BEHIND THE NUMBERS
Quality of Earnings Analysis

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Dentsply Sirona Inc. (XRAY)
Earnings Quality Update

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 at 3- (Minor Concern)

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

Executive Summary

- XRAY was down over 12% on news of the CEO's departure and the revelation that upcoming 1Q22 earnings and revenues will miss forecasts by a wide margin only a few days after the CFO's departure was announced.

- We speculate this relates to the BYTE acquisition which has already seen the outlook downplayed by management in the last two quarters. The company was also already relying on multiple low-quality source of EPS growth in the last few periods.

- This episode is eerily similar to the 2015 merger of Dentsply and Sirona which saw multiple executive departures in the wake of the deal followed by massive writedowns and earnings downgrades.

The Announcement

More fireworks at Dentsply-Sirona (XRAY) in the last week. First, the CFO announced he was leaving last Monday (April 11). Then on April 18, the CEO Don Casey was terminated immediately. The company also announced that its upcoming earnings would miss by a significant margin. Revised forecasts now call for sales of $965 million vs. forecasts of $1.02 billion and adjusted EPS 48-52 cents vs. estimates of 67 cents.

XRAY warned in February that supply chain issues and chip shortages would hurt 1Q and 2Q22, but it still expected to achieve 4%-5% organic growth in 2022 and EPS of $3.05-$3.25 vs $2.87 in 2021 which represented +6% to +13% growth. Announcing that the company is dealing with a lack of chips to fulfill all its orders for technology equipment sales is hardly unique to XRAY. The majority of companies including semiconductor companies themselves have complained about this for 6-7 quarters now.

So what went wrong?

We are speculating that the sudden change of outlook may relate to the $1.1 billion BYTE acquisition from 2020. The purchase price was allocated to goodwill of $627 million and other intangibles of $416 million. This acquisition was expected to add 5 cents to 2021 adjusted EPS (which added back all the amortization). In 3Q21, only 3 quarters after the deal, XRAY cut guidance on BYTE. This was a key part of future growth. The company's long-term forecasts called for dental sales to grow 3-4% annually and the BYTE products were expected to add 100-200bp to that growth forecast. However, the company has already warned that things were not progressing as planned at BYTE:

- 3Q21, XRAY said BYTE was running below forecasts as consumers were not receiving as much in government Covid support checks and it might not make 2021 forecasts.

- 4Q21, XRAY said BYTE was still a key to the future, but it now expected y/y sales declines for BYTE. Again, consumer spending shifted away from buying aligners at rates seen during Covid.

Were there warnings signs?

Are there impairments coming here in 1Q22? This was the first big acquisition after the merger of Dentsply and Sirona.

We could also speculate that this news of departures and reduced guidance ties back to several items in recent quarters that did not look like they could repeat but were adding material amounts to adjusted EPS:

- XRAY reduced its tax valuation allowance from $287 million to $267 million in 4Q21. That included a $10 million credit. This is seen in the 10-K and we believe much of the change for this item happens in the fourth quarter. A $10 million credit is worth 3.6 cents in EPS.

- Inventory reserves fell from $117 million to $86 million from 4Q20 to 4Q21. This added 10 cents to 1Q21 and nearly 15 cents to all of 2021.

- Stock compensation (which is included in adjusted EPS) was $54 million through September and finished at $48 million in December – a credit of $6 million, which added 2.1 cents to EPS. y/y the swing was $18 million or 6.4 cents.

- R&D spending is still worth monitoring. XRAY says it wants to spend 4% of sales on R&D. We noted that it was not hitting that figure through the first 9 months of 2021 – coming in at $112 million or 3.5% of sales. It hit the 4% figure on the nose for the year with $59 million or 5.4% of sales in 4Q21. However, it moved $10 million of SG&A costs already expensed in the first 9 months of the year into R&D for the 4Q. To us, it sounds like they were still $10 million light on the target, and EPS in the first 9 months already reflected the $10 million in expense. So in 4Q21, R&D increased by $10 million, but SG&A declined by $10 million, which is a wash. This looks like another area where one could argue EPS was inflated by 3.6 cents.

- We also know that as part of the many restructuring charges that XRAY has taken in recent years, it was accelerating some depreciation into those charges. We noticed that depreciation expense turned flat in early 2021, but it dropped noticeably in 3Q and 4Q:

Depreciation	4Q	3Q	2Q	1Q
2021	$30	$30	$32	$32
2020	$38	$39	$33	$32

In 2020, XRAY recognized $14 million of accelerated depreciation. The $8 million drop in depreciation for 4Q21 added 2.9 cents to EPS. We think investors should also look at the adjusted gross margin of 57.7% up 100 bps for 4Q21. The drop in depreciation and decline in inventory reserve equals that margin gain. We also note that XRAY uses FIFO accounting, which should also be helping gross margin in the current environment.

Echos from the past?

When we first read the news of the executive departures and downgraded outlooks after a large deal, we thought we had seen a similar situation before. Then we remembered – “Oh yes! It was right after the Dentsply-Sirona merger.” In late 2015, the two companies announced they would merge and it was completed in February 2016. In 2017, the four executives who did this deal were all gone – CEO of Dentsply, CEO of Sirona (who became the CEO), CFO of Dentsply, and COO of Dentsply.

Only months after filing the 2016 10-K in early 2017, when XRAY said goodwill and intangible valuations were fine, XRAY took a $1.1 billion impairment on goodwill and another $80 million write of other acquired intangibles in 2Q17. This was followed by $581 million of goodwill impairments and $267 million of intangible impairments in 4Q17. In the 2017 10-K, XRAY even seemed to lower the hurdle rate to test these asset values. They used a range of 6.4%-14.7% in 2016 and 7.8%-9.5% in 2017, but they wrote off $1.8 billion that year. That was followed by another $1.1 billion of goodwill being written off plus another $179 million of intangibles in 2Q18. Not surprisingly, the SEC stepped in to review the company’s accounting and disclosures.

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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