BEHIND THE NUMBERS
Quality of Earnings Analysis
August 6, 2021

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Dentsply Sirona Inc. (XRAY)
Earnings Quality Update- 6/21 Qtr

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 at 3+ (Minor Concern).

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

Summary

XRAY's 71-cents of non-GAAP EPS beat 2Q21 estimates by 5-cents. Following the beat in 1Q, XRAY boosted guidance for the year by 10-cents. No increase in guidance accompanied this latest beat. We believe there are several reasons for this that indicate some headwinds for the rest of this year. We also saw 6-cents of EPS in 2Q21 that may not repeat or reverse:

- FX has been a positive on earnings in both 1Q (adding 5.3% to sales) and 2Q (adding 10.7% to sales). XRAY is reporting that its EURO to Dollar forecast from the start of the year is not valid and the change in forecast is expected to hurt EPS by 5-cents for the 2H21.

- The effective tax rate may see upward pressure beyond the forecast of 23-24%. In 1Q, XRAY added 2-cents to non-GAAP EPS from a lower tax rate of 22.9%. In 2Q, it added 3-cents from the effective rate of 23.9%. In the 10-Q, XRAY notes that more sales to higher tax countries are moving the tax rate higher. There are still disputes on appeal for

taxes with the IRS and Sweden for prior year returns and XRAY has not established a liability for either at this point.

- Bad debt reserves declined from $18 million to $14 million from 1Q to 2Q even though receivables rose from $661 million to $692 million. This added 2-cents to 2Q21 EPS.

- XRAY changed the last of its inventory from LIFO to FIFO in 2Q21 also. This resulted in a mark-up of inventory of $4 million that boosted Cost of Goods by the same $4 million. This was added back and gave XRAY another 1-cent in adjusted EPS in 2Q.

- XRAY's inventory reserve figure fell again. We expected this to happen, but it is now down to 21.7% and it normally is about 25% of finished goods. This has been adding to EPS and gross margin in 2021:

	2Q21	**1Q21**	**4Q20**
Fin Goods Inv.	$336	$303	$264
Inv. Reserve	$93	$95	$117
Reserve %	21.7%	23.9%	30.7%
Help to EPS	3 cents	10 cents	
Help to GM%	89bp	204bp	
Reported GM	58.7%	59.5%	

Here is another tailwind that helped EPS in the 1H21 that may vanish or even reverse in 2H21.

- XRAY still has not caught up to its R&D spending forecast of $160 million for the year. They were light by $3 million in 1Q, which helped that quarter's EPS by 1-cent and XRAY still expects to see R&D increase in dollar terms in the 2H compared to 1H21.

- There may still be inventory headwinds to deal with that can impact sales. DSIs finished 2Q at 105 days, marginally better than the 102 days of 1Q. That is still below the normal 120+ days figure. XRAY also voiced concerns that distributors are struggling to keep inventories where they need to be and that could impact the technology equipment sales the most. Patterson's last quarter had DSIs of 53, down from 62 to start the calendar year and normal levels are about 70 days. Henry Shein reported DSI this week of 74 – which is normal for them.

- XRAY has talked about great potential for BYTE driving sales, but has not boosted guidance there for 2021. The forecast for BYTE is to add 5-cents of non-GAAP EPS

which is entirely from adding back 15-cents in amortization expense. This may help in future years, but there is apparently significant work to go in building it up.

- Looking at guidance – XRAY touted its higher $1 billion share repurchase plan. However it is still guiding to a slightly higher number of shares this year. Also, we believe working capital will consume cash the rest of this year. We know guidance is for $160 million in capital spending and only $66 million has been spent in 1H21 so that will rise. And, XRAY spent $241 million on acquisitions so far this year. We wouldn't count on considerable cash flow to fund share repurchases.

- Also looking at guidance – XRAY is forecasting an adjusted operating margin above 20%. They've done that with 21.3% in 1Q and 20.5% in 2Q. However, that has been fueled by the cuts to inventory reserves, bad debt allowances, and spending below forecast on R&D so far. They are also cutting their FX guidance that helps sales and have some inventory concerns that can impact large ticket items sales. It is important to remember that with inflationary pressures – XRAY uses FIFO accounting, which normally helps margins with rising inflation.

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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