GlassHouse Research

02/06/19

Throw the BABY (Natus Medical Inc.) Out with the Bathwater

Who is GlassHouse Research? GlassHouse Research (GHR) is made up of former forensic accountants/analysts who have worked for prominent hedge funds on Wall Street, as well as boutique forensic accounting firms. Our purpose is to expose public companies that have been taking advantage of US GAAP as well as IFRS accounting for their benefit. We seek to find companies where GAAP (or even worse, non-GAAP) earnings are deviating from true economic earnings of the target firm.

Overall, we search for evidence of a "culture of fraud" within public companies.

Initiation of Natus Medical Inc. (BABY) with a Target Price of $9.80 (70% downside)

Lowered guidance, impairments, write-offs, restatements and fines from the SEC are all on the table as Natus will need to deal with these major accounting concerns in 2019.

- Concealed obsolete inventory makes Natus inventory position one of the worst we have ever seen. We calculate that at minimum, Natus needs to write-off/take losses on approximately $18.0 million (one-fifth of total inventory, or 30% of TTM earnings) in obsolete inventory.

- Natus' warranty/bad debt reserves and prepaid expenses accounts have all been depleted/manipulated over the last year to artificially increase EPS by $0.33 (or nearly 25% of TTM earnings). This *will reverse violently* in 2019.

- Based on comment letters found from the SEC, the Commission has been highly critical of Natus' use of non-GAAP exclusions in the past. Today, we see BABY's current exclusions as the most aggressive they have ever been.

- **CEO Kennedy and CFO Davies left their past companies in ruins with both Intersil and Extreme Network's stock price falling over 55% each before they bailed as CFO to come to Natus Medical.**

Key Similarities Between Natus Medical and Logitech's Fraudulent Activity

GlassHouse juxtaposes both Natus Medical (BABY) and the past transgressions of the prior fraud Logitech International (2011). Based on our research, we believe Natus is in a much worse accounting position than Logitech ever was in 2011. **The end result for Logitech was not a pretty one. Restatements, fines with the SEC, but most importantly the stock price dropped over 70% as a result of management's malfeasance.**

Key Characteristic	Logitech International (2011)	Natus Medical Inc.
Business Strategy	A roll-up company that based most of its future guidance on sales from acquisitions and new product lines.	A roll-up company that bases most of its future guidance on sales from acquisitions and new product lines.
Misstatement of Inventory Accounting	Logitech deliberately minimized the write-down of millions of dollars of excess component parts for a product which Logitech had excess inventory in FY11.	**We opine that BABY's current inventory position is much worse than Logitech's in 2011.** This is after the Natus has already received material weaknesses and an adverse opinion from their auditor (KPMG) regarding their deficient inventory accounting.
Violations of Accrual Accounting	Logitech paid fines regarding violations related to warranty accrual accounting and failure to amortize intangibles from an earlier acquisition.	GlassHouse observed highly aggressive accounting regarding the firm's warranty and bad debt reserve. Natus recently received a material weakness regarding its acquisition accounting in 2017 that has yet to be remediated.
Reduced Sales Guidance	The SEC stated that Logitech mgmt. schemed to inflate the company's operating income after experiencing poor sales for their new product, Revue, among others product lines.	Natus has reduced their sales guidance time and time again over the last two years as new product lines and acquisitions have failed to deliver.
Motivation	"Logitech failed to write down the value of its inventory to avoid the financial consequences of disappointing sales." - SEC	Amid an unruly proxy fight with Voce Capital, disappointing acquisitions, and lackluster organic growth, mgmt. possesses high motivation to artificially enhance earnings.
Correspondence with SEC	From 09/14/2010 onwards, Logitech received multiple letters from the SEC challenging the firm's use of critical accounting estimates and revenue recognition policies.	Natus has received several comment letters from the SEC and **in a very rare comment, the SEC accuses Natus of classifying "normal operating expenses" as restructuring costs among other concerns**.
End Result	**In 2011 after reducing guidance, restating earnings and paying fines for fraud, the stock price fell from $20 to a low of $6 (70% drop).**	**???????**

Concealed Non-Current Inventory Makes BABY's Inventory Diagnostics One of the Worst GHR has Ever Seen

Let GlassHouse be perfectly clear that after examining Natus' current inventory metrics, **we find the firm's inventory diagnostics to be one of the worst we have ever seen when analyzing public companies**. When we dig into BABY's 10K and 10Q filings, the situation only becomes graver as we believe management will need to write-off and take losses on most of their obsolete inventory. Exacerbating the issue, it appears that analysts are completely blind to the highly growing balance of inventory on the company's balance sheet as inventories have been rarely discussed in recent conference calls. In this regard, we find it peculiar that days-sales-outstanding (DSO) metrics are disclosed by the CFO every period, but we are befuddled to why inventory metrics are rarely discussed.

Diving into Natus' inventory metrics, GHR finds a plethora of accounting concerns that all point to the fact that BABY is 1) currently stuffing its channel/end user to increase sales and/or 2) refusing to write-down their obsolete inventory in order to keep margins artificially healthy. Due to the company's recent proxy fight with Voce Capital, we believe that prior CEO Jim Hawkins and now new CEO Jonathan Kennedy possessed high motivation to cosmetically increase sales/margins and may have resorted to these accounting gimmicks in order to do so. While non-GAAP gross margins have recently hovered around the 60% value over the last two years, we believe that this ratio has been highly inflated due to management's efforts. But again, these games can only be played in the short-term and will violently reverse in future periods.

Overall, our research has pointed to BABY's inventory previously being pushed onto hospitals, physician offices, and clinics to the point where they are stuffed with products and are hesitant to procure any more inventory. **To make matters worse, it appears that management's visibility into future buying trends of its clients were highly inaccurate and now the company is stuck with bloated inventory on its shelves and balance sheet; in some cases, the products have been discontinued and have become obsolete.**

What does this ultimately mean for Natus with respect to future sustainability of earnings? With only unfavorable options on the table for BABY, we believe our inventory analysis puts a time catalyst of BABY's share price decline (within one-to-three quarters). Below we detail Natus' unfavorable recent inventory metrics:

- Natus' current inventory balance has recently increased by 16.2% YOY to $80.6 million, which outpaced sales (cost of revenue) growth of only 6.5% (6.9%) in the Q3 2018 period. As a result, 3M days-sales-of-inventory (DSI)[1] increased to 139 days as of Q3 2018, which stands at a five-year seasonal high and the largest figure reported by BABY since Q3 2011. Longer-term metrics report similar results with 12M DSI increasing by 13.3% YOY to 127 days, again representing a five-year maximum.

- Natus' inventory-to-quarterly-sales metric also portrays a harbinger for future margin compression as this metric has increased by 516 bps YOY to 61.7% at the end of Q3 2018; a new five-year high. Inventory-to-12M-sales follow a similar pattern growing by 93 bps YOY to 15.5% in the latest period.

- Now that we have discussed BABY's dire inventory predicament, let us highlight an excerpt from Natus' inventory footnotes discussed in its 10K filing:

Table of Contents

NATUS MEDICAL INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS-(Continued)
Years Ended December 31, 2017, 2016 and 2015

	December 31,	
	2017	2016
Raw materials and subassemblies	$ 44,699	$ 28,245
Work in process	3,788	1,507
Finished goods	43,488	34,908
Total Inventories	91,975	64,660
Less: Non-current Inventories	(20,446)	(15,073)
Inventories	$ 71,529	$ 49,587

At December 31, 2017 and 2016, the Company has classified $20.4 million and $15.1 million, respectively, of inventories as non-current. This inventory consists of service components used to repair products held by customers pursuant to warranty obligations and extended service contracts, including service components for products that the Company no longer sells, inventory purchased for lifetime buys, and inventory that is turning at a slow rate. The Company believes that these inventories will be utilized for the intended purpose.

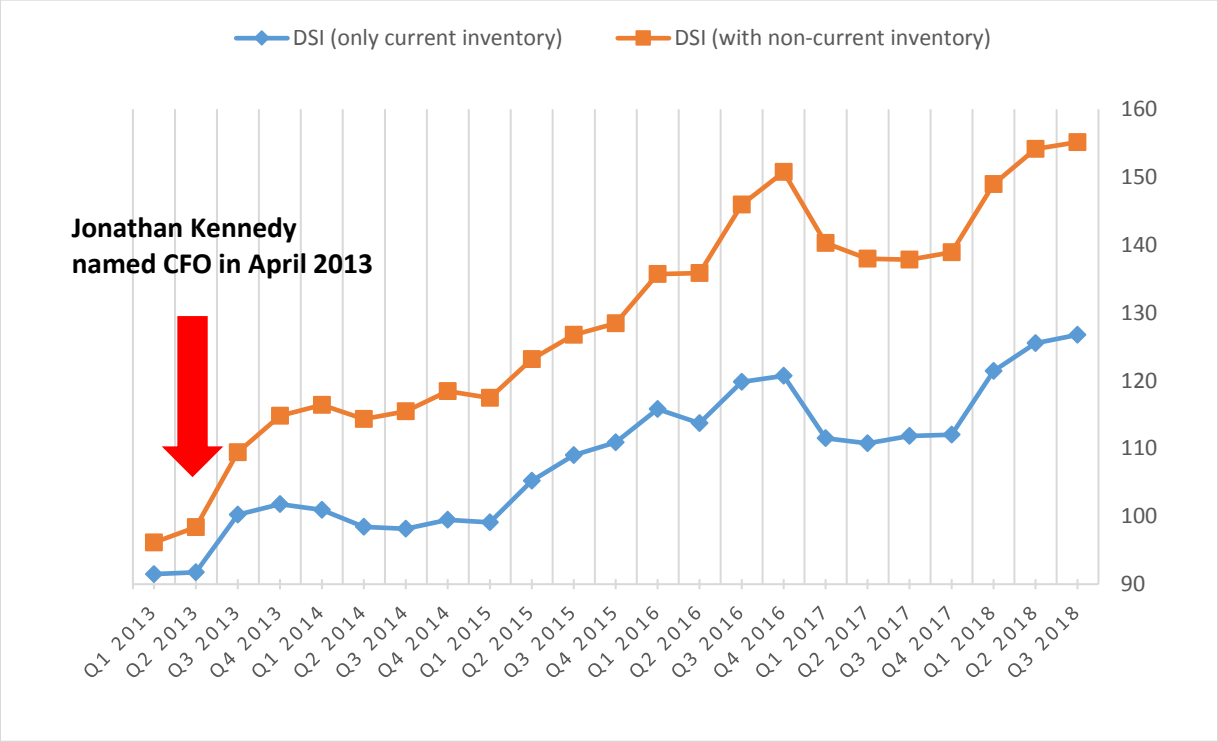
[1] Three-month days of inventory (3M DSI) = Average total inventory QOQ / 3M COGS * 91.25

- Here we can see that management has chosen to classify some of its longer-term (and higher risk) inventory as "non-current inventories" under the "Other Asset" balance sheet line-item. Now, when we calculate Natus' already dreadful inventory metrics to include its higher risk non-current inventory, their inventory diagnostics become one of the worst in the space.

