BEHIND THE NUMBERS
Quality of Earnings Analysis
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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Zimmer Biomet Holdings (ZBH) Earnings Quality Update 12/20 Qtr.

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 of ZBH at 3+ (Minor Concern) rating

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

Summary

ZBH reported non-GAAP EPS of $2.11 which was 5 cps ahead of the consensus. We view the company's discontinuation of its receivables factoring program as a positive for the quality of future cash flow growth. However, we are reluctant to raise our earnings quality rating on ZBH given the extensive list of non-GAAP add-backs.

ZBH announced in the quarter that it will be spinning off its Spine and Dental business to shareholders in a tax-free distribution of shares in a new publicly-traded company. The spin-off is not targeted for completion until mid-2022.

What is strong?

- The company's rising use of its factoring facilities was a focus of concern for us in past reviews. However, we raised our rating in late 2020 as the company began to throttle back on the rate of factoring. ZBH discontinued its factoring programs in the fourth quarter

for its US and Japan operations. The company estimated that discontinuing the programs cost it $300 million in cash flow growth in 2020. Note that the company still sells receivables to third parties in Europe. It has never been involved in the collection process in Europe and has not disclosed detail on European receivables such as amounts factored but still outstanding or payments received. It remains to be seen what information the company will disclose regarding the European factoring program going forward. Regardless, we view the termination of the US and Japan facilities as a positive for the quality of future cash flow growth.

What is weak?

- The effective non-GAAP tax rate fell to 15% in the 12/20 quarter from 16% in the year-ago fourth quarter. This added about 2.5 cps to EPS growth. The company attributed this to geographic mix and discrete tax benefits from recent audit settlements. This was likely lower than what most analysts were predicting. Management is predicting a "modestly higher" tax rate for 2021.

- An increase in other income added almost 1 cps to earnings even after non-GAAP adjustments for "other charges." This account includes items such as changes in the value of equity investments and non-operational pension amounts. Given that the company considers items such as litigation charges and quality remediation costs which occur every quarter as necessary add-backs to earnings for non-GAAP purposes, we are surprised that it also does not remove gain and losses from equity investments and unusual pension benefits.

- About unusual pension benefits, disclosures indicate the total pension expense fell by 4 cps for the full year largely due to lower recognized actuarial losses. Unfortunately, ZBH no longer discloses pension expense on a quarterly basis so we cannot see which quarters benefited the most from the expense decline.

What to watch

- We continue to see the company's long list of adding back "non-operating" expenses to adjusted results as eroding the quality of non-GAAP earnings. Case in point, the company regularly adds back excess and obsolete inventory charges which amounted to roughly 11 cps in the 12/20 quarter. Also included in the 12/20 quarter adjustments were 4 cps for quality remediation expenses which occur every quarter and 3 cps for "other charges"

which include “costs related to legal entity, distribution and manufacturing optimization, including contract terminations, gains and losses from changes in fair value on our equity investments, as well as our costs of complying with our Deferred Prosecution Agreement (“DPA”) with the U.S. government related to certain Foreign Corrupt Practices Act matters involving Biomet and certain of its subsidiaries.”

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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