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Zimmer Biomet Holdings (ZBH) EQ Review

Current EQ Rating*	Previous EQ Rating
3-	NA

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

We initiate coverage of Zimmer Biomet (ZBH) with a rating of 3- (Minor Concerns)

ZBH reported adjusted EPS of $1.63 versus the consensus targets of $1.60. However, we note meaningful one-time benefits and other red flags in the quarter that investors should be aware of.

- The effective tax rate for the 9/18 quarter was materially lower than forecasted. If the rate had remained consistent with the prior quarter, it would have taken 5 cps off of EPS. However, if we adjust for the full $16.9 million from the change in adjustments cited in the 10-Q, it would have reduced reported EPS by 8 cps. Either adjustment implies an earnings miss for the quarter.

- ZBH has been rapidly expanding its accounts receivable factoring program since 2016. While accounts receivable days of sales (DSO) growth adjusted for sold receivables remains in-line, factoring growth is providing a material boost to operating cash flow that will wane as the growth of the expansion of the program slows.

- The company took $305 million in goodwill and intangible impairments in 2017. While impairments fell to under $4 million so far in 2018, the company noted that a recent review indicated that fair value of $390 million of goodwill related to its Dental unit was only 5% above its carrying value. This indicates a reasonable risk of future write-downs.

- As is typical with any medical products company, ZBH is dealing with multiple litigation and regulatory issues. Items of note mentioned in the 9/18 10-Q include a warnings letter from the FDA received in August citing manufacturing violations at its Warsaw, Indiana facility and ongoing patent litigation with Stryker with a potential cost of $170 million.

The Quarter Was a Miss Without Lower-Than-Expected Tax Rate

ZBH's headline non-GAAP earnings per share of $1.63 topped estimate by 3 cps. However, the company stated in the conference call that the effective tax rate for the quarter was lower than anticipated due to tax planning initiatives:

> *"In addition, we have taken advantage of further tax planning opportunities,* ***which is primarily why you see the third quarter tax rate coming in lower than expectations.*** *Because of this, we now expect the tax rate for the full year to be below our prior guidance range."*

The effective tax rate was 16.5% in the 9/18 quarter, but it has been running closer to 19% in the last couple of quarters. We estimate that if the effective tax rate had remained level with the previous quarter's 18.9%, it would have shaved about $10 million or 5 cps off of non-GAAP EPS, leading to a 2 cps miss in the quarter. However, we also note that the company disclosed the following in its 9/18 10-Q:

> *"In the three and nine month periods ended September 30, 2018, we recognized tax benefits resulting from return to provision adjustments related to changes in estimated tax rates on deferred tax liabilities recorded on acquisition-related intangible assets.* ***The change in estimates from these adjustments resulted in tax benefits of $16.9 million in the three and nine month periods ended September 30, 2018."***

If we assume the full $16.9 million in adjustments was unexpected, it indicates a benefit of over 8 cps and implies a 5 cps miss in the quarter.

Management expects that a higher than expected FX drag will offset the benefit from lower taxes on the year:

> *"Because of this, we now expect the tax rate for the full year to be below our prior guidance range. While the points I just discussed will likely move some specific line items in your models, we do not expect dramatic changes to 2018 earnings.* ***In other words, the positive effect of tax and interest will largely offset the negative FX impact that we are seeing in 2018."***

We also note that management cited the timing benefit of certain contract tenders boosting revenue growth in the quarter:

> *"But before I do that with the idea of being fully transparent on the quarter our results actually look a little better than they actually are for a couple reasons. First of all and I think this is probably pretty clear to everyone, we had a pretty easy third quarter comp, which buoyed revenue growth in the quarter obviously and unfortunately, that will not continue in the fourth quarter. We have a much more challenging comp in the fourth quarter.* ***In addition to that, we experienced notable timing benefits in the quarter with regard to both tenders and capital sales on the tender front that happened both ,in Asia-Pacific for us as well as EMEA and on the capital side it was mainly in our S.E.T. business, either way that those buoyed the third quarter results and will come as a result of that with some pressure to the fourth quarter.*** *Good news is we have banked the revenue, which is the most important thing. So even though you are going to move those between quarters, I would much rather have the sale. So as much as we are happy with the third quarter, I believe it's important to highlight these factors, because I think very importantly, I don't want my team or you to get too excited that we appear to be at a weighted average market growth for the business."*

We appreciate the company's candor and investors should take the beneficial timing of revenue into consideration when forecasting growth in upcoming quarters.

Receivables Sales Boosting Cash Flow Growth

Like several companies we have been following, ZBH instituted a receivables factoring program two years ago and it has been increasing its scope rapidly in the last several quarters. Receivables are sold to third-party financial institutions and the company retains no interest or servicing liability. It guarantees the factored receivables and purchases insurance on them to limit its exposure. Receivables are removed from the balance sheet when sold.

The following table shows the receivables remaining on the balance sheet, factored receivables, and an adjusted DSO calculation. In addition, the company discloses the face value of outstanding factored receivables at the end of each quarter, the year-to-date amount of receivables factored during each period, and its estimate of how much incremental operating cash flow was provided by its factoring program.