- Specifically, when including non-current inventories, 3M DSI spikes up to 168 days as of Q3 2018, which near an all-time high of 170 days. Longer-term metrics are just as bad with 12M DSI increasing by 12.6% YOY to 155 days, representing an all-time maximum for BABY (see Chart 1, below).

- Natus' total inventory-to-quarterly-sales metric also follows suit as this metric has increased by 544 bps YOY to 73.4% at the end of Q3 2018; a new five-year high. Total inventory-to-12M-sales also increased by 95 bps YOY to 18.4% in the latest period.

Chart 1: Analysis of Both Current and Total DSI Metrics



- **In our experience, we cannot remember ever seeing inventory being stored as a long-term item even after going through countless SEC filings.** Therefore, GlassHouse executed a screen to search for the keyword non-current inventories (and other similar monikers such as long-term inventories etc.) in the filings of companies classified under "Health Care Equipment/Services". **Our screen that searched through over 965 companies with a market cap over $25 million in this industry only found four (or 0.4%) of Health Care Equipment/Services companies that classified inventory as long-term/non-current**:

    - Natus Medical (BABY), non-current inventory = 16% of total inventory
    - Inogen (INGN, Market Cap $3.10b) = 5% of total inventory
    - Xtant Medical (XTNT, Market Cap $31.7mm) = 1% of total inventory
    - Rockwell Medical (RMTI, Market Cap $173.8mm) = 30.6% of total inventory; however, RTMI breaks out its LT inventory separately on its balance sheet.

- Even worse, we point out that the long-term balance of non-current inventory has been skyrocketing in recent years. To illustrate this, we observe that non-current inventories have increased by 35.6%, 89.3% and 4.5% in 2017, 2016, and 2015, respectively. Management describes these items as "service components, inventory purchased for lifetime buys, or *inventory that is turning at a slow rate*". **But let us be perfectly clear, these are basically the worst type of inventory that stays on the top rack of Natus' warehouse and accumulates dust**. **Management is concealing what should be these written-down inventories under non-current other assets in order to artificially enhance their inventory metrics and reported earnings.**

- We also find it highly perplexing that a company whose inventory is growing by double-digits in every period over the last three years has not been asked about its snowballing balance dating back to the Q3 2016 earnings call?

- Can it get even worse for Natus' inventory? Yes, it can. This is because in every period management has decided to transfer some of its inventory into PP&E (this is separate from BABY's non-current inventory stored in "Other Assets" on the balance sheet). Disclosed below in the firm's 2017 10K:

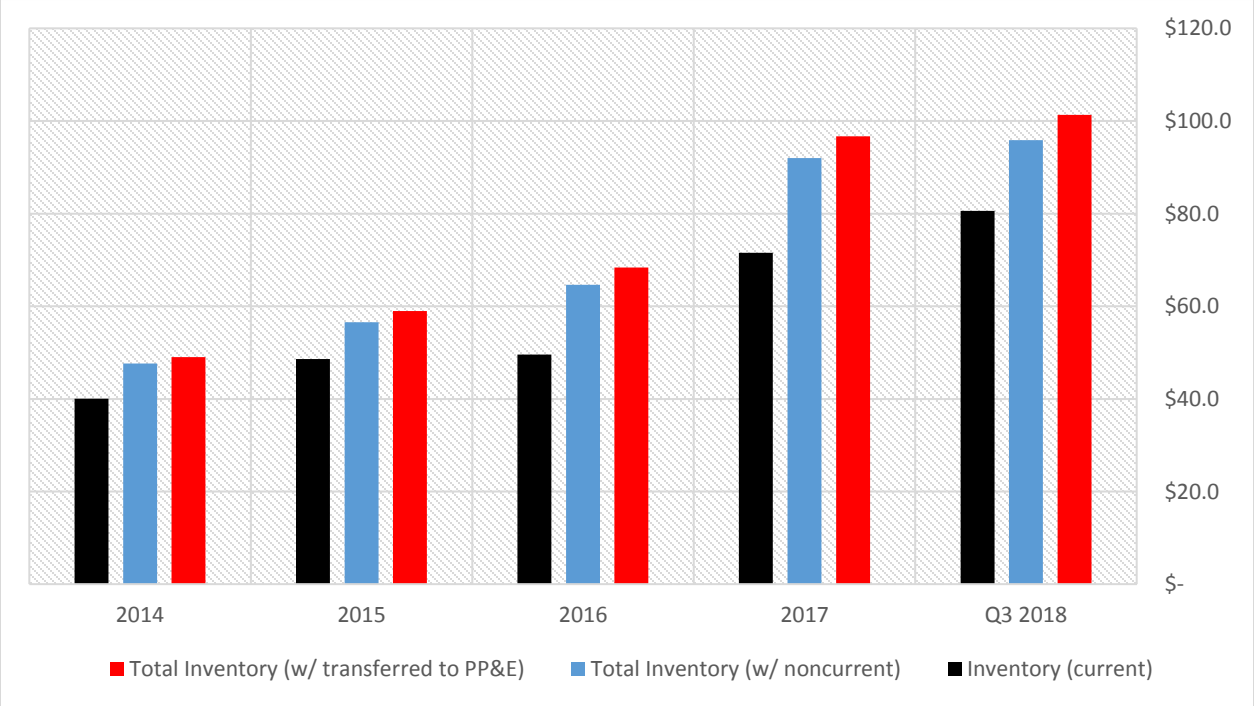
Non-cash investing activities:			
Property and equipment included in accounts payable	$ 148	$ 134	$ 289
Inventory transferred to property and equipment	$ 1,006	$ 1,303	$ 1,056

The accompanying notes are an integral part of these Consolidated Financial Statements.

- The accumulation of these transferred inventory equates to $5.5 million over the past five years. While this number may appear to be minimal, if we add this figure to the overall inventory balance, **this equates to a new 3M DSI balance of 178 days, over 10 days added to the firm's DSI balance of 168 days.**

Chart 2: Natus' Absolute Inventory Figures

(#s in millions)

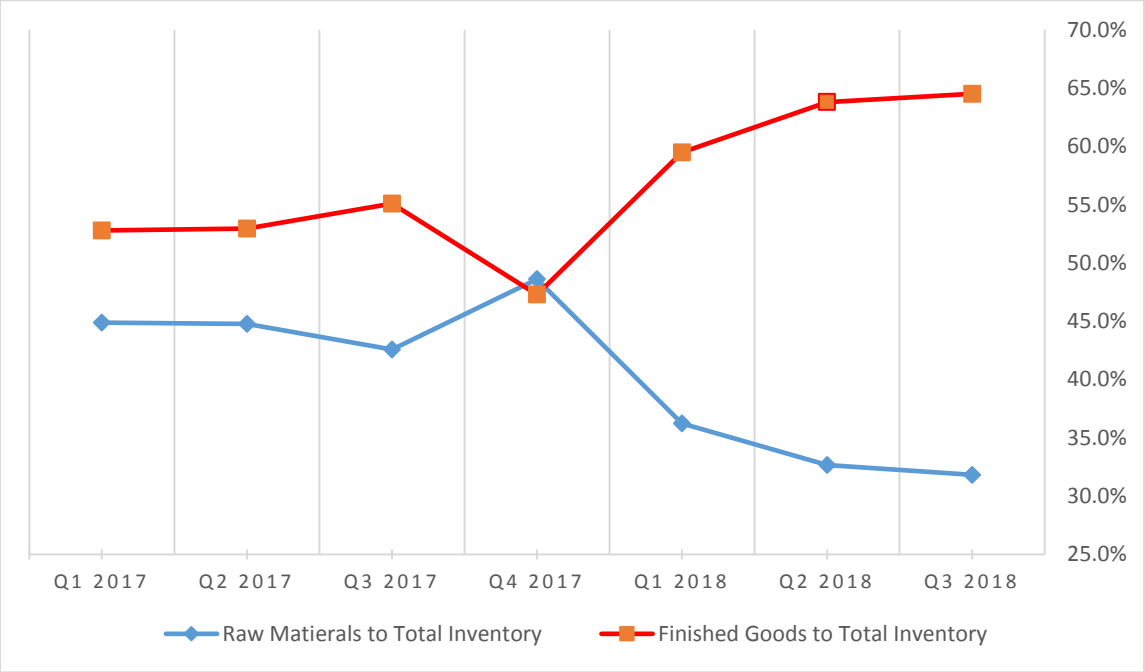


Distinct Inventory Metrics Show that Natus' Current Channel is Stuffed with Products

- When we dig further into Natus' inventory problems, things continue to get worse and worse as we find finished goods has spiked by 34.9% YOY to $61.8 million as of 09/30/18. Again, this classification of inventory remain the highest risk as finished goods represent products sitting on shelves and are at most risk for obsolescence. Relative to 3M sales, finished goods increased by 997 bps to 47.3%, representing a five-year seasonal high.

- Furthermore, when we analyze the ratio of finished goods and raw materials to total inventories, it confirms that Natus is currently carrying a historically higher amount of finished goods on its balance sheet. Where BABY once carried 55.1% of its inventory as finished goods, this metric jumped 942 bps YOY to its current ratio of 64.5% (see Chart 3, below). This represents the highest percentage of finished goods to total inventory in any period in the last five years.

Chart 3: Natus Finished Goods and Raw Materials Relative to Total Inventory



- What the above Chart reveals to us is that Natus is not purchasing raw materials at an accelerated rate in order to sell into heightened demand. In fact, it's quite the opposite. **The**

company appears to have an extremely weak demand environment for its products and they are now gathering dust in their warehouses.

