

Zimmer Biomet (ZBH) EQ Update

Current EQ Rating*	Previous EQ Rating
3-	4+

*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 3- (Minor Concern).

ZBH is in a turnaround mode and it is benefitting from certain costs a year ago not repeating this year. Most of these items are being adjusted out in the non-GAAP presentation. In our minds, this affords the company some grace patience when assessing the quality of its earnings. However, the company is barely beating the consensus targets as it topped 3/19 forecasts by only a penny, and we can't ignore that there are multiple small items without which it would have missed. Thus, we lower our rating back to 3- (Minor Concern.)

- On-balance sheet receivable DSOs fell by 7.6 days while outstanding factored receivable DSOs (not on balance sheet) rose by 3.4 days. Overall receivables DSOs continue to decline. While ZBH is still expanding its factoring, the year-over-year pace has slowed significantly. It sold \$799.4 million of receivables during the 3/19 quarter compared to \$617 million in the 3/18 quarter. While still a meaningful increase, consider that the company only sold \$208.7 million in the 3/17 quarter. The artificial boost to operating cash flow is disappearing as receivables generated \$50.7 million in cash in the 3/19 quarter versus \$146.2 million in last year's first quarter.
- ZBH noted in its 10-Q that gross margin improved due to hedging gains of \$7.2 million in the current quarter versus losses of \$11.1 a year ago. However, these are related to derivatives qualified as hedging instruments, meaning these amounts were reclassified from other comprehensive income and were presumably offset by gains/losses of roughly equal amounts in the hedged transaction. Therefore we do not view these as non-operational benefits.

- However, the company also has foreign exchange forward contracts not designated as hedging instruments which are marked to fair value at the end of each reporting period with gains and losses recognized in other income. The net impact was a \$7.8 million beneficial swing in the quarter or about 3 cps.
- The company reversed a reserve related to its Durom Cup claims resulting in a \$2.5 million gain, or a little less than a penny per share. This may have been included in its “other charges” segment of non-GAAP adjustments although it is not specifically cited.
- Gross margin also benefitted from lower obsolete inventory charges. These amounts are taken out of adjusted EPS. ZBH has reworked its product line since the turnaround began in 2017, so the charges last year are not unusual. However, investors should remember that the boost to unadjusted margin growth will not repeat next year. Other one-time items included in the quarter included adjustments to uncertain tax positions and a \$23.5 million gain from litigation gain. However, these were also removed from the adjusted non-GAAP EPS numbers.

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 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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