BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Zimmer Biomet (ZBH) EQ Update 12/19 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	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 an explanation of the EQ Review Rating scale, please refer to the end of this report

We are lowering our earnings quality rating to 2- (Weak) from 3- (Minor Concern)

Adjusted EPS of $2.30 beat the consensus by 3 cps. However, we saw multiple red flags that continue to undermine ZBH's earnings quality. We also observe that ZBH's list of non-GAAP adjustments is always long, but its quarters regularly include unusual benefits adding a few pennies to EPS.

- Pension expense fell by almost 3 cps in the 12/19 quarter compared to a year ago. This was almost entirely due to a one-time curtailment gain of $7.2 million. This gain is not removed from the company's non-GAAP disclosures and there was no discussion of it in the press release or the conference call. The MD&A section of the 10-K simply stated that "the decline in other expense, net was driven by higher pension-related gains." As such, we believe this material boost likely "flew under the radar" of many investors. The company's non-GAAP adjustments regularly feature several lines with the 12/19 and 12/18 quarters each including 12 separate adjustments adding back one-time expenses. Some were smaller than the curtailment gain, including the adding back of $5.2 million in quality remediation expenses and $3.9 million in "other charges."

- We remind investors that on the first day of the second quarter of 2019, ZBH bought the rights to certain licensing arrangements from a third party for $192.5 million. The company previously paid royalties for the use of these rights which were recorded under cost of sales. The $192.5 million was capitalized and is being amortized through 2029. However, while results are benefitting from the lower cost of sales, non-GAAP results also have the increased amortization expense added back, so there is no offset. We had previously estimated the benefit to be about 2 cps per quarter based on the amortization period of the capitalized payment. However, the company disclosed in the 10-K that gross margin for the 2019 full year received a 40 basis points boost compared to 2018 as a result of lower royalties. This amounts to about 12 cps for the full year, or about 4 cps per quarter for the three quarters the lower royalty was in effect. The company regularly refers to the benefit of the lower royalty expense, but investors should keep in mind that this material tailwind will expire after the first quarter. For perspective, the approximate 4 cps boost from lower royalty accounted for a third of the 12 cps increase in non-GAAP EPS in the 12/19 quarter.

- Inventory DSIs posted another sizeable jump in the quarter, climbing 21 days to almost 377. As we noted in our review of the 9/19 quarter, management addressed the large inventory balance in the third quarter call, referring to it as a "challenge" and noting that the "*deferred or capitalized costs will flow through at a higher level into 2020, so that's a headwind*."

- The year-over-year pace of receivables factoring fell for the first time in years as ZBH sold a total of $732 million of receivables in the 12/19 quarter versus $764 million in the year-ago period. More importantly, the total balance of US and Japanese receivables sold but still outstanding at the end of the quarter was $270 million compared to $366 million last year. As we have noted before, the sold but outstanding balances do not include sold European receivables for which the company does not maintain servicing responsibilities. Given management's comments, we do not believe these balances are very large. Receivable DSOs adjusted for the sold but outstanding amounts fell by 2 days from last year's fourth quarter.

- We noted in our last review that ZBH warned that the carrying values of its EMEA and Dental reporting units remain susceptible to write-downs. This was

quantified in the 10-K as the company stated that: "*In our annual impairment test in the fourth quarter of 2019, we estimated the fair value of our EMEA and Dental reporting units only exceeded their carrying values by less than 5 percent… As of December 31, 2019, the remaining goodwill on the EMEA and Dental reporting units were $749.8 million and $397.7 million, respectively.* Remember that ZBH reported a $976 million goodwill write-down in 2018 and given the narrow fair value premium for the above segments the chance of another meaningful write-down seems quite possible.

- ZBH announced its latest restructuring plan which is expected to result in total pre-tax charges of $350-$400 million with half expected to fall in 2020. The plan has a goal of reducing annual operating expenses by $200-$300 million by the end of 2023. The company incurred $33 million in charge in the 12/19 quarter related to employee termination benefits, consulting, and project management.

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.

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