	9/30/2018	6/30/2018	3/31/2018	12/31/2017
Sales	$1,836.7	$2,007.6	$2,017.6	$2,084.1
Accounts Receivable	$1,262.7	$1,335.3	$1,418.5	$1,544.1
Outstanding Derecognized Receivables	$341.8	$338.9	$323.4	$261.2
Adjusted Receivables	$1,604.5	$1,674.2	$1,741.9	$1,805.3
Adjusted DSOs	79.7	76.1	78.8	79.0
YTD Receivables Sold	$1,942.8	$1,260.7	$617.0	$1,456.9
Receivables Sold During the Quarter	$682.1	$643.7	$617.0	$406.4
Company's YTD Estimated Incremental Cash Flow Boost	$25.0	$30.0	$12.0	$174.0
YTD Operating Cash Flow	$1,367.9	$883.8	$490.5	$1,582.3

	9/30/2017	6/30/2017	3/31/2017	12/31/2016
Sales	$1,813.1	$1,949.5	$1,972.4	$2,013.1
Accounts Receivable	$1,318.5	$1,423.0	$1,600.1	$1,604.4
Outstanding Derecognized Receivables	$276.1	$228.7	$100.2	$65.5
Adjusted Receivables	$1,579.7	$1,651.7	$1,700.3	$1,669.9
Adjusted DSOs	79.5	77.3	78.7	75.7
YTD Receivables Sold	$1,050.5	$582.7	$208.7	$103.1
Receivables Sold During the Quarter	$467.8	$374.0	$208.7	$103.1
Company's YTD Estimated Incremental Cash Flow Boost	$273.0	$210.0	$50.0	$103.0
YTD Operating Cash Flow	$1,179.4	$715.9	$275.4	$1,632.2

We have several observations from the data above:

- For the last three quarters, adjusted DSOs have tracked steadily on a year-over-year basis. This alleviates concern that the factoring program is masking a buildup in total trade receivables.

- Receivables sold on a quarterly basis rose rapidly from $103 million in the 12/16 quarter to $682 million in the most recent period. The sequential increase has slowed some in the last three quarters, but the year-over-year pace was still almost 50% in the 9/18 quarter. This dramatic rise in factoring activity has been a huge boost to reported cash flow growth. However, the growth is clearly beginning to level off.

- According to the company's 10-Q filing for the 9/18 quarter, ZBH estimated that *"the incremental operating cash inflows related to all of our receivables purchase programs were approximately $25 million in the nine-month period ended September 30, 2018."* We are not certain how the company defines that figure. We believe the analytically significant number would be the amount extra cash that was generated by the expansion of the factoring program compared to last year. We know that in the first nine months of 2018, the company sold almost $900 ($1,942.8 million - $1,050.5 million more in receivables than it did in the comparable year-ago period. We can also see that the amount sold each quarter gradually rose as well. In addition, outstanding factored receivables at the end of the 9/18 quarter were $66 million higher ($341.8 million -$276.1 million) than at 9/17. With all this in mind, it seems to us that the amount of cash collected in the nine months ended 9/18 that would not have been collected without the expansion of factoring activity is closer to the $66 million figure than to the company's $25 million. This would mean that about 35% of the increase in reported operating cash flow in the nine months ended 9/18 was a result of increased factoring.

It is also worth noting that operating cash flow growth for the nine months ended 9/18 received a boost from $30.5 million in penalty payments and an undisclosed amount of payments related to the Durom Cup settlement. Consider the quote from the 9/17 10-Q filing:

> *"Cash flows provided by operating activities were $1,179.4 million in the nine month period ended September 30, 2017, compared to $1,005.0 million in the same prior year period. The increase was driven by our sale of accounts receivable in certain countries in the 2017 period which we estimated provided an incremental $273 million of additional cash, partially offset by product liability payments related to the U.S. Durom Cup Settlement Program and $30.5 million in penalties paid to resolve previously-disclosed FCPA matters involving Biomet and certain of its subsidiaries as discussed in Note 15 to our interim condensed consolidated financial statements included in Part I, Item 1 of this report."*

We estimate that after the benefit from increased factoring in 2018 and the one-time penalty and settlement payments in 2017, operating cash flow for the most recent nine-month period was about 2%. To management's credit, it mentions all of these factors in its liquidity discussions in its 10-Q filings. We admit that the company would not have reported negative cash flow growth even with our higher estimate of incremental cash from increased factoring activity. However, it has clearly been a material tailwind to cash flow growth that has come from a dramatic expansion of the program that could fade or even reverse in the future.

Goodwill Write-Offs

ZBH has reported a consistent string of goodwill and intangible impairments over the last few years. During 2017, the company recorded $304.7 million in goodwill impairments including a fourth-quarter charge of $272 million related to its Spine reporting unit. So far in 2018, it has only recorded $3.8 million in impairments. However, it did disclose that disappointing sales in its Dental unit led to an assessment of goodwill in the third quarter. While it was determined that the associated goodwill was not yet impaired, the fair value of the unit was less than 5% greater than the carrying value, so further deterioration could very well lead to more write-downs. The carrying value of the goodwill in question was $389.1 million.

Lawsuits and Warnings Letters

A full analysis of legal and regulatory risks is beyond the scope of our *EQ Reviews*. However, we do want to point out recent developments noted in filings that investors should be aware of.

ZBH disclosed in its 10-Q for the 9/18 quarter that on October 2, 2018, the Belgian Court of Appeal of Mons issued a judgment in favor of Heraeus in its trade misappropriation complaint seeking past damages and an injunction preventing future sales of certain European cement products in Belgium. ZBH is currently appealing.

It is worth noting that the company is involved in a patent infringement case against Stryker which the company states could result in a charge of up to $170 million in the event of a negative outcome.

The company also noted in the 10-Q that it received a warning letter in August from the FDA related to “observed non-conformities with current good manufacturing proactive requirements” at its legacy Biomet manufacturing facility in Warsaw, Indiana.

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 recent 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

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