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BEHIND THE NUMBERS
Quality of Earnings Analysis

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Dentsply Sirona, Inc. (XRAY) Earnings Quality Update 9/20 Qtr.

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

We are raising our earnings quality rating of XRAY to a 3+ (Minor Concern) from 3- (Minor Concern).

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

Summary

We see some tailwinds for XRAY in the near term for 4Q20 and 1Q21. Inventory levels at the distributors look low and XRAY's own inventories are down. That should help drive more sales as business recovers and help leverage fixed costs on production to improve margin. Also, accruals on working capital items should return to normal levels and help EPS in the coming quarters after being sizeable headwinds in 2Q20 and 3Q20. If XRAY is successful in reaching even some of its cost-savings target from restructuring, that could also be a tailwind for earnings.

However, XRAY will likely need to boost R&D after cutting it in 2019 and likely deferring more in 2020. Also, margins in 3Q20 were still helped by employees working fewer hours, salary cuts, and lower selling-related expenses like travel. Those should return to normal as business picks up.

Overall, we are still not impressed with XRAY's future plan of reaching $4 billion in sales and a 22% adjusted margin. Doing so would put it back in the same position it was in during 2015-16

before years of restructuring. Also, that goal would only produce an ROI of 13%, which would only be that high because XRAY wrote off $2.9 billion in acquired goodwill in recent years. If the equity base didn't take that hit, the best-case ROI target would be 9%. Those forecasts would result in adjusted EPS of about $2.75-$2.85, with about $0.65-$0.70 of that EPS coming from adding back amortization of acquired intangible assets.

What is strong?

- A resolution may be near with the SEC. From the 10-Q, "*As previously disclosed, in 2017, the Division of Enforcement of* ***the SEC asked the Company to provide documents and information relating to the Company's accounting and disclosures****. The Company has been fully cooperating with the SEC in connection with its investigation.* ***The Company now is discussing a possible resolution of the investigation.*** *Any agreement reached with the staff would be subject to Commission approval. There is no assurance that a settlement will be reached, or whether it will have a material impact on the Company's consolidated financial position, results of operations or cash flows."*

- XRAY hit its 22% adjusted operating margin in 3Q20. Even the company believes that may be a short-lived situation as big parts driving achievement were employees working fewer hours and employees with pay cuts – which will vanish if sales recover further and those temporary measures canceled.

- Inventory levels at distributors look low, which could produce some restocking demand for XRAY.

- Eliminating two lower-margin businesses in traditional Ortho and Lab should boost operating margin at XRAY – which describes their profit contribution as immaterial.

What is weak?

- XRAY pointed to a tough comp from 3Q19 as a headwind for 3Q20 sales dropping y/y along with COVID. We would have expected stronger sales simply because 2Q20 was so awful with dentists closed and sales falling $519 million (51%) creating a huge amount of pent-up demand. We still see XRAY seldom reaching its target of 3%-4% organic growth.

- R&D spending declined in 2019 from $161 million to $131 million. That was 80bp of the company's margin gain that year. XRAY talked about deferring spending in 2020 which may have included R&D again. The goal at XRAY is to speed the development of new products so we would expect a large bump in R&D spending going forward, which may be an earnings headwind.

What to watch

- Another acquisition? XRAY bought Byte for $1.04 billion in cash two weeks ago. Byte is expected to be accretive in 2021 with about 5-cents in EPS added. The plan is to boost Byte's profitability by rolling its product out on XRAY's much larger distribution system.

- We would like to see the break-out of where the purchase price was allocated, which should be in the next 10-K. With $200 million in revenues, XRAY paid 5x sales and for a fast-growth business, the sellers took all cash rather than any XRAY shares. This deal will likely have considerable goodwill, which will not be expensed, and other intangible assets that XRAY will add back to adjusted EPS. That is why the deal will have a small accretion to EPS. On the call following the deal, XRAY noted that Byte will help it achieve its 3%-4% revenue growth target. The issue is the $200 million in sales is not organic growth.

- Cash flow benefited from working capital being reduced during COVID. This added over $300 million in cash flow in 2Q and 3Q. As business returns, we expect much of that to reverse. Before the Byte deal, XRAY had $1.3 billion in cash on hand against $2.2 billion in debt. Byte cut the cash balance by just over $1 billion. That combined with working capital building and restoring reduced capital spending may slow share repurchases for a few quarters.

- Sales to the Rest of the World (not the US or Europe) are about 25% of total sales at XRAY. This was the area first hit by COVID and after 3Q, it is not mirroring the bounce in sales from the other two regions. The stronger dollar against those currencies could continue to weigh on XRAY sales or force it to lower prices which would hurt margin targets.

Supporting Detail

Restructuring Cost-Saving Forecasts Should Have Margins Coming in Much Higher than XRAY's Touted Goal

XRAY has been restructuring since 2016 and its merger with Sirona. We are hard-pressed to see the results being promised or if investors should even be judging results based on XRAY's goals. The goal is to achieve 22% operating margins by 2022.