- Further corroborating this thesis, we can turn to the firm's accounts payable-to-inventory ratio. As of 09/30/18, this ratio currently stands at its lowest value ever recorded at 21.5%. This divulges to us that management has been actually *decreasing* its inventory purchases over the last three years (see Chart 4, on Page 11). **However, inventory continues to build due to depressed sales. Again, these accounting metrics point to massive channel stuffing done by management in previous periods in order to achieve short-term gains.**

- Finally, we ask ourselves can Natus be procuring more inventory in order for the launch of new products in the upcoming periods? We can answer this with a resounding no as the numbers do not lie. Using consensus sales estimates for future periods, we can analyze inventory relative to future sales to see if these figures are historically within norms for BABY.

- After performing our analysis, we actually found that metrics were dangerously high for the firm. Analysts are predicting low-single-digit growth for Natus over the next year and with inventory sitting at all-time highs, there appears to be little future demand to push its inventory onto customers. Relative to forward 3M and 6M sales, we find that inventory stands at 70.2% and 35.5%, respectively as of 09/30/18. Both the values stand at five-year maximums for the firm, thus debunking any future demand for Natus' current inventory levels.

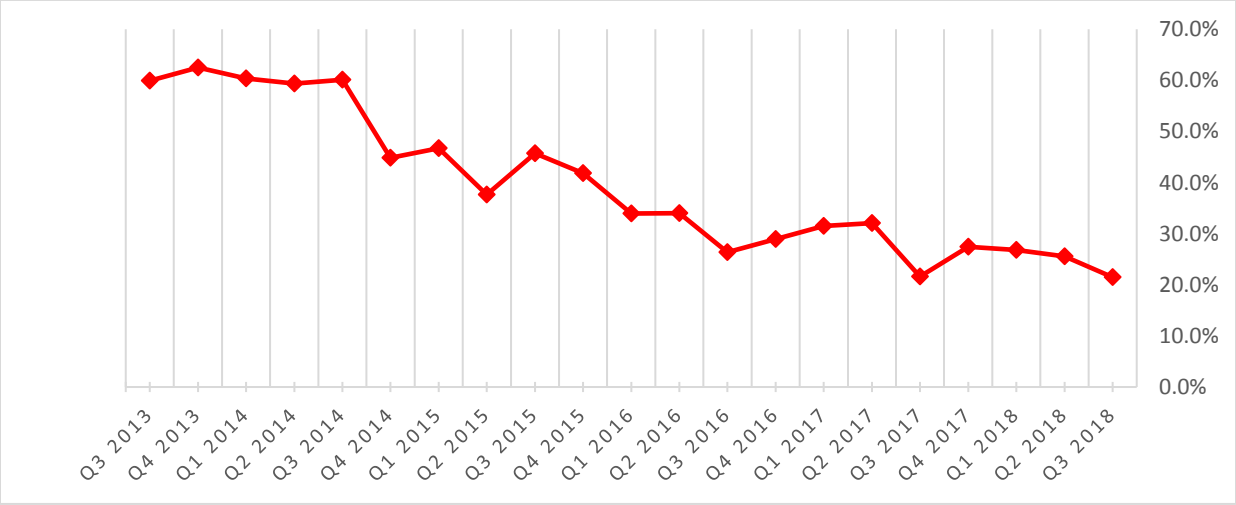
- As aforementioned, there are only two possible outcomes in this scenario based on our experience 1) Natus will attempt to maintain its price points on its products resulting in decreased sales and future impairment risk of its inventory and/or 2) the company will need to discount its products significantly in order to move inventory and avoid warehousing & transporting costs. **Even worse with management just discontinuing its Global Neurodiagnostics (GND) and NeuroCom balance product lines, this will cause revenues to drop by an approximate $19 million in 2019. This leaves more obsolete inventory on the books waiting to be written-off as full losses.**

- To quantify the impact that not impairing these inventories has had on earnings, we can reverse engineer Natus' inventory balance using the firm's five-year DSI average of 133 days. As a result, we estimate that BABY should have written-off $17.8 million of their inventory in the latest year to match a historical balance for the firm. **This impact would result in a $13.9 million after-tax loss for BABY in the TTM, or $0.42 of EPS.**

Table 1: Natus' Inventory Metrics and Trends

Period Ended:	Q3 2018	Q2 2018	Q1 2018	Q4 2017	Q3 2017
Current Inventory	$80.6	$76.6	$74.5	$71.5	$69.3
Total Inventory	$95.9	$94.1	$90.9	$92.0	$83.2
3M DSI	168	160	151	146	161
12M DSI	155	154	149	139	138
Inventory-to-3M Sales	73.4%	72.1%	70.7%	70.0%	67.8%
Inventory-to-12M Sales	18.4%	18.3%	18.0%	18.4%	17.4%
Finished Goods	$61.8	$60.1	$54.1	$43.5	$45.8
Finished Goods-to-Inv.	64.5%	63.8%	59.5%	47.3%	55.1%
YOY					
Current Inventory	16.2%	10.6%	10.1%	44.2%	34.2%
Total Inventory	15.2%	12.8%	9.9%	42.2%	28.3%
3M DSI	4.1%	14.9%	27.6%	4.0%	–5.3%
12M DSI	12.6%	11.7%	6.2%	–7.9%	–5.6%
Inventory-to-3M Sales (bps)	554	379	435	994	-351
Inventory-to-12M Sales (bps)	95	–39	–172	143	10
Finished Goods	34.9%	35.9%	23.9%	24.6%	27.7%
Finished Goods-to-Inv. (bps)	942	1,084	669	–670	–25

Chart 4: Natus Accounts Payable-to-Inventory Ratio



Channel Stuffing and Failing to Write-Off Obsolete Inventory Will Doom Natus

Our overall thesis revolves around Natus management stuffing its customers with products in order to increase sales at a time when there was clearly a weak demand environment. Judging from excerpts from prior earnings calls, we can now see that management has overbuilt its current inventory position and will now face an ominous future as it will need to unwind its slow moving and/or obsolete inventory on its balance sheet.

As the reader can see from Chart 1 on Page 6, DSIs have been growing in a stair-step fashion dating back to 2013. While Voce Capital previously praised newly appointed CEO Jonathan Kennedy for securing "low hanging fruit" in order to boost BABY's share price, we believe the opposite may be true. For example, we do not believe it is coincidence that DSI levels have risen so sharply coinciding with Mr. Kennedy's tenure as CFO. As a result, margins may have been artificially protected as Mr. Kennedy and Mr. Hawkins stubbornly refused to write-off obsolete inventory.

Furthermore, when analyzing comments made by management in the past year, it is apparent that 1) management has zero visibility into its future demand environment based on continued missed projections, 2) management is extremely fixated on securing gross margins above 60% at all costs, 3) the firm has failed to write-off the correct amount of inventory when it has discontinued its products and 4) the amount of inventory being held as "ship-hold" in its Seattle warehouse is adding to Natus' inventory woes.

We observe this with Mr. Hawkins comments made in the Q4 2017 earnings call:

> As we previously reported, revenue in the fourth quarter was lower than expected due to weakness in our U.S. neurodiagnostic business and lower-than-expected revenues from Otometrics…In our neurodiagnostic business, while we were disappointed with the results in the fourth quarter, we are encouraged that in 2018, *we will receive the orders of customers delayed in the fourth quarter. In fact, some of these large orders have already been booked in the first quarter.*

However, after this statement we found that Q1 2018 projections where then missed with Mr. Hawkins stating in the Q1 2018 earnings call:

> While our neurodiagnostic business bounced back nicely in the first quarter, *we continue to experience longer sales cycles in the United States.*

Finally, in the Q2 2018, newly appointed CEO Jonathan Kennedy states:

> *And so as we've learned more and understand more the requirements there and get used to sort of the shift in the purchase cycle*, I think that, in and of itself, firms up our ability to predict and our ability to meet customers' needs along the way of the selling process to include IT.

And by "get used to sort of the shift in the purchase cycle", GlassHouse believes that customers are not buying products at the rate they did previously. Even worse, when management has admitted to "end of life-ing" products, we have seen no apparent writing-off of inventory on the income statement or footnotes. Here we disclose an excerpt by Mr. Kennedy in the Q2 2018 earnings call:

> Revenue from our Newborn Care business declined approximately 15% versus the same quarter last year. **This decline was led by intentional end-of-life decisions for certain products that did not have the required scale to remain viable**. While we have made most of these product liability decisions, you should expect to see marginal downward effects on Newborn Care revenue over the next several quarters.

We also find in the Q4 2017 where Mr. Hawkins discussed discontinuing product lines:

> **We continue to prune smaller products that don't warrant the resources to keep them in the market**, and we now have a number of new product development projects underway.

And more statements from Mr. Hawkins on Investor Day – 06/22/17:

> **Also, there's a $3 million or $4 million worth of product that we have decided not to try to remediate**. The amount of work the FDA wants us to do for that amount of revenues doesn't make sense. So we haven't shipped those products since, I think, August of last year and **we're basically going to, as we say, throw them in the ocean and not bring those back out. It just doesn't make sense**.

We would expect BABY's inventory balance to somewhat fall as these obsolete inventories should have been written-off the books, but the opposite has occurred. This leads us to believe that management is incorrectly storing most of this obsolete inventory under "other assets" on the balance sheet.

When researching Natus' inventory in the wild, we found employees that described Natus' products as "outdated" and "10 to 15 years old." An employee also felt that Natus' products were of inferior quality in order to "pad the pockets of senior staff and major shareholders." Overall, we suspect BABY's outsized inventory balance is composed of legacy products that are not being sold or will be cannibalized by newer offerings and will inevitably be written off.

Lastly, the company has detailed serious issues regarding their FDA deficiencies in their manufacturing processes in their Seattle facility (received in 2014 and 2016). As a result, the FDA imposed "ship-holds" on certain products produced there and Natus has discontinued certain other products in the facility. Moreover, what was initially believed to be a transitory item, has turned into a long drawn out process that the company did not envision. While the company has recently completed audits of its Seattle facility in Q3 2018, this does not relieve the Warning Letter. Natus goes into detail in its 2017 10K stating:

> The company has classified $15.1 million and $8.0 million, respectively, of inventories as non-current… This consists of inventory that will be shipped when the ship-hold on the NeoBLUE products is released. The company believes that these inventories will be utilized for the intended purpose.

