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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Zimmer Biomet (ZBH) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	2-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are upgrading our earnings quality rating to 3+ (Minor Concern)

ZBH's adjusted EPS of $1.81 in the 9/20 quarter sailed past the consensus EPS targets by 73 cps. We are raising our earnings quality rating mostly on the improvement in the receivables situation although we are still cautious of the company's long list of non-GAAP add-backs.

What improved?

- While days of sales for receivables left on the balance sheet increased YOY from 55.9 to 63.9, days of sales based on receivables that have been sold but remain outstanding at the end of the period fell dramatically, causing the total adjusted receivables DSOs to decline from 74.1 to 68.1. We view this as a positive for the quality of earnings in the period. However, the massive decline in factoring resulted in a drain on cash flow growth with the company quantifying the impact at $230 million for the first nine months of the year.

What to watch

- ZBH announced its 2019 Restructuring Plan at the end of 2019. It is expected to cost $350-$400 million through 2023 and result in $200-$300 million in annual cost savings by then. It incurred $89 million in costs in the first nine months of 2020 which it added back to non-GAAP results. Our concern level will increase with any expansion of the size or scope of the plan or the addition of any new plans. We note that the company already took over $2 billion in merger-related and restructuring charges in the two years following the $14 billion Biomet deal.

- In addition to restructuring charges, the company regularly adds back items such as obsolete inventory and manufacturing-related charges on product lines it plans to discontinue, ongoing quality remediation charges, litigation charges as well as an "other" category which includes a hodge-podge of charges including "legal entity, distribution and manufacturing optimization, and costs to comply with its DPA agreement with the government. Some of these amounts may be reasonable to add back but other categories seem broad and potentially operational in nature.

- Like most companies, ZBH temporarily reduced spending on discretionary items including travel and unnecessary items. The impact on R&D was particularly noticeable with adjusted R&D declining to $83.9 million in the 9/20 quarter from $103 million in the year-ago period. Just that amount represents about 7 cps which will inevitably have to reverse over the next couple of quarters.

Receivables Securitization Declined

ZBH maintains a receivables factoring program by which it sells customer receivables to third-party financing institutions to accelerate the receipt of cash. We have previously pointed out that the use of the factoring program was rapidly increasing and masking an overall increase in the level of receivables as well as temporarily boosting cash flow growth. This situation has now reversed, as seen in the following table:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Trade Receivables	$1,340.7	$1,064.5	$1,039.1	$1,363.9
Outstanding Principal Amount Derecognized for US and Japan	$87.0	$220.3	$421.8	$270.2
Receivables Adjusted for US and Japan Factoring	$1,427.7	$1,284.8	$1,460.9	$1,634.1
Trade Receivables Days of Sales	63.9	79.0	53.0	59.0
Factored Receivables Days of Sales	4.1	16.4	21.5	11.7
DSOs Adjusted for US and Japan Factoring	68.1	95.4	74.5	70.7

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Trade Receivables	$1,150.8	$1,247.1	$1,225.3	$1,275.8
Outstanding Principal Amount Derecognized for US and Japan	$372.6	$378.1	$390.4	$365.9
Receivables Adjusted for US and Japan Factoring	$1,523.4	$1,625.2	$1,615.7	$1,641.7
Trade Receivables Days of Sales	55.9	57.1	55.8	56.7
Factored Receivables Days of Sales	18.1	17.3	17.8	16.3
DSOs Adjusted for US and Japan Factoring	74.1	74.4	73.6	72.9

While days of sales for receivables left on the balance sheet increased YOY from 55.9 to 63.9, days of sales based on receivables that have been sold but remain outstanding at the end of the period fell dramatically, causing the total adjusted receivables DSOs to decline from 74.1 to 68.1. We view this as a positive for the quality of earnings in the period. However, the massive decline in factoring resulted in a drain on cash flow growth with the company quantifying the impact at $230 million for the first nine months of the year.

We also note that the outstanding principal amount of receivables sold and still outstanding include US and Japan receivables but not European receivables. In a previous review, we noted that language in the company's 10-Q made us wonder if the figure for total receivables sold to third parties also did not include receivables sold in Europe. For clarification and future reference, the company has confirmed that it does.

Restructuring and Cost Reduction Initiatives

ZBH announced a restructuring program at the beginning of 2019 to reduce operating costs. The "2019 Restructuring Plan" is expected to result in $350-400 million in spending through 2023 with the hopes of generating $200-$300 million in annual cost savings by then. The charge is expected to consist of "employee termination benefits; contract terminations for facilities and sales agents; and other charges, such as consulting fees, project management and relocation costs." In the first nine months of 2019, pretax charges have amounted to $89 million or approximately 9% of non-GAAP operating income. If the program stays on track in terms of scope and time frame, we will not be overly concerned.

However, we remind investors that ZBH took enormous restructuring charges after the 2015 acquisition of Biomet. Between 2015 and 2017, ZBH recorded "Biomet Merger-Related Charges of $1.4 billion-plus another $730 million in "Other Special Items." The company discussed the "Other Special Items" in its 2017 10-K as follows:

> *"We recognize expenses resulting directly from our business combinations, employee termination benefits, certain R&D agreements, certain contract terminations, consulting and professional fees and asset impairment or loss on disposal charges connected with global restructuring, quality and operational excellence initiatives, and other items as "Special items" in our consolidated statements of earnings. We recognized significant expenses in 2015 due to Biomet merger-related expenses, such as the acceleration of unvested LVB stock options and LVB stock-based awards, retention bonuses paid to Biomet employees and third-party sales agents who remained with Biomet through the Closing Date, severance expense and contract terminations. Expenses declined in 2016 due to the absence of certain of these expenses. In 2017, Biomet-related integration expenses continued to decline, but we have incurred additional costs related to quality remediation at our Warsaw North Campus facility."*

Unusual expenses related to an acquisition as large as the $14 billion Biomet deal are understandable. Regardless, our concern will increase if the size and scope of the 2019 plan begin to increase or new plans are announced.

Explanation of EQ Rating Scale

Rating	Explanation
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 Concerns"	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 may 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 the next quarter. 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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