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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH
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Thermo Fisher Scientific (TMO) EQ Review Update-6/18 Quarter

Current EQ Rating*	Previous EQ Rating
4+	NA

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

We initiate coverage of Thermo Fisher (TMO) with a 4+ (Acceptable) rating.

Despite a history of making multiple acquisitions, TMO does not display any of the warning signs of a serial acquirer failing to create value with its deals. In addition, we currently have no significant items of concern regarding the company's earnings quality.

- We note that the company's adoption of ASC 606 has resulted in inventories being materially lower than they would have been under the old method of accounting for revenue recognition. Since the company utilized the modified retrospective method of adopting ASC 606, historical periods have not been restated for the change. Rough adjustments for the accounting change indicate that DSIs in the first two quarters would have increased around 2-4 days over the comparable year-ago periods. This is not overly alarming given the unavoidable uncertainty in our adjustments and the strong reported organic growth.

Note on Adoption of ASC 606

TMO adopted ASC 606 starting in 2018 and, like most companies we have reviewed, elected to use the modified retrospective method of adoption. As such, it recorded a one-time adjustment to retained earnings and will apply the new accounting method on all new contracts and all uncompleted contacts as of the date of adoption. TMO is not required to

restate historical periods for the change, but it does disclose what the 12/17 account balances were prior to restatement. Adoption of the new revenue recognition guideline did not have a meaningful impact on reported profits or cash flows, but we do want to point out that it did have a meaningful impact on the company's reported inventory balances which must be taken into consideration when analyzing inventory balances for the next two quarters.

Prior to adoption, TMO recorded costs related to pharmaceutical development and manufacturing services were in inventory. However, such costs are now recorded under contract assets which are included in the "other current assets" account. The shift resulted in inventory at 12/17 being $252 million, or about 7 days of cost of sales lower than under the old method. This must be taken into consideration when comparing current inventory levels to historical balances that have not been restated for the change.

	6/30/2018	3/31/2018	12/31/2017	9/30/2017
Inventory DSIs	81.4	83.9	83.4	106.2

	7/01/2017	4/01/2017	12/31/2016	10/01/2016
Inventory DSIs	85.7	86.8	79.3	93.7

Note that the 12/17 quarter is based on the original inventory balance reported under the old method, not the adjusted amount disclosed in the notes of the last two 10-Qs. Likewise, none of the previous quarters have been restated for ASC 606. As noted above, the 12/17 inventory balance adjusted for the accounting change would have taken about 7 days off the 12/17 DSI figure. While we don't know what inventory balances for 6/18 and 3/18 would have been under the old method, we think it is reasonable to add 5-7 days to each quarter's DSI when comparing to the year-ago periods. Using the high-end of adding 7 days to the first two quarters of 2018, we get that DSIs would have registered year-over-year increases of 2.5 days and 4.1 days in the 3/18 and 6/18 quarters respectively. We are not very concerned about these increases, especially given the unavoidable uncertainty in our adjustments coupled with the roughly 8% organic sales growth the company is reporting. Still, investors should be aware of the necessary adjustments when analyzing inventory balances over the next two quarters.

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 recent 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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