Due to this ship-hold, we believe that a material amount of inventory has sat in Natus' Seattle warehouse left to grow obsolete. And again, where we believe management should have written-off much of this inventory, it continues to grow on the balance sheet.

In the immediate-term, we do not see how management will be able to achieve higher gross margins at a time when demand for their products, especially within the Newborn and Otometrics segments, are facing material headwinds. Newly appointed CFO Benjamin Davies, also appears to be fixated on gross margin in the latest earnings call stating:

> I think now that I've joined the company, that's one of the things that I've kind of had the opportunity to work on at my last company and some of the other places I've worked, really focus on gross margin and a lot of areas. I did a lot of work in cost and inventory in the early part of my career. And that's – those are areas that I'm going to focus on as the year goes on here.

To conclude let us leave the reader with a major statistic that details Mr. Kennedy's tenure as CFO. **During his tenure as CFO/CEO, Natus' DSI metric has increased by 57 days, from 98 days to 155 days!** And for some reason, no analysts want to discuss the spiking inventory balances quarter after quarter!

Under Jonathan Kennedy, Natus needed to Restate its Financials Due to a Material Weakness Regarding its Inventory Accounting Amongst Other Reasons

After examining Natus' inventory, GHR continued to ask ourselves, can this situation get any worse? Well, let us point out that under Mr. Kennedy's watch as CFO in 2014, the firm received an adverse opinion from KPMG. This was due to a material weakness found with its design controls over its accounting for inventory. In Natus' own words let's take a look from Natus' 2014 10K:

> Management's assessment of our internal control over financial reporting as of December 31, 2014, **identified a control deficiency was not effective due to a lack of sufficient resources to effectively design, implement, and operate controls over certain accounts with an appropriate degree of precision. Specifically, the design of controls over the accounting for inventory, accounts receivable and revenue recognition for software contracts and multiple element arrangements was inadequate**, which in the aggregate constituted a material weakness in our internal control over financial reporting.

We find this to be highly concerning given the current ominous state that Natus' inventory balance is in. Even now the company is still dealing with a **new material weakness** regarding its acquisition accounting! We want to point out how rare it is for a company to receive a material weakness as they far outweigh normal control deficiencies. **The fact that Mr. Kennedy has received two different material weaknesses over a three-year period is astonishing to say the least.** Here is management's statement regarding its new material weakness that has not been remediated as of today [2017 10K]:

> **If we do not remediate a material weakness in our internal control over financial reporting, the accuracy and timeliness of our financial reporting may be adversely affected**
>
> Management's assessment of our internal control over financial reporting as of December 31, 2017, identified a control was not effective because we did not perform an effective risk assessment relating to significant acquisitions, and as a result, we did not adequately design control activities over the accounting for the acquisition of Otometrics. The first fiscal year exemption for internal controls over financial reporting does not apply to controls over purchase price accounting, which constituted a material weakness in our internal control over financial reporting… The existence of this material weakness and of any other ineffective controls over our financial reporting could result in one or all of the following: 1) Revision of previously filed financial statements; Failure to meet our reporting obligations; Loss of investor confidence; and Negative impact on the trading price of our common stock.

Delayed Payment from Customers Threaten Persistence of Earnings

In combination with BABY's added risk of a stuffed inventory channel, their accounts receivable (AR) on the balance is in no better position. In our experience, the heightened balance in both these balance sheet accounts points to future share price degradation in upcoming periods as the firm works to normalize these line-items.

Management's aforementioned statements of longer product cycles speaks to both a stuffed channel and revenue that has been pulled forward to meet sales/earnings estimates. Again, while management may cosmetically enhance sales and earnings through these accounting gimmicks for a short-period of time, these actions are not sustainable in the long-term and points to a decreased demand for their products. Over the next year without the help of any acquisitions, GHR believes that most investors can expect a large drop off in revenues as the previous non-recurring and acquisition revenue gains disappear. Below, we highlight Natus' current receivable trends.

- Currently, Natus' days-sales-outstanding (DSO)[2] levels stand at 85 days and 86 days of 3M DSO and 12M DSO, respectively as of Q3 2018. This represented an increase of 9.1% YOY from Q3 2017. **We view the current levels of 86 days to be extremely heightened from an absolute level as the firm is now waiting approximately three months to get paid on its products.**

- Previously, the firm listed an improvement in its receivables in its 2016 10K stating, "The change in operating assets and liabilities was driven primarily by a decrease in accounts receivable following increased collections efforts…" However, this was to be short-lived as in fiscal 2017, the firm faced collection issues again detailed in the 2017 Annual Report:

  > The change in operating assets and liabilities was driven primarily by an increase in accounts receivable and lower collections during the year compared to the year prior 2016.

- In the Q3 2018 earnings call, we get a clearer picture as CEO Kennedy discusses recent issues regarding AR collections. Here, he details the following credit issues with Turkey/Iran:

  > I mean, we went through that analysis last week. Very minimal. **Like I said there, we do have delays or really a stop in shipments to Turkey and Iran over their ability to pay. And that hurts us about $1 million a quarter.** So that was a piece of it…

[2] Three-month days sales outstanding (3M DSO) = Average total AR QOQ / 3M Sales * 91.25

> This was the first quarter of it. It will continue until we resolve Iran and Turkey. My speculation is that Iran probably gets solved first as we figure out what the supply chain has to look like to be able to get medical devices in Iran. I do believe that'll happen. It's just a little more complicated than it was.
>
> And then with Turkey, it's your – anybody's guess as to when the currency in Turkey becomes something that they're able to buy – import products. They have 40% or 50% decline in the Turkish lira, so that pretty much pulls them out of buying international products because of the cost to them has gone up so high, doubled.

- Finally, for the first time the firm discloses credit concerns regarding its Peloton product line:

> Sure. Peloton remains a solid business for us. We've got about 130 hospitals that we do the hearing screen service for. **We've gone through time and had experience on the receivables on that side. Even this quarter, we had another $1.5 million receivable adjustment that we took for Peloton from – over – that accumulated over the last several years where we're just not getting payment from certain hospitals and certain states**.
>
> So we're, again, going through this annual planning process to decide where do we stand with some of these dates **that you just can't quite get payment to the level you need to.** Some of those contracts is converted to just direct payment for fee-for-service directly to the hospital. **So just in a simple outsource program where we're not actually trying to bill payers**. We'd like to see that adoption more often than not, but you're dealing with the economic ability of the hospital whether or not they can do those sorts of things. So it's an evolving business and I would say one that keeps us close to our customers, which we like but also one that we've had some challenge with over the last several quarters.

- These collections issues combined with Natus' channel being stuffed leads us to believe a disastrous road lies ahead for BABY over the next year. **Reduced guidance, sales declines, the write-downs of inventory and receivables, and goodwill impairments are all on the table for Natus as it enters into 2019 with new board members looking to shake things up.**

- Exacerbating BABY's collection concerns, we find that management has chosen to reduce the firm's allowance for doubtful accounts (AFDA) by 38% YOY to only $6.3 million as of Q3 2018. While DSO trends have been rising and collections are obviously an issue, we can see no logical reasoning as to why Natus' deemed it appropriate to lessen this much need reserve.

- Relative to gross AR, this ratio has plummeted by a material 307 bps YOY to only 4.9% as of 09/30/18. Again, with the reported heighted DSO balance by Natus, we would expect the

contrary to be true with this reserve increasing in the period. As a result of this decrease, this has allowed Natus to receive an aesthetic margin expansion over the TTM.

- For example, if we use Natus' Q3 2017 ratio of 8.0% as our baseline, we calculate that BABY's AFDA reserve should stand at $9.7 million based on gross receivables of $127.4 million. **As a result, this difference in reserve leads to a $3.4 million ($2.7 million after-tax) tailwind to earnings over the past year, or a $0.08 positive impact to EPS (5.7% of TTM non-GAAP EPS).**

Chart 5: Natus' DSO Trends

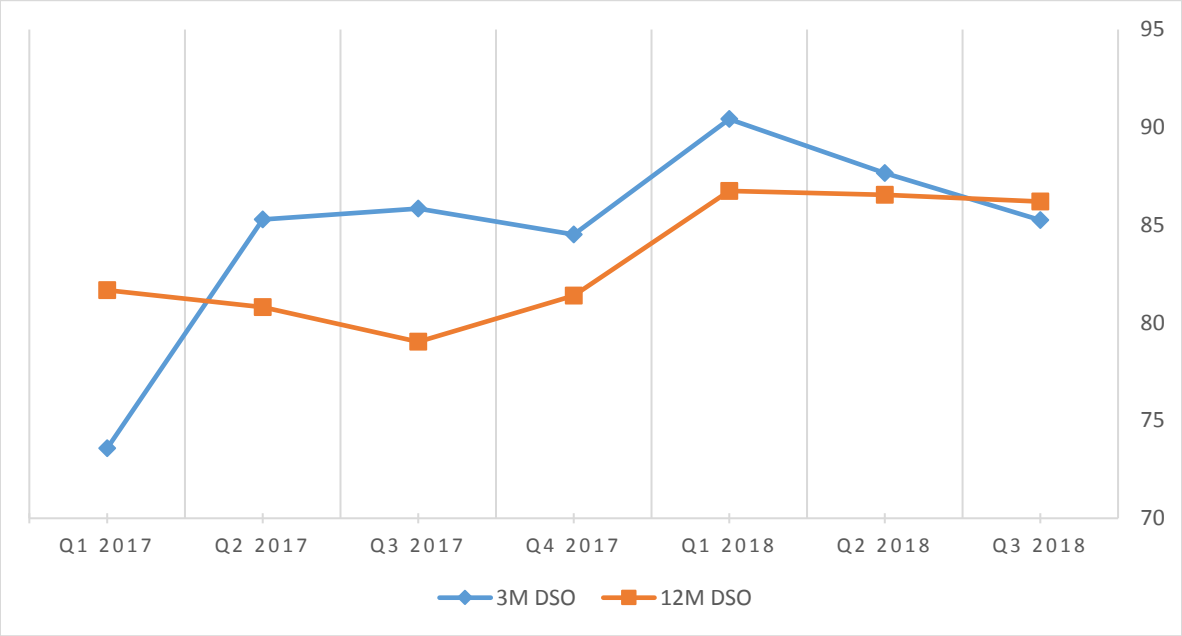


Table 2: Natus' Allowance for Doubtful Accounts Metrics

Period Ended:	Q3 2018	Q2 2018	Q1 2018	Q4 2017	Q3 2017
Allowance for Doubtful Accounts (AFDA)	$6.3	$6.6	$8.2	$9.0	$10.2
AFDA / Gross Receivables	4.9%	5.1%	6.0%	6.6%	8.0%
YOY					
Allowance for Doubtful Accounts (%)	–38.0%	–28.4%	63.3%	114.7%	116.1%
AFDA / Gross Receivables (bps)	–307	–238	181	201	277

Salient Growth in Prepaid Expenses Indicate Future Margin Compression

In general, we view growth of prepaid expenses and other current assets (AKA prepaids) ahead of revenue and/or total operating expenses as a potential indicator of excess costs stored on the balance sheet (i.e., excess relative to their expected future benefits). Regardless of whether the build-up occurred as a result of deterioration in (macro or micro) economic circumstances or a relatively higher rate of capitalization (slower amortization) than in prior periods, the end result is the same. Absent similar growth in revenues, margins will decline as these costs must ultimately be amortized against earnings.

