BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

November 14, 2019 | www.btnresearch.com

Zimmer Biomet Holdings (ZBH) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	3-

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 a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We are maintaining our earnings quality rating of 3- (Minor Concern)

- The pace of receivables securitization continued to slow in the 9/19 quarter, with the balance of sold but outstanding receivables rising by only 1 day on a days of sales basis versus the year-ago quarter. Total receivable DSOs including sold receivables declined by more than 6 days. (We note that the balance of sold receivables includes the US and Japan portion and not factored European receivables in which the company is not involved in collections and does not disclose data.) Cash from operations adjusted for a one-time lawsuit payment declined slightly in the nine-month period ended 9/19. The company noted the following in its explanation of the decline: *"Additionally, in the prior year period, we continued to expand our sale of accounts receivable in certain countries which provided additional cash inflows, compared to the 2019 period where our sales of accounts receivable have not expanded significantly and therefore the incremental benefits to the period are less."*

- ZBH's gross margin benefitted from a one-time refund of medical device excise taxes during the quarter which was not quantified. On one hand, the presence of the benefit was noted in the MD&A section of the 10-Q, the conference call, and the impact was

forecast ahead of time in the outlook given in the second-quarter conference call. However, we have to question why the non-operating benefit was not excluded from adjusted non-GAAP earnings figures while items like obsolete inventory charges, termination of supply agreements, and costs to comply with legal agreements were.

- Inventory DSIs continue to rise with days of sales breaching the 400 mark in the quarter. DSIs are always relatively high for a medical device maker and ZBH is gearing up for new product launches. Nevertheless, 400 is an eye-popping number. Management made the following comment in the conference call regarding the inventory impact on upcoming gross margins: *"And as you know we have close to a year of an inventory which is another challenge and an opportunity we have in front of us. But those deferred or capitalized costs will flow through at a higher level into 2020, so that's a headwind."*

- At the beginning of the 6/19 quarter, the company paid $192.5 million to acquire the rights to certain intellectual property it had previously paid royalties to utilize. The purchase price was recorded as an intangible asset which is being amortized through 2029. However, given the company's policy of adding back the amortization of intangible assets to its non-GAAP earnings, the cost associated with utilizing these rights was effectively removed from adjusted results. We do not know the amount of the royalties previously paid, but we can estimate that the amount of quarterly amortization of the associated intangible is around $5 million or almost 2 cps. Management highlights the absence of the royalty payments in the MD&A section of the 10-Q although it is not quantified. As we have noted in past reviews, our opinion is that ZBH's policy of adding back amortization of intangibles to adjusted earnings overstates the company's true earnings power as it dismisses the cost associated to obtain these earnings-generating assets. For perspective, the non-GAAP EPS figure of $1.77 for the 9/19 quarter had $0.58 per share of intangible amortization added back.

- We remind investors of ZBH's history of impairment charges. The 9/19 10-Q echoed the previous warning issues after the 4Q 18 writedowns that the $732 million carrying value of its EMEA reporting unit remains susceptible to further write-downs should conditions deteriorate with the same true for the $387.2 million carrying value of its Dental unit.

Explanation of EQ Rating Scale

Rating	Description
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.

Disclosure

BTN Research is a research publication structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. Information included in this report is derived from many sources believed to be reliable (including SEC filings and other public records), but no representation is made that it is accurate or complete, or that errors, if discovered, will be corrected.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.