If we start in 2014 and 2015 and simply add the operations of Dentsply and Sirona together, the combined company was essentially at that level already:

First Merger	2015	2014
Dentsply Sales	$2,582	$2,793
Sirona Sales	$1,161	$1,171
Total Sales	$3,743	$3,964
Dentsply Adj. Op. Income	$521	$513
Sirona Adj. Op. Income	$289	$277
Total. Adj. Op Income	$810	$790
Adjusted Oper. Margin	21.6%	19.9%

The first step was restructuring after the merger and was expected to produce $125 million in synergies and cost savings. **That alone should have boosted margins to 24.9%.** XRAY was also expecting to produce 3%-4% organic revenue growth during this time. Neither situation happened:

XRAY Results	2019	2018	2017	2016	2015
Sales	$3,988	$3,949	$3,957	$3,855	$3,743
Internal Growth *	5.7%	-1.8%	-0.2%	2.4%	
Adj. Operating Income	$742	$614	$791	$804	$810
Adj. Operating Margin **	18.6%	15.5%	20.0%	21.8%	21.6%

*Internal growth for sales excludes FX, acquisitions, dispositions

**Adjusted Op. Margin excludes amortization of acquired intangible, restructurings, impairments

Sales in 2019 were about $400 million light of where organic growth projections should have had the company. Plus, operating margins were expected to benefit from $125 million in cost savings after the 2016 restructuring. Operating income adjusted for all the acquisition costs and problems was down in dollar terms and in margin terms.

In the 3Q18, XRAY announced another $250 million in restructuring that was forecast to produce between $200-$225 million in cost savings by 2021. On roughly $4 billion in sales, that would add 500-560bp to operating margins. This would get XRAY to a 22% operating margin by 2022. The bulk of the savings was expected to come from lay-offs. The company announced that 2019 had $89 million in savings realized. Margins grew by 310bp from 2018 to 2019. The $89 million is 220bp and XRAY cut R&D spending by $31 million adding another 80bp.

Now let's look at what happened in 2020. The restructuring was expanded again from a $275 million program to $375 million in scope and cost. The expected savings were raised from $200-$225 million to $250 million or 625bp. With this incremental cost savings of 65-125bp, XRAY is forecasting the same margin target of 22% as before. The key to the enlarged restructuring is the company is exiting its traditional Ortho and Lab businesses. These two units had combined sales of $176 million and profits were immaterial. Exiting these businesses will result in a reduction of 6%-7% of the workforce. If profits were immaterial, it sounds like these units were lower margin than the rest of the company – which XRAY says in the 10-Q but does not quantify. Simply subtracting a lower margin unit should boost overall margins. So here's another tailwind that should materialize, yet where is XRAY setting its target – at the same 22% level!

To make this whole process even more suspect, the company was even hedging on the 22% figure on the 3Q call, which they reached in the quarter:

> "***we had laid out the target of 22% in 2022****. Whether that target is exactly hit, given COVID and given where revenues potentially could fall in 2021,* ***it's still a little bit of a question for us.*** *I would tell you; we're really committed to that 22% number.* ***And obviously, look, we hit it this quarter. And I think we're trying to tell you guys that there have been excellent structural improvements, but there were some stuff that was like temporary work – short work week, furloughs and other things [non-permanent cost savings] that ramp down as we bring people back, and you're starting to see revenue****.*
> *I mean, we had a $900 million revenue quarter. There's –* ***we pay commissions and we pay dealers and all that stuff, so some of that [cost] comes back.*** *But the 22% margin is, in our mind, absolutely, A, attainable; B, it's really something we're committed to. And again, what the exact timing is, that could get pushed a little bit but we think we're going to get there."*

We continue to be astonished that XRAY started in 2016 with a 21.6% operating margin and done three major things designed to boost margins by over 300bp, 500bp, and now another 125bp. Yet, the goal is to get to an operating margin of 22% by 2022 where it was in 2015. Looked at another way, a 22% margin on $4 billion in sales is only $880 million in operating income without accounting for amortization of intangibles vs. $810 million in 2015. COVID or not, we're amazed XRAY is having a tough time battling to get to that $880 million figure after all the touted cost-cutting and focus on growth markets.

Allowances May Decline and Help EPS, Working Capital May Be a Headwind for Cash Flow

Some of the reserves against working capital have been working against XRAY's recent EPS. We would expect these reserves to decline going forward and become EPS tailwinds:

	3Q20	2Q20	1Q20	4Q19
Inventory Reserves	$126	$102	$96	$85
Finished Goods Inventory	$282	$322	$368	$356
Reserve %	44.5%	31.7%	26.1%	23.8%
Seq. Change EPS Impact (cents)	-8.6	-5.2	-0.4	

In our view, the reserve is most likely applied to finished goods inventory. Throughout 2019 and even until the start of COVID, this reserve has been about 25% of finished goods +/- 2%. The inventory figure is likely to rise again too. In has been about $390 million for finished goods in most quarters. That would mean a reserve of just under $100 million. **Even if the level of inventory rises, XRAY's reserve should decline. They have suffered an 8.6 cent headwind in 3Q20 and 5.2 cent headwind in 2Q20 against reported adjusted EPS of 67 cents in 3Q and -18 cents in 2Q.**

The bad debt reserve for accounts receivable looks similar, but the level of receivables is low too. Historically, the bad debt reserve has been 4%.