Capitalizing expenses is the easiest way for CEOs and CFOs to create faux earnings in any given period. Prepaid expenses never get discussed on conference calls as analysts are too busy digesting management's guidance and updating their models.

In our experience, it is the perfect account that no one looks at to manipulate.

- GHR has observed a consistent rise in prepaid expenses and other current assets located on BABY's balance sheet. In Q4 2015, the company reported a balance of only $11.2 million, however since then, this balance has increased in a stair-step fashion up to $30.8 million in the latest period. Lacking from Natus' footnotes, the firm reported an astonishing 174.5% YOY jump to its current balance with very little explanations given in the firm's filings.[3] An increase of this magnitude with no clarifications we find to be highly peculiar, especially with a blessing from Natus' auditor.

- Prepaids are discussed briefly in the firm's 2016 10K report in the liquidity and capital resources section stating, "The change in operating assets and liabilities was driven by… an increase in prepaid expenses related to prepayments we made to our distribution partner for the Venezuelan contract." During this timeframe prepaids almost doubled from $11.2 million as of 12/31/15 to $22.0 million at 12/31/16. But while this figure

[3] Natus does not disclose a prepaid and other current asset footnote with sub-line items broken out in its annual filings.

continued to increase into 2019, there was little to no disclosures to why the current balance stands at $30.8 million.

	Nine Months Ended September 30,	
	2018	2017
Operating activities:		
Net loss	$(11,301)	$ (13,198)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Provision for losses on accounts receivable	5,871	8,704
Depreciation and amortization	25,652	20,859
Loss on disposal of property and equipment	410	14
Warranty reserve	73	5,307
Share-based compensation	15,446	7,223
Changes in operating assets and liabilities:		
Accounts receivable	2,955	(13,660)
Inventories	(5,183)	6,791
Prepaid expenses and other assets	(14,398)	1,395
Accounts payable	(3,799)	(9,530)
Accrued liabilities	968	(8,537)
Deferred revenue	1,745	(7,890)
Deferred income tax	517	16,770
Net cash provided by operating activities	18,956	14,248

- We observe that in the excerpt above from the Q3 2018 10Q filing, we can see that prepaids consumed over $14 million in cash in the period, a highly material amount. However, we are perplexed to why no mention of this highly material consumption of cash is to be found in the liquidity and capital resource section of this 10Q.

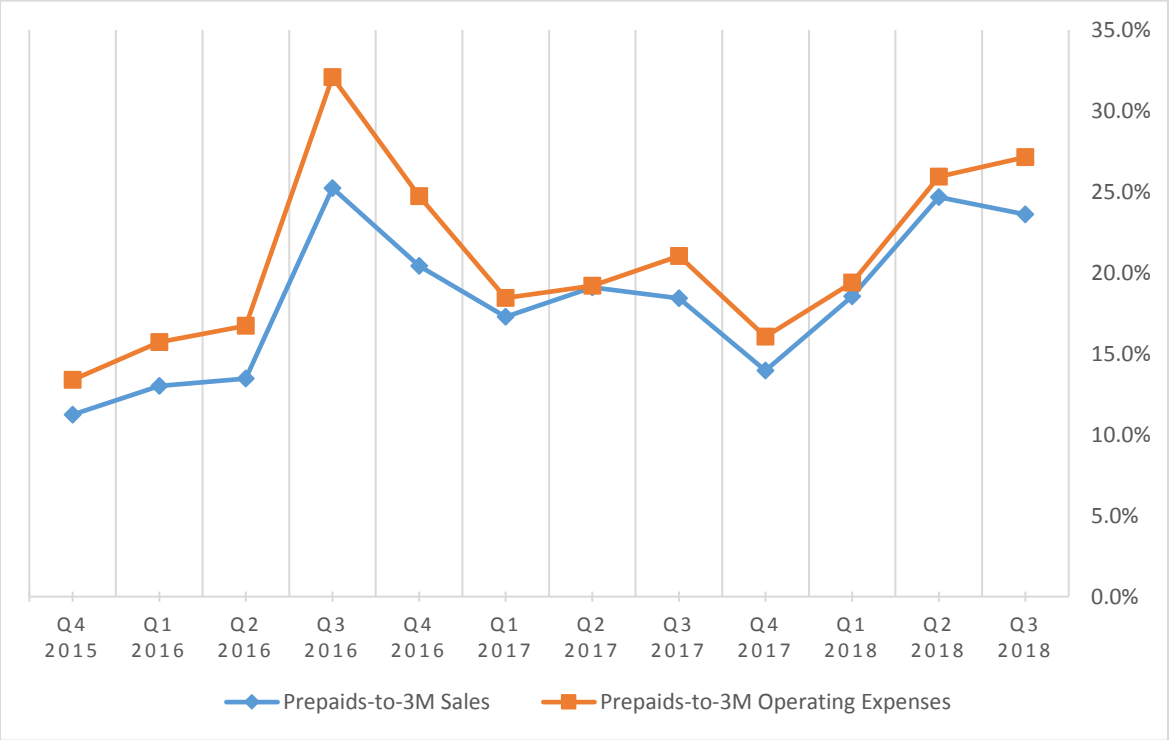
- Digging into the numbers, prepaids have outpaced both 3M and 12M sales on a YOY basis by 518 bps and 118 bps, respectively as of Q3 2018. As a result of the recent growth in this account, prepaid expenses are up to 23.6% (5.9%) relative to 3M sales (12M sales). Both these ratios are near their respective five-year high showing the severity of this unusual increase.

- We find similar results when the level of prepaids is measured against total operating expenses (rather than revenues). For instance, prepaids jumped 129 bps YOY to 6.5% of

12M operating expenses. Again, analyzing shorter-term patterns, prepaids also increased 610 bps YOY to 27.1%, of total three-month operating expenses.

- To quantify the rise in prepaid expenses relative to earnings, we calculate that if Natus would have kept the prepaid-to-12M sales ratio constant at its Q3 2017 value of 4.7%, **the company would have to reduce its EPS by $0.15 over the TTM. This EPS value also equates to 10.3% of TTM non-GAAP EPS.**

Chart 6: Natus Relative Prepaid Expense Trends



Natus Warranty Reserve is Severely Under-Accrued

In combination with BABY's added risk of a stuffed inventory channel and delayed payment from major customers, the company's balance sheet woes continue as GHR believes its warranty reserve is insufficiently funded. Listed in the company's risk factor section in its 10K, Natus discloses how inadequately or miscalculating its warranty reserve can impact its company:

> **Liability for product warranties**
> The Company provides a warranty for products that is generally one year in length. In some cases, regulations may require the Company to provide repair or remediation beyond the typical warranty period. **If any products contain defects, the Company may be required to incur additional repair and remediation costs**. Service for domestic customers is provided by Company-owned service centers that perform all service, repair, and calibration services. Service for international customers is provided by a combination of Company-owned facilities and vendors on a contract basis.
>
> A warranty reserve is included in accrued liabilities for the expected future costs of servicing products. Additions to the reserve are based on management's best estimate of probable liability. The Company considers a combination of factors including material and labor costs, regulatory requirements, and other judgments in determining the amount of the reserve. The reserve is reduced as costs are incurred to honor existing warranty and regulatory obligations.

- In GHR's view, management has been under-reserving its warranty reserve in recent periods which has cosmetically enhanced margins. Specifically, as BABY has been growing the top-line through acquisition growth and reporting increased warranty settlements over the past five years, we find that BABY's provisioning for its warranty reserve (warranty expense) has been underfunded based on our calculations.

- To illustrate this, GHR calculates a highly material 27.1% YOY decline of Natus' warranty reserve to $9.1 million as of Q3 2018. However, more importantly, the warranty reserve fell by 320 bps YOY to 6.9% relative to 3M sales. This is important to understand because as Natus' increases its sales (mostly through acquisitions), the firm will naturally need a higher reserve to account for those extra sales, hence the ratio with sales. However, conflicting with this line of thinking, Natus management has chosen to decrease its reserve by a significant amount.

- Looking at longer-term trends for Natus, the company's warranty reserve fell by 87 bps YOY to 1.7% of 12M sales as of 09/30/18. **Thus, if we use the 2.6% prior year's ratio as a baseline, GHR calculates an 11 cent benefit to the bottom line for BABY over the TTM. Or**

in other words, 7.8% of non-GAAP EPS over the TTM (11 cents) was based on this unsustainable warranty reserve benefit alone.

