/or work with customers to ensure those remaining can be profitable for TEVA. The goal was to reduce the costs by $3 billion.

The restructuring was heaviest in 2017 and 2018. However, TEVA has been reporting restructuring charges for years before and since that time:

in millions $	2020	2019	2018	2017	2016	2015	2014	2013
Restructuring	$120	$199	$488	$535	$245	$183	$246	$201

Everything we read from management points to the reasons TEVA undertook a large restructuring program of late are still not slowing down:

- Customers are more concentrated giving them more power in their buying and rebates and on pricing.

- More generic drugs continue to roll-out, (including from the large pharma companies) which challenge TEVA's own branded drugs. This continues to push pricing down.

- TEVA has a large portfolio with products coming and going along with changes in its distribution models.

We would argue that restructuring will continue to be an annual cost of doing business for TEVA. The nature of what is being done will change year to year and some of it will be non-cash. However, we think investors should be prepared for TEVA to have some amount of headwind on earnings and free cash flow because of these types of actions. Every $100 million of recurring restructuring that is ignored adds 7-cents to non-GAAP EPS.

… and Don't Forget Regulatory Changes or Contingency Payments

There are also other items being added back that recur annually. These include costs to deal with regulatory changes and liabilities that need to be paid for royalties and milestone achievements from acquisitions. In prior years, there have been inventory step-ups where acquired inventory is marked up and amortized into Cost of Goods Sold (this has not been an issue in the last few years) plus TEVA is adding back recurring equity compensation:

in millions $	2020	2019	2018
Contingent Payment	-$81	$59	$57
Regulatory Chg Cost	$23	$45	$14
Equity Comp.	$129	$123	$152
Other R&D	$37	$15	$83
Total	$108	$242	$306

As we noted above, $100 million in costs impacts non-GAAP EPS by about 7-cents. These costs are lumpy, but they tend to recur every year. Investors should note that the Contingent Payment in 2020 was $81 million in income rather than an expense. This was due to a change in royalty payments to Allergan for a past deal and TEVA revalued the liability. That alone should produce a headwind for 2021 Free Cash Flow. TEVA is already ignoring these recurring items in non-GAAP EPS and EBITDA.

TEVA Is the Poster Child to Argue Against Long and Eternal Intangible Asset Lives

We mentioned above that TEVA reports a GAAP and non-GAAP Cost of Goods Sold. The largest difference between the two figures is the amortization of acquired intangible assets. Regular readers know that we believe acquisitions consume cash at the time of purchase. Also, had the company built the same assets in-house, there would have been research and wage expenses, which would have been expensed and not added back as non-GAAP items. Here is the difference in COGS and it is generally about $1 billion:

in millions $	2020	2019	2018
GAAP COGS	$8,933	$9,351	$9,975
non-GAAP COGS	$7,925	$8,185	$8,725
Difference	$1,008	$1,166	$1,250
Amort. Intangibles	$894	$973	$1,004

The $894 million being added back helped non-GAAP EPS by 66-cents in 2020. Investors can reach their own comfort level on this level of earnings being due to this area. On the pro side, TEVA cannot afford to do acquisitions of late and has not done a major deal since 2016. (The years 2016, 2015, and 2011 are the years of sizeable deals in the last ten years). Thus, the cash aspect of acquisitions is not a recurring item. Also, the amortization life is 10-years for the bulk of these assets and there are certainly many companies going much longer than that.

On the con side, these assets did cost cash and if they were built in-house would have also consumed cash that was expensed. That would have lowered profitability and cash flow. Adding back the expenses ignores the cost of the deal and inflates results.

However, one thing neither the company nor the pro side of adding this chargeback as a non-cash item can ignore is the asset lives do not look like have nearly the value as they do on the balance sheet. Even with TEVA expensing over 10-years, these assets are still not able to justify their shrinking valuation as patents expire, pricing pressure builds, and profitability falls. TEVA has been taking impairments on acquired intangible assets annually for years.

in millions $	2020	2019	2018	2017	2016	2015	2014	2013
Intang. Impairments	$1,502	$1,639	$1,991	$3,800	$746	$265	$224	$393

Of course, these impairments are being added back to non-GAAP EPS too. It appears that 10-years is much too long of an expected life for many of these assets. On the balance sheet, the $8.9 billion in intangibles is still nearly all of book value which is $11.1 billion at the end of 2020. In the 1Q21, TEVA took another impairment of $649 million.

Goodwill is an even larger issue at TEVA. This is considered to have a perpetual life and is not amortized at all. A stark difference between building in-house vs. acquiring assets. In the case of TEVA, Goodwill peaked at $44.4 billion in 2016. Depending on where the acquired assets are held in the world, there are some annual FX translation adjustments. We do not have an issue with that. TEVA has also sold and divested some assets that led to reductions in Goodwill. But the same problems impacting the company in recent years, have also made Goodwill valuations unsustainable on forecasts of future cash flows. TEVA has had huge impairments of Goodwill:

in millions $	2020	2019	2018	2017	2016
Goodwill Impairments	$4,628	$0	$3,027	$17,100	$900

These assets are supposed to have eternal life like *Mickey Mouse* and *Coca-Cola* brand names. 39% of the peak goodwill of $44.4 billion didn't make it through 1-year. Goodwill of $20.3 billion still stands at almost double the equity balance of $11.0 billion. We would expect more of these sizeable impairments based on the pressures management has been talking about for several years. If interest rates increase, the hurdle rate of valuing these assets could also increase and lower the values further.

