BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Dentsply Sirona (XRAY) Earnings Quality Update

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 XRAY of 3+ (Minor Concern).

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

Summary

XRAY's adjusted 3Q21 EPS of $0.68 beat forecasts by 3-cents. While the company narrowed guidance and raised the top-end for 2021 by 2-cents to $2.87-$2.92; it implies a lower EPS for 4Q21 ($0.76-$.0.81 vs 4Q20 at $0.87). XRAY also reduced forecasts for the BYTE acquisition on the call. In another indication of how low XRAY had set guidance, it cut its Euro/USD forecast again from 122 to 118 and now to 116. After the first cut, XRAY said it would hurt 2H21 by 5-cents in EPS. Maybe it was 2-cents in 3Q and now 4-cents in 4Q. Yet, the company could still boost guidance and project a 6-cent y/y decline.

Many of the recent issues we have pointed out as impacting earnings were still present in 3Q but were less significant. If XRAY was spending 4% of sales on R&D, it would have met forecasts rather than beat by 3-cents. There still appears to be some areas for concern in our view:

What is strong?

- XRAY is still guiding to R&D spending of 4% of sales. Original guidance was $160 million, based on current sales forecasts now it should be closer to $170 million. We are in favor of R&D so we are considering this a strength. The problem we see is the company is only at $112 million after three quarters which is 3.5% of sales and that fell to 3.3% in 3Q. R&D in 4Q20 was $36 million (3.3% of sales). It would need to be $48-$58 million in 4Q21 to hit guidance. That would be between 4.2%-5.1% of the high-end of 4Q sales guidance. This would be 4-7 cents of EPS headwind for 4Q. In 3Q, 0.7% of sales as additional R&D to be on track would have cost XRAY 3-cents against its 3-cent beat.

- The Swedish tax issue dispute appears moving in XRAY's favor. The amount of the dispute has fallen from $57 million to $49 million and now $12 million. The EU courts have ruled in favor of XRAY and it is now on appeal.

What is weak?

- Guidance for BYTE was to post an accretive 5-cents in EPS this year as long as investors add back the amortization of intangibles. On the call, management hinted several times they may not reach that goal and pointed to several items such as less government pay for people not working, more people going on vacation rather than buying dental procedures, seasonality with the holidays…. We don't want to go overboard on this, the potential miss is likely 1-2 cents for 4Q. But come on, XRAY paid a sizeable premium and $1 billion for this company based on it being a fast-growth area. Management forecast that its long-term growth rate target of 3-4% would rise 100-200bp with BYTE. Three months ago, it was performing at expectations. Now, it may miss because an irrational short-term unemployment situation that paid many people more to remain unemployed expired? XRAY does not have the best track record on making acquisitions so this sends up some red flags.

- Inventory reserves declined again in 3Q. It did not have a material impact on margins or EPS in the period. However, we will point out again, this reserve is normally about 25% of finished goods inventory. At some point, there may be $15 million or about 5-cents of EPS in headwind for XRAY.

	3Q21	2Q21	1Q21	4Q20
Fin Goods Inv.	$327	$336	$303	$264
Inv. Reserve	$89	$93	$95	$117
Reserve %	21.40%	21.70%	23.90%	30.70%
Help to EPS	0.4 cents	3 cents	10 cents	
Help to GM%	12bp	89bp	204bp	
Reported GM	58.40%	58.70%	59.50%	

- Bad debt reserves were flat on higher receivables. In 2Q, they fell by $4 million to $14 million. In 3Q, they stayed the same as receivables rose 8%. This is not a major red flag at all – but this is another tailwind that appears to be gone for XRAY's EPS.

- Recovery in higher tax areas was expected and forecast by XRAY and it came true with an effective tax rate of 23.4% for 3Q. This looks like another headwind that will continue.

What to Watch?

- Inventory levels remain low at XRAY with DSIs at 102 after 3Q, down from 105 in 2Q. Historically, XRAY holds about 120 days of inventory. Asked about this on the call, management said they expect their historical average level of inventory to decline. We still believe this deserves to be followed for out-of-stock situations and because it could consume cash going forward if the DSIs rise. That may be $50-$60 million of cash to boost DSIs about 10 days.

- The share purchase plan was recently raised by $1 billion. Where things stand now, we believe this will take some time. YTD in 2021, Free Cash Flow was $86 million and the dividend was $68 million. Debt is elevated after the BYTE deal and other purchases. It doesn't look like there will be a surge in EPS growth from shrinking the share count in the immediate future.

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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