- Exacerbating this unsustainable boost to earnings over the TTM, we found that Natus has disclosed specific warranty accruals for its NeoBLUE phototherapy products that are on a ship-hold in Seattle due to the FDA:

> **As of December 31, 2017, the Company has accrued $5.4 million to bring certain NeoBLUE® phototherapy products into U.S. regulatory compliance**. The Company's estimate of the costs associated with bringing the NeoBLUE® phototherapy products into compliance is primarily based upon the number of units outstanding that may require the repair, costs associated with shipping and repairing the product, and the assumption that the FDA will approve the Company's plan for compliance

- So where clearly management continues to have issues with the ongoing ship-hold of its products in Seattle, the firm's warranty reserve continued to dwindle. This puts the company at risk of heightened write-offs and subsequently warranty expenses. **In our view, we see an acceleration of margin degradation in future periods (within the next three quarters) based on the firm's inadequate warranty reserve alone.**

Table 3: Natus Warranty Reserve Metrics

(#s in millions)

Period Ended:	Q3 2018	Q2 2018	Q1 2018	Q4 2017	Q3 2017
Warranty Reserve	$9.1	$10.9	$9.1	$11.0	$12.4
WR / 3M Sales	6.9%	8.4%	7.1%	8.4%	10.1%
WR / 12M Sales	1.7%	2.1%	1.8%	2.2%	2.6%
YOY					
Warranty Reserve (%)	–27.1%	–22.8%	–28.7%	3.0%	13.0%
WR / 3M Sales (bps)	–320	–322	–315	–154	–196
WR / 12M Sales (bps)	–87	–105	–124	–60	–33

Non-GAAP Exclusions Accelerate After Drawing Ire of SEC

In this section we will not argue the veracity of management's use of non-GAAP exclusions with amortization, acquisition and restructuring costs. However, what we will point out are management's extensive acceleration of these exclusions over the tenure of CEO Jonathan Kennedy. **Exacerbating the issue, it appears that the SEC has already come down on Natus in the past for their non-GAAP exclusions where they call out Natus for "restructuring costs… which may be inconsistent with Compliance and Disclosure Interpretations".**

Obvious to everyone following Natus, non-GAAP earnings for BABY have been substantially higher than the company's as-reported GAAP earnings. For example, in the trailing 9M period, non-GAAP EPS was a positive $0.99; a major contrast from the GAAP *loss* of $0.35. Throughout all of 2017, non-GAAP EPS of $1.45 dwarfed the GAAP loss reported of $0.62 (see Table 4, on Page 26).

We can see throughout Mr. Kennedy's tenure as CFO, these bifurcations of GAAP and non-GAAP income have accelerated dating back to 2013. These deviations from non-GAAP-to-GAAP stand at $0.29 (39.2%), $0.29 (29.9%), $0.41 (36.0%), and $0.33 (25.6%) in fiscal years 2013, 2014, 2015, and 2016 respectively. **Finally, in the last two years, the deviations accelerated with non-GAAP earnings of $1.45 and $0.99 and GAAP *losses* of $0.62 and $0.99 in 2017 and 9M 2018, respectively.**

On 07/07/2016, then CFO Jonathan Kennedy received a comment letter from the SEC that detailed the following regarding its use of non-GAAP earnings:

> 3. We note that you present non-GAAP earnings per share and non-GAAP gross margin in the headline of your press release as "record" results without also presenting GAAP earnings per share with equal or greater prominence, as required by Item 10(e)(1)(i)(A) of Regulation S-K. Similarly, you discuss forward-looking non-GAAP earnings per share guidance without providing the corresponding GAAP earnings per share amounts or the required quantitative reconciliations. **Your presentations appear to give greater prominence to the non-GAAP measures than to the comparable GAAP measures which is inconsistent with the updated Compliance and Disclosure Interpretations issued on May 17, 2016**. Please review this guidance when preparing your next earnings release.
>
> 4. **We note that your non-GAAP measures exclude restructuring costs that appear to be normal, recurring operating expenses necessary to operate your business, which may be inconsistent with the updated Compliance and Disclosure Interpretations issued on May 17, 2016**. Please review this guidance when preparing your earnings release.

The most concerning item lies with bullet point #4 that accuses Natus of excluding normal operating expenses from non-GAAP earnings, thus improving margins dramatically. We note that in our time studying SEC comment letters, it is *extremely rare* for the SEC to accuse a company of excluding normal operating expenses from non-GAAP earnings. The company responded with the following comment with regards to this accusation:

> We believe that adjusting non-GAAP results for restructuring costs is consistent with each of the foregoing. **While there have admittedly been adjustments for these charges in past earnings releases, these costs have been in response to the relatively unique circumstances of the respective acquisitions giving rise to the restructuring activity (other than the much less frequent restructuring charges that have been in response to significant changes in the markets the Company serves or the Company's business).**
>
> The Company has over time completed multiple acquisitions of other companies and businesses. Following an acquisition the Company will, as it determines appropriate, initiate restructuring events to eliminate redundant costs. Restructuring expenses which are excluded in the non-GAAP items are exclusively related to permanent reductions in our workforce and redundant facility closures. Consistent with Compliance and Disclosure Interpretation 102.03, we do not describe these charges as non-recurring or in other terms that mischaracterize the frequency of these charges.

This was back in the middle of 2016 where BABY ended up excluding only $0.05/per share in restructuring charges in all of 2016. **Since that time, Natus' restructuring exclusions have skyrocketed to $0.22 and $0.58 in 2017 and 9M 2018, respectively.** Also, as we can see from the above statement, management has tied restructuring charges to acquisitions. However, we point out that the last acquisition the firm made was assets of Integra back on 10/06/17! While we would expect some restructuring charges to carry over, we do not understand how over a year later since their last acquisition the firm has accelerated its restructuring and acquisition charges.

Finally, when we look at Natus' non-GAAP earnings, the firm's material exclusions of "recall accrual and remediation efforts", which are associated with the firm's Seattle FDA recall, appear to be part of the firm's regular operating business. **Especially, due to the length of time (approximately five years since the first letter), we believe these expenses to be highly *reoccurring* in nature and a normal operating cost for the company.** As the reader can see in Chart 7, these charges continue to be a highly material percentage of earnings that management wants investors and analysts to ignore as true costs to the business.

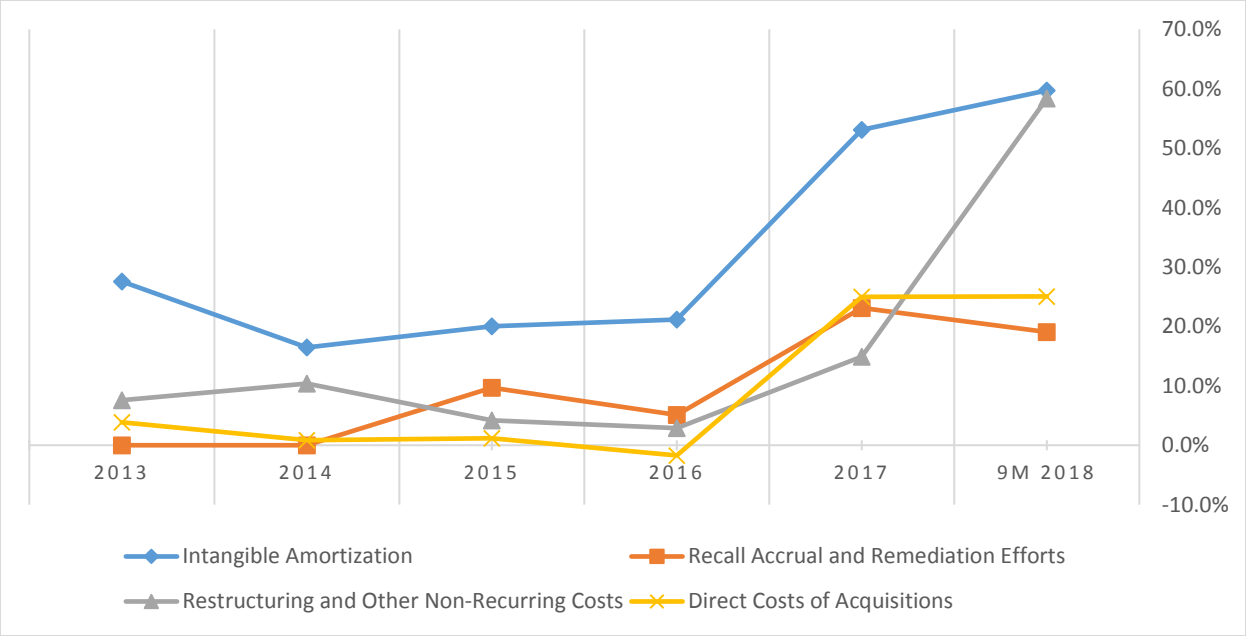
With the SEC already closely watching management's use of non-GAAP exclusions, we believe that the firm's use of non-GAAP exclusions has been highly aggressive under Mr. Kennedy as

CEO/CFO. While the company believes these costs to be non-recurring, we believe these to be true costs to the company as cash is going out the door at an accelerated pace.

Table 4: GAAP to Non-GAAP Reconciliation Analysis

Period Ended:	9M 2018	2017	2016	2015	2014	2013
GAAP EPS	**–$0.35**	**–$0.62**	**$1.29**	**$1.14**	**$0.97**	**$0.74**
Amortization Expense	$0.60	$0.78	$0.34	$0.31	$0.21	$0.28
Recall Accrual and Remediation	$0.19	$0.34	$0.08	$0.15	$-	$-
Restructuring and Other	$0.58	$0.22	$0.05	$0.06	$0.13	$0.08
Direct Costs of Acquisitions	$0.25	$0.37	–$0.03	$0.02	$0.01	$0.04
Extraordinary Annual Meeting	$0.07	$-	$-	$-	$-	$-
Extraordinary Patent Litigation	$0.03	$0.05	$-	$-	$-	$-
Income Tax Impact	–$0.37	$0.31	–$0.12	–$0.13	–$0.09	–$0.11
Non-GAAP EPS	**$0.99**	**$1.45**	**$1.62**	**$1.55**	**$1.26**	**$1.03**

Chart 7: Natus Expense Exclusions as a % of Non-GAAP Earnings



Inept Natus Management Has Led the Company Down a Dark Path

Natus Medical Inc. (BABY) has had an interesting last 12 months to say the least. The medical device company has gone through a well-publicized proxy fight with Voce Capital, organizational changes, material weaknesses relating to their financials, continued issues with the FDA, and finally, a recent consolidation of their segments in order to "increase transparency". Before this segment consolidation occurred, Natus operated in three segments: Neurology (neurodiagnostics and monitoring), Newborn (neonatal assessment and treatment), and Otometrics (hearing aid fitting, screening, and assessment).