The Restructuring Plan Achieved Many of Its Goals

Looking back to 2016 and 2017, it has closed/divested facilities and square footage as planned. It planned to cut the workforce from by 14,000. It has fallen from 53,000 to 39,700 at the end of 2020. It has worked to help profit levels on some products with items like the changes in royalty levels mentioned earlier and in 2020 it noted some improved gross margin from better product mix. The goal was to reduce the cost base by $3 billion. Here are the non-GAAP costs:

non-GAAP Costs	2020	2019	2018	2017
COGS	$7,925	$8,185	$8,725	$10,351
R&D	$941	$1,004	$1,102	$1,515
Sales/Mrkg	$2,322	$2,438	$2,718	$3,149
G&A	$1,115	$1,145	$1,228	$1,413
Total	$12,303	$12,772	$13,773	$16,428

We would note three potential things to watch:

- Sales are down significantly too – gross sales fell from $43.5 billion to $31.1 billion too. We already talked about how net sales benefited from lower sales allowance items in 2020, but reported net sales are still down from $22.4 billion to $16.7 billion. The lower sales totals are also bringing down EBITDA despite the lower cost total. Non-GAAP EBITDA fell from $6.7 billion in 2017 to $4.9 billion in 2020, even with some cost savings.

- TEVA still has a sales team that goes out to pitch products to doctors. In 2020, COVID restricted travel and there were fewer doctor visits. That helped lower S&M costs in 2020 by about $120 million and that may bounce back in 2021.

- There was some accelerated depreciation recognized as part of the restructuring. About $100 million of the cost savings has come from deprecation being lower.

The Future for Shareholders

The shares of TEVA have been thoroughly carpet-bombed in recent years. The company cut, then eliminated the dividend, had large-scale restructuring, has taken billions in write-offs, and is focusing on reducing debt. The goal is to get net debt under 3x EBITDA by the end of 2023. Based on 2020 figures, non-GAAP EBITDA is $4.9 billion and the market cap is $23.2 billion in

net debt + $11.5 billion in stock value or $34.7 billion. TEVA is trading for 7x non-GAAP EBITDA.

Getting the debt down to less than 3x EBITDA would mean retiring another $8 billion in debt, and assuming no increase in the multiple of 7x EBITDA – that $8 billion should transfer to the stock value and add about $7/share.

Here is where shareholders should still have some worries:

- We noted above, there are some huge recurring cash costs related to rebates and other sales allowances. The total spending in that area was down over $900 million in 2020. Litigation is part of the TEVA business model and last year it only spent $60 million in that area – not the normal amounts that often approach $1 billion. We would argue that debt should NOT be netted against the cash on hand of $1.7 billion as TEVA has many huge cash expenses. Or investors should be expecting that cash balance to be much lower after 2021 and 2022.

- Non-GAAP EBITDA is benefiting from ignoring legal costs and the much lower sales allowances of 2020 too. It also was helped by a lack of travel costs. We doubt, TEVA will ever start viewing legal costs as ongoing expenses and subtract them from EBITDA, but there should easily be over $1 billion in EBITDA from 2020 that may not repeat if travel and sales allowances return to normal levels. That means EBITDA may be closer to $3.9 billion. Trailing EBITDA is already down $200 million after 1Q21.

- Going from Net Debt of $23.2 over $4.9 billion in EBITDA or 4.7x to Gross Debt of $25.0 billion over $3.9 billion in EBITDA would have TEVA at 6.4x EBITDA still on debt ratios. Remember, that doesn't include the legal bills. To hit 3x EBITDA, it would require debt payments of $13 billion not $8 billion.

Then, what is Free Cash Flow that will be necessary to repay the debt and drive shareholder value? The company defines this a Cash from Operations + Proceeds from Securitized Receivables + Proceeds from Asset Sales – Capital Spending. This would take into account cash legal costs, travel costs, sales allowances rising, and cash restructuring costs:

Cash Flow	2020	2019	2018
Cash from Ops	$1,216	$748	$2,446
Securitizations	$1,405	$1,487	$1,735
Asset Sales	$67	$343	$890
Capital Spending	-$578	-$525	-$651
Total	$2,110	$2,053	$4,420

This compares to non-GAAP EBITDA at about $5 billion. The company is losing steam from asset sales. It is counting on newer products to offset the pricing decay that has hurt results in recent years and is forecasting Free Cash Flow at $2.0-$2.3 billion after capital spending of $0.6 billion. We think 2020's figure was inflated with the lower legal, travel, and sales allowance costs. Having those become headwinds may make 2021 guidance tough and put considerable pressure on the newer drugs to perform very well.

Under a scenario of underperforming, the debt reduction efforts may take 7-8 years vs. the expected 3 years. And while it's tough to knock a stock at 7x EBITDA after all this one has been through; it looks more leveraged than people think, and the non-GAAP figures are inflating the EBITDA. We also would be concerned that after pulling $3 billion in costs out of the business as planned, non-GAAP EBITDA is still down $1.8 billion during that time. The pricing pressures that have impacted TEVA for years now may continue, which could make EBITDA and free cash flow lower beyond 2021.

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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