	3Q20	2Q20	1Q20	4Q19
Bad Debt Reserve	$31	$37	$31	$29
Accounts Receivable	$628	$500	$709	$782
Reserve %	4.7%	7.0%	4.2%	3.6%
EPS Impact from 4% (cents)	4.0	-5.3	-0.6	

If the reserve had been 4% during 2020, XRAY had a small headwind for EPS in 1Q, a 5.3 cent headwind in 2Q, and then 3Q would have benefitted by 4.0 cents on EPS vs. 2Q's $37 million reserve. Going forward we would expect receivables to rise as sales recover further. XRAY may not have a tailwind from bad debt reserves after enjoying the decline in 3Q.

For other items, XRAY saw stock compensation decline by $15 million in 2Q20 which added 5.0 cents to EPS. The tax rate dropped by 450bp in 3Q and generated 3.8 cents. Neither seems likely to be sustained.

Cash flow will likely have some headwinds as working capital is rebuilt. Releasing it has been a large part of recent cash flow:

XRAY Cash Flow	3Q20	2Q20	1Q20
Accts Rec.	-$119.6	$215.4	$53.3
Inventory	$74.8	$56.3	-$57.3
Prepaid Exp.	$17.2	$60.2	-$27.2
Other n/c assets	$2.1	$12.7	-$6.8
Accts Payable	$24.0	-$59.8	-$28.9
Accrued Liabilities	$66.0	-$43.5	-$95.1
Working Cap. Chg.	$64.5	$241.3	-$162.0
Cash from Ops	$207.1	$175.1	-$10.7

It is possible that 4Q and 2021 could see working capital consume more than $200 million in cash flow.

XRAY Cash Flow	3Qs 2020	2019	2018	2017
Working Cap. Chg.	$143.8	-$2.1	-$28.8	-132.5
Cash from Ops	$371.5	$632.8	$499.8	601.9
Capital Spending	$60.0	$122.9	$182.5	144.3
Acquisitions	$2.0	$3.2	$130.5	145.9
Free Cash Flow	$309.5	$506.7	$186.8	$311.7
Dividends	$65.9	$80.9	$78.6	$78.3
Share Repurchases	$140.0	$260.0	$250.2	$401

If working capital consumes cash going forward and we know XRAY already spent over $1 billion on another acquisition at the end of 2020, how much can it afford to spend on shares in the near future? Plus, capital spending has been low for two years already and should increase going forward. Also, if R&D increases back to 2018 levels, that will lower Cash from Operations too. This is not a dire situation overall, but it could slow the share buybacks. In 2020 so far, repurchases added 2-cents to adjusted EPS.

Inventory Levels Are Low and Could Help Sales Growth and Operating Leverage for Margins in Near Term

If we look at the inventory at XRAY and at the distributors – there should be some more demand coming for XRAY to fulfill pent-up demand and simply boost inventories available. This could be a tailwind for 4Q20 and even 1Q21 for XRAY sales:

XRAY DSIs	Dec	Sept	June	March
2020		115.0	176.4	143.4
2019	111.3	123.2	118.5	126.3
2018	102.2	135.6	124.3	143.8
2017	114.2	126.6	121.4	126.2

Sales falling in the 2Q20 certainly impacted the DSIs for inventory. The large reserves against inventory mentioned above also lower the DSIs. Arguably XRAY was in good shape starting 2020 on inventories and then COVID has lowered them further. That should enable the company to build what is most in demand and not suffer as much from inventory reserve accruals as in 2Q and 3Q. That should help near-term earnings.

For the distributors, we see the same thing. COVID had inventory levels out of whack based on lower sales earlier in 2020. However, now that business is correcting, the inventories may be too low. As we've noted in our past report on XRAY, when the channel is replenishing inventory levels – it tends to be positive for XRAY's gross margin:

Patterson DSIs	Dec	Sept	June	March
2020		56.0	64.4	74.7
2019	69.1	64.3	71.1	61.8
2018	70.3	65.2	73.3	64.1
2017	74.5	67.9	70.6	58.6

Henry Schein DSIs	Dec	Sept	June	March
2020		64.0	104.4	72.0
2019	70.2	71.1	74.3	77.7
2018	72.9	73.8	72.6	79.1
2017	73.0	66.4	64.4	70.6

And XRAY's adjusted gross margin has already bounced back:

XRAY adj Gross Marg.	Sept	June	March
2020	56.6%	42.1%	57.0%
2019	56.9%	57.7%	57.1%

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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