With the stock price somewhat stagnant over the past five years, this drew the ire of institutional shareholders Voce Capital (Voce). As a result, in April 2018, Voce informed the Board of Directors of their intent to nominate new director candidates to replace 50% of the Natus Board (three of the six seats, including the Chairman of the Board – Robert Gunst). Furthermore, Voce was not discreet regarding their disdain for long-tenured CEO Jim Hawkins. Specifically, Voce took issues with Mr. Hawkins' future vision of Natus as they described the company as "in disarray". Here is an excerpt describing Mr. Hawkins in their letter to the Board:

> **CEO Jim Hawkins had long pursued a "roll-up" strategy, with a string of poorly integrated acquisitions, muted organic growth, declining profitability and management turnover. His primary talking point in our first meeting with him was that he intended to maximize the value of Natus through a sale once he stabilized the business.**
>
> Having completed 2012 with annual revenues of $292 million, he stated that he had build Natus through acquisitions to reach $300 million in revenues which was the "critical mass" he felt he needed to attract the attention of General Electric and Philips, competitors whom he stated were his preferred acquirers of Natus. (That bogey steadily grew over time, to $400 million, then $500 million and beyond…) CEO Hawkins also represented that he was in annual dialogue with each those parties concerning a potential sale of the company.

We agree with Voce Capital that Natus was and still is a company in disarray. We also find it quite disconcerting that management's focus appeared to be raising the top line by any means possible in order to entice a sale. Illustrating this idea, Voce wrote about CEO Hawkins' failed acquisitions strategies in their press release (04/23/18)[4]:

[4] https://www.businesswire.com/news/home/20180423005404/en/Voce-Capital-Nominates-Natus-Directors

> CEO Hawkins has always appeared to prefer doing deals over building Natus organically. Yet his success extracting value from acquisitions is dubious at best. **In 2005, when this buying spree began, Natus had approximately $43 million in revenue. The aggregate revenue of the companies purchased since then, measured at the time of their acquisition, is approximately $492 million. Yet Natus' pro forma 2017 revenue (inclusive of its acquisitions of Otometrics and Integra), was approximately $531 million. This implies total organic revenue growth of negative $4 million over the previous twelve years.**
>
> Despite its aggregate investment of $569 million over more than a decade the Company has nevertheless managed to shrink its revenue base! Nor do the acquisitions appear to have generated any benefits of scale: **Natus' gross margins and operating margins were higher in 2005 than now (63% and 14% then versus 60% and 13% today**, respectively), before the acquisition frenzy started and when the Company had a fraction of its current revenues.

Surprisingly, Voce appeared to favor the firm's previous CFO Jonathan Kennedy in the same press release:

> After the arrival of CFO Jonathan Kennedy in March 2013, the Company appeared to regain its footing as CFO Kennedy began mopping up CEO Hawkins' mess. Over the next three years, Natus made only three small acquisitions totaling approximately $17 million in value (one of which was only $1 million).
>
> Boosted by facility consolidation (necessitated from all the previous buyout activity), gross and operating margins both expanded. **CFO Kennedy also reduced the corporate tax rate from 31% to 23% through a series of shrewd maneuvers. Earnings jumped from $0.62 in 2012 to $1.55 in 2015, with the Company consistently beating and raising guidance.**

GHR essentially disagrees with Voce's entire sentiment surrounding Mr. Kennedy's job as CFO. As the reader will come to see in our detailed report, we believe many of the "shrewd maneuvers" orchestrated by Mr. Kennedy were nothing more than smoke and mirrors.

While Voce Capital has hope for Natus under the newly appointed CEO Mr. Kennedy, we at GlassHouse are not as optimistic. In fact, we argue that the company is currently screwed either way. Yes, the string of acquisitions did help to conceal a deteriorating core company. However, now that the acquisitions will most likely cease, we believe the company will need to "reset expectations" with investors and analysts, as it will need to deal with the cornucopia of accounting issues detailed herein.

Manipulated inventories, receivables, prepaids, taxes, cookie-jar reserves and faux non-GAAP exclusions were all used by CFO Jonathan Kennedy to create transitory artificial gains with no real substance. This is the new CEO of Natus Medical.

Voce Capital Wins Two Seats on Natus Board

Natus, in its defense, (and defense of former CEO Hawkins), gave a series of retorts through press releases leading up to the 06/22/18 vote for new directors. Within these retorts, Natus defended their track record of enhancing shareholder value, endorsed the incumbent board members (Robert Weiss, Doris Engibous, and Robert Gunst), and detailed Voce's lack of a new strategy.[5]

When the chips were all settled on 06/22/18, Voce Capital was able to replace two board members (Robert Weiss and Doris Engibous) with Lisa Heine and Joshua Levine. However, Voce's endeavors to remove Chairman of the Board Robert Gunst failed. Subsequently, with two new members added to the board, CEO Jim Hawkins "retired" abruptly a few weeks later on 07/11/18, after 14 years of service. As a result, the former CFO Jonathan Kennedy, who appears to have Voce's blessings, was promoted to CEO and appointed to the Board of Directors. Subsequently on 09/17/18, Natus appointed Drew Davies as Executive Vice President and CFO effective 10/01/18. Mr. Davies appears to have close ties with Mr. Kennedy as they both previously worked for Intersil Corporation as Controller and CFO, respectively.

[5] https://investor.natus.com/press-releases/detail/239/natus-medical-highlights-boards-strengths-and

New Management is Cut of the Same Cloth as Jim Hawkins

Let us be perfectly clear, Natus Medical is one of the worst run public companies we have ever come across throughout our research. **In recent years, under the helm of Mr. Hawkins and Mr. Kennedy, Natus 1) started multiple new product lines, only to discontinue them in future periods, 2) purchased new bolt-on acquisitions and subsequently shut them down a short time later, 3) endorsed new hires to lead divisions only to fire them in later periods, 4) continued to give guidance that was missed over and over again due to management's lack of visibility into future demand, and 5) finally under Mr. Kennedy's watch, the firm received two material weaknesses regarding its inventory, AR, and then acquisition accounting in 2014 and in 2017.**

We believe that Voce Capital was only partially correct by blaming just Jim Hawkins for the tribulations of Natus. While Mr. Hawkins may be mostly at fault for the operational deficiencies of Natus, we believe Mr. Kennedy will soon be held accountable for the myriad of financial engineering red flags that have been employed by the company. Below, let us dissect and counter each of Voce's accolades, given to the newly appointed CEO in their press release:

1. CFO Kennedy reduced the ETR from 31% to 23% through a series of shrewd maneuvers

As trained accountants, we do not view the reducing of their tax rate to be any kind of accomplishment. This is especially true after reviewing exactly how Mr. Kennedy was able to reduce the firm's tax rate down to 23% (reached in FY2016). So how was Mr. Kennedy able to reduce taxes by over 800 bps? A straightforward strategy of shifting its profits overseas to low-tax jurisdictions, **a strategy that we honestly do not believe will hold water with the IRS**.[6]

2. Earnings jumped from $0.62 in 2012 to $1.55 in 2015

For brevity's sake, we do not believe Voce should be pleased with Mr. Kennedy as we believe much of the firm's earnings growth was due to financial engineering and unsustainable sources. For example, Mr. Kennedy decided to exclude $0.15 (10% of non-GAAP EPS) of product remediation costs in 2015, however we consider this to be a normal operating cost of the business. Furthermore, the company accelerated its exclusions of amortization costs over the same timeframe. Finally, we believe a substantial portion of these earnings gains were due to inventory accounting games as we have discussed in our prior Inventory Section on Page 4.

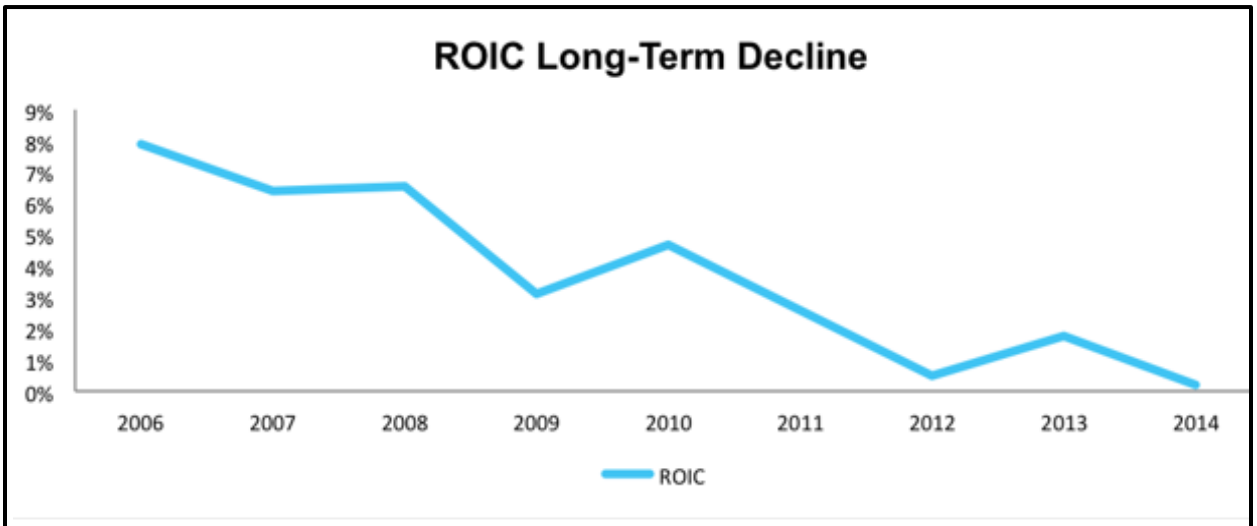
[6] See Exhibit 1 in Appendix on Page 42.

Newly Appointed CEO Kennedy and CFO Davies Have Left Prior Companies in Disarray

Coincidentally, we find that CEO Jonathan Kennedy (June 2004 to April 2013) and CFO Drew Davies (April 2009 to August 2012) both worked together previously at the semiconductor firm Intersil Corporation (ISIL, now acquired by Renesas Electronics). While Natus and Intersil operate in two different industries, we have found several uncomplimentary similarities between the two firms. During Mr. Kennedy's tenure as CFO, ISIL's stock price was at approximately $20 as of June 2004. While the stock performed admirably over the next two years, it cratered during the recession and never recovered. **At the time of Mr. Kennedy's departure, the stock price stood near $7, representing 65% of value deterioration over nine years**.

What brought ISIL down? Well, a lot of the same issues currently coinciding with Natus: 1) Declining profitability/ROIC metrics (see Chart 8, below) as the company tried to acquire its way to growth, 2) too many product lines that needed to be condensed, 3) and finally, inventory concerns as the firm's DSI balance spiked to a high of 126 days in 2010 with the stock price never to recover.

Chart 8: Intersil Corporation Prior ROIC Trends



Sources: New Constructs, LLC and company filings.

