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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

April 13, 2019 | www.btnresearch.com

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Zimmer Biomet (ZBH) EQ Update- 12/18 Quarter

Current EQ Rating*	Previous EQ Rating
4+	3-

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

We are upgrading our earnings quality rating of ZBH to 4+ (Acceptable) from 3- (Minor Concern).

- Our primary concern with the quality of the previous quarter was the lower-than-expected tax rate without which the company would have missed earnings targets. In the 12/18 quarter, the effective tax rate was in-line with expectations.

- The outstanding principal amount of receivables sold increased to $365.9 million versus $261.2 million at the end of 2017. Still, after adjustment for the receivables sales, days sales outstanding still declined by approximately 7 days from a year-ago. The face value of receivables sold off during 2018 was $2.7 billion, up from $1.5 billion in 2017. Still, the company estimated that incremental cash flow from its receivables securitization programs was only $33 million for the year ended 2018, down from $174 million last year. Given the approximate $105 million increase in sold receivables outstanding we are not sure how there was only a $33 million incremental increase to cash flow. According to the cash flow statement, the decline in receivables balances added $213.6 million to operating cash flow in 2018 versus $161.7 million in 2017. Clearly, increased collections and sales of receivables have combined to provide a meaningful boost to cash flow growth which will likely begin to fade in 2019.

- Accounts payable days at the end of the 12/18 quarter rose by more than six days compared to the year-ago quarter. This is the first large jump in recent experience and coincides with an increase in inventories as the company increases in-stock levels and prepares for new product rollouts.

- The company has provided modest guidance for 2019 of essentially flat sales growth with flat-to-down operating margin growth which reflects increased investments. The mid-point of the expected operating cash flow forecast represents a decline of about $90 million and includes an anticipated $170 million litigation payment. Cash flow growth should be boosted some by a decline in integration and quality remediation payments. We consider the cash flow forecasts to be more than reasonable even if the receivables tailwind weakens.

- ZBH took an additional $975.9 million write-off to goodwill in the 12/18 quarter. About $567 million related to the EMEA reporting unit, leaving $755.2 million related to that division on the books. Another $401.2 million was related to the Spine reporting unit which totally wrote off the balance of that segment's goodwill which was a result of the 2015 Biomet and 2016 LDR acquisitions. The company also warned in the 10-K that fair value of the $387 million of goodwill associated with its Dental unit was only 5% above its carrying value meaning more impairments could be on the way.

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.

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