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Dentsply Sirona Inc. (XRAY) Earnings Quality Update 12/20 Qtr.

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

We maintain our earnings quality rating on XRAY of 3+ (Minor Concern)

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

Summary

XRAY beat 4Q20 forecasts by 23-cents with an adjusted EPS of 87-cents. We can see some areas where XRAY picked up some short-lived items such as cutting R&D in 2020 to only $115 million, which added 6-cents to 2020 EPS. Adjusted SG&A declined from $420 million to $362 million in the 4Q. That was 21-cents and would have included the R&D decline. It also included lower marketing, lower commissions, and travel. We don't have a break-out of all those costs. We would say that XRAY did beat forecasts as those items are unlikely to amount to more than half the SG&A decline.

We should also point out that XRAY is guiding to $90 million in higher SG&A in 2021 and is guiding to R&D recovering from $115 million to $160 million. That should create higher quality earnings but may pressure margins in 2021.

Where we are still negative on XRAY are its ugly history of acquisitions, its continual restructuring, and the fact that based on its best-case scenario the adjusted ROI is about 9% with a decent part of that coming from adding back amortization of acquired intangibles. We would urge investors to review our prior update from January 15 on XRAY that details how the company's goal is to restructure for years and end up at the same profitability as 2016.

What was stronger?

- Low inventories in the channel should help XRAY's near-term gross margin. It should boost sales, allow for greater leveraging of fixed costs during manufacturing, and perhaps help pricing remain firm. XRAY is only carrying 83 days of inventory, which is the lowest figure in four years. 102 days was the prior low in December 2018. Patterson normally carries about 70-days and is now at 62. Henry Schein is at 60 days vs. the normal 70. Even adjusting for the $31 million write-off of inventory by XRAY in 2020 would only add 5-6 days to DSI's and it would still be very low. A 1% boost to gross margin would add 14-cents to EPS in 2021.

- The inventory reserve figure is already declining. It peaked at $126 million or 44.5% of finished goods inventory in 3Q20. It hurt EPS in 3Q by over 8-cents. In 4Q, the reserve is down to $117 million and 44.3% of finished goods inventory. This ratio is normally 25%. Even assuming the DSI rises to 112-115, if the reserve falls to 25%, XRAY could see this reserve fall under $100 million and thus the expense could be $15-$20 million lower in 2021. That would be 5-7 cents in EPS tailwind.

- The SEC investigation into past accounting and disclosures is now complete. The final resolution included a minor civil payment of only $1 million. This was dealt with in 4Q.

What was weaker?

- As we feared, the acquisition of BYTE for $1.045 billion was essentially completely assigned to intangible assets. $631 million is going to goodwill, which will not be expensed. Another $416 million was added to intangibles with basically half being technology amortized over 10 years and the rest tradenames amortized over 20 years. Guidance is that BYTE will add 5-cents to EPS in 2021, which is about $14 million in adjusted pretax earnings. Amortization alone will be almost $34 million. That tells us that in reality, BYTE is going to lose at least $20 million. That also ignores that goodwill would be another $16 million in expense if it was amortized over 40 years. Plus, XRAY issued $750 million in debt at 3.3% last year and this is arguably where that cash went. It is paying $25 million in interest on that money. The ROI on the rough guidance is just over 1% adding back the amortization and ignoring the interest cost.

- XRAY has taken several impairments in recent years of intangible assets including more in 2020. They are using a discount rate as low as 9% in determining fair market value. The repeated write-offs are evidence to us that there should be a faster amortization period and/or a higher discount rate. There is only $5.0 billion in equity here vs. $6.5 billion in intangible assets, with $4.0 billion not being amortized at all.

- The company still has an outstanding dispute with the IRS over a $546 million deduction from 2013. The IRS disallowed the deduction and XRAY is appealing. There is also a Swedish tax dispute involving $57 million for interest deductions that were disallowed. XRAY has not set up a reserve for either matter.

- XRAY has one of the longest auditor letters we have seen in a while. It is 5-pages long and excludes BYTE from the 2020 assessment of internal controls but does call out valuations assigned to intangible assets for BYTE as critical audit matters and highlights the large degree of judgment and high use of forecasts. It further notes that the huge amount of intangibles overall are critical to the audit as well as the tax issues.

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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