BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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# Thermo Fisher Scientific (TMO) EQ Update 9/19 Qtr.

| Current EQ Rating* | Previous EQ Rating |
|---|---|
| 3- | 4+ |

| |
|---|
| 6- "Exceptionally Strong" |
| 5- "Strong" |
| 4- "Acceptable" |
| 3- "Minor Concern" |
| 2- "Weak" |
| 1- "Strong Concerns" |

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

**We are lowering our earnings quality rating to 3- (Minor Concern) from 4+ (Acceptable).**

TMO beat EPS estimates by 6 cps in the 9/19 quarter. Management indicated that earnings were 9 cps ahead of its midpoint outlook, attributing 6 cps to strong operational performance and 3 cps from less adverse FX. Taking out the lower FX impact from the 6 cps consensus beat still leaves a 3 cps upside. However, we note several one-time benefits in the quarter as well as some minor red flags. Our reduction in rating is a result of the increase in DSOs, the decline in allowance percentage, and the extension of restructuring charges announced.

- Accounts receivable DSOs rose by almost 4.5 days over the year-ago quarter which the company attributed to supporting sales growth. However, this is definitely out of line with the year-over-year increases in the 6/19 and 3/19 quarters of approximately 1 and -0.3. The sudden nature of the increase is a concern as it could be an indication that the company lured sales into the quarter with easier credit terms.

- The company also stated in the 10-Q that other assets consumed an additional $186 million in the nine months ended 9/19 due to the timing of customer billings. We

assume this corresponds to the 1.7-day increase in contract asset days of sales versus the year-ago quarter. These contract assets relate to unbilled receivables where the company has recognized revenue under long-term contracts prior to billing the customer. This timing issue appears to have benefitted revenue growth in the current quarter. If contract assets had grown in line in sales, it would have taken over $100 million off of reported revenue in the 9/19 quarter.

- However, the company also stated in the 10-Q that cash flow was boosted by an increase in other liabilities due to increased customer deposits, which can be viewed as a type of deferred revenue. We assume this corresponds with the 1.4-day increase in contract liability days in the quarter. This is a positive for the quality of reported revenue as it represents cash received from customers which has yet to be recognized as revenue. This would offset most of the benefit of the increase in contract assets noted above.

- The allowance for doubtful accounts as a percentage of gross receivables fell to 2.4% from a peak of 2.9% hit in the year-ago quarter. While the company does not disclose quarterly provision expense, we estimate it would take almost 5 cps in provision charges to boost the reserve back the year-ago level.

- Warranty expense in the 9/19 quarter fell by almost a penny per share while the warranty allowance as a percentage of trailing 12-month sales fell to 0.34% from 0.38%. We estimate it would take about 2 cps in charges to boost the reserve to year-ago levels.

- The company identified an additional $80 million in restructuring charges it will take over 2019-2020. TMO features regular restructuring costs in its result which are added back to non-GAAP results. We again point out that the company adds back the amortization of acquired intangibles to adjusted earnings which amounted to $0.85 per share in the 9/19 quarter on total adjusted earnings of $2.94.

# 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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