[7]

[7] https://seekingalpha.com/article/3196156-intersil-stuck-at-the-bottom-of-its-industry

Furthermore, when we dig into Drew Davies' past endeavors, they do not appear to paint a pretty picture. After leaving Intersil and spending only six months working for Marvell Technology (MRVL) as their Corporate Controller, Mr. Davies took a CFO position at Extreme Networks (EXTR) starting in June 2016. Throughout his tenure, the stock price of EXTR jumped to a high $15.00 at the end of 2017. **However, the high would be short-lived, as the stock plummeted to a low of $5.50 when Mr. Davies exited the company amongst accounting system issues in September 2018.** A cursory review of EXTR's non-GAAP earnings appears to show management using aggressive non-GAAP exclusions that we take issue with.

Overall, while Voce Capital believes they have the right leadership to steer Natus into prosperity, we believe Mr. Kennedy and Mr. Davies are cut from the same cloth as Mr. Hawkins and will lead the company into unfortunate despair. Furthermore, GlassHouse takes issue with Natus' current weak Audit Committee which appears to have no accounting background experience. The Audit Committee consists of Board Members Kenneth Ludlum (Chairman), Robert Gunst, and William Moore. While Mr. Ludlum has been deemed an "audit committee financial expert" by the Board, we note that he has no prior public accounting experience. Furthermore, he does not possess a CPA license nor an accounting degree in any form.

In the midst of two material weaknesses found under his watch as Audit Committee Chairman, GHR wonders how Mr. Ludlum has been able to keep his job as Audit Chairman for this long. Based on history, it is apparent that this Audit Board has let Mr. Kennedy do as he pleases in terms of aggressive acquisition, inventory, AR, reserve, and revenue recognition accounting. So why should investors trust this Audit Board now to protect Natus' investors?

As we go forward, we're going to drive to $1 billion in 5 years. That's our goal. Doing some of this through organic growth and some through acquisitions… And it's a very exciting goal that we've set internally and we're committed… to make happen.

-- CEO of Natus Medical, Jim Hawkins

We think a billion company can generate a lot more profits. It can be a lot more attractive to investors. We want to become a billion plus company, and we do it organically eventually, but we can accelerate with good acquisitions.

– CEO Electronics for Imaging, Guy Gecht

Natus Management with No Visibility Misleads Investors Time and Time Again

In our next section, GlassHouse will go step by step in discussing the multitude of instances where management misled or were flat out wrong when discussing Natus and its future. We believe this is important to investors because we ask ourselves, why should we trust management now when they have been so deceitful in the past?

Date / Filing / Author	Initial Statement	End Result
Q4 2016 Earnings Call, CEO Jim Hawkins	"For our full year 2017, we expect non-GAAP earnings per share guidance of $1.80 to $1.85."	The company reported non-GAAP EPS of only $1.45 (a 21% miss) as the firm continued to lower its EPS guidance after every period.
06/22/17, Investor Day, CFO Jonathan Kennedy	Mr. Kennedy disclosed revenue guidance of $505 to $510 million for 2017. "We should be able to achieve that with revenue growth driven in Otometrics, Newborn Care and Neurology."	Even halfway into the year, mgmt. missed guidance with revenue of only $501.mm. However, sans acquisitions, BABY would have only produced sales of $386.mm, or only 1.2% organic growth. Neuro and Newborn sales were only up 1.9% and 0.2%, respectively. The firm also reported "lower than expected revenues from Otometrics."
06/22/17, Investor Day, CFO Jonathan Kennedy	Goal of 20% operating margin for 2017. And >22% long-term.	The firm reported non-GAAP operating margin of only 13.2% for FY2017. FY2018 isn't much better with only 12.0% margins reported.

06/22/17, Investor Day, CFO Jonathan Kennedy	Relating to ROIC – "If you look at 2012, down at 6%, okay, that's not too bad, but it's not stellar. But getting into '14 and '15, 13%, 15% and then 14% ROIC in 2016. So a 14% ROIC for last year. And then if we look at Otometrics, we paid about $150 million for that business. If we achieve our 20% margin goal on – by the time we get there, it's $115 million, $120 million business, the return on capital on that business will exceed what I'm showing here today, **will be in the mid-teens**."	According to GHR calculations that use BABY's non-GAAP data, we calculate ROIC as being lower amounts of 8.8%, 11.2%, 13.2%, and 9.6% in 2013, 2014, 2015, and 2016, respectively. Furthermore, while management was hoping for mid-teen ratios for the future**, this metric dropped off a cliff to 7.9% in 2017. The firm stopped disclosing its ROIC metric after 06/22/17.**[8]
06/22/17, Investor Day, CEO Jim Hawkins	"So we're really positioned now for very fast organic growth along with layering in acquisitions for the next 5 years. We put out there for ourselves a goal that we believe we can be a 5% to 7% organic growing business. That's a big statement."	Mgmt. incorrectly stated that consolidated organic growth **was +3% in the Q1 2018 period (it was -4.6%).** Natus has now reported negative organic growth in 4 straight periods. Mgmt. has also appeared to stop disclosing the consolidated organic growth rate for BABY.
06/22/17, Investor Day, CEO Jim Hawkins	"And how we look to do that is certainly led by Otometrics. We believe they can grow 10% to 15% a year." This business was selling approximately $100mm a year when Natus acquired them. Mr. Hawkins also proposed a 20% operating margin for the Otometrics segment.	Otometrics sales growth has decelerated greatly over the last two periods; reporting no growth in the latest period. Margins are nowhere near 20% as the firm was expecting to sell its Otoscan product for $15,000 and has only been able to sell a lackluster 50 units near an $8,000 price point.

[8] See Exhibit 2 in Appendix on Page 43.

06/22/17, Investor Day, CEO Jim Hawkins	"Really interesting kind of spin on our EEG business is GND. So we acquired GND in January of 2015… It works very, very well. And from the payer's perspective, it is a lot less expensive, a lot less expensive to do this in the home versus doing in the hospital. So GND has been a wonderful, wonderful addition to our EEG portfolio."	In its 01/15/19 Press Release, Natus exited this "non-core" business. The GND business accounted for approximately $12mm in revenue in 2018. After only 3 years in the Natus family, GND was discarded. **As a result, GHR expects material impairments to goodwill and inventory in the next period.**
06/22/17, Investor Day, CFO Jonathan Kennedy	Regarding payment for Peloton service, "We talked last quarter on our call about some of the issues we've had in Peloton just recently with reimbursement rates… So in response to that, **we have made a strategic shift to focus only on profitable hospitals**; in other words, those hospitals where we aren't dependent on solely third-party payers."	From the Q3 2018 earnings call, "Even this quarter, we had another **$1.5 million receivable adjustment that we took for Peloton from that accumulated over the last several years where we're just not getting payment from certain hospitals and certain states**... So it's an evolving business… but also one that we've had some challenge with over the last several quarters."
Q2 2017 Earnings Call, CEO Jim Hawkins	"In the second quarter, Jonathan Kennedy, our CFO, was appointed to also head up our Newborn Care business unit. I would like to report that significant progress has been made to improve our processes in our Seattle facility, where we are operating under a warning letter. **We look to complete this remediation work in the first half of 2018."**	While the company has reported positive audits in the Q3 2018 quarter, Natus has still been unable to remediate its ship-hold in the Seattle facility with the FDA, two periods after it was forecasted to be completed.

Q3 2017 Earnings Call, CFO Jonathan Kennedy	"**As we talked about before, Peloton coming down from a revenue perspective due to lower revenue per baby**. In terms of getting Peloton on track, earlier in the year**, Peloton was not profitable**, and I'm happy to report that today, we've restructured that, and that business is doing quite well from a margin perspective… from a growth perspective, Peloton will continue to grow, although priced lower than past expectations but will continue to grow."	While mgmt. has pretty much stopped discussing Peloton numbers all together, GHR cannot imagine them doing well with the Newborn segment TTM sales being down 17% YOY.
Q3 2017 Earnings Call, CEO Jim Hawkins	"We announced the acquisition of neurosurgery business assets from Integra LifeSciences… for $47.5 million. With historic annual revenue of approximately $50 million."	GHR calculates that these Integra assets produced only $39.2 million of revenue over the TTM. While mgmt. did not set any sales goals for these assets, **we cannot fathom a 21.5% decline in sales is what they were expecting.**
Q4 2017 Earnings Call, CEO Jim Hawkins	"For our full year 2018, we now expect revenue of $535 to $540 million and non-GAAP EPS guidance of $1.60 to $1.65.	Mgmt. has now reduced guidance twice in 2018, with full year revenues guided to be $525 to $530mm and non-GAAP EPS of $1.47 to $1.50.
Q1 2018 Earnings Call, CEO Jim Hawkins	"Our Newborn Care supply business increased. This leads us to believe that birthrates increased in the quarter, which would obviously be a positive for our Newborn Care business if this continues."	In every publication GHR researched relating to U.S. birthrates, this number has been falling precipitously, since a recent high in 2007. No data suggest that this trend is changing whatsoever. This is even more apparent in the Newborn segment's lackluster sales declines of -14.7% and -7.3% in Q2 and Q3, which caught mgmt. by surprise.[9]

[9] https://www.statista.com/statistics/195943/birth-rate-in-the-united-states-since-1990/

Q1 2018 Earnings Call, CEO Jim Hawkins & Q2 2018 Earnings Call, CFO Jonathan Kennedy	"We hired new leaders for our Newborn Care business and Otometrics: … Carsten Buhl at Otometrics. Carsten is an experienced medical device executive that **I am confident will greatly contribute to the future success of these businesses and to Natus**."	Narrator: He did not contribute to the future success of Natus. Reflecting the poor condition of the Otometrics segment, Mr. Buhl was let go on 01/15/19.
03/01/2018, 10K Filing	We expect to remediate the material weakness during 2018 as we operate our redesigned purchase price allocation controls to account for the acquisition of our Neurosurgery business which we acquired during the Q4 2017.	The company has yet to disclose any full remediation regarding its material weakness at this time.
Various Earnings/Guidance Updates	Est. Q4 2016 GAAP EPS guidance = $0.48 Est. Q1 2017 GAAP EPS guidance = $0.22 Est. Q2 2017 GAAP EPS guidance = $0.11 Est. Q3 2017 GAAP EPS guidance = $0.17; Est. Q4 2017 GAAP EPS guidance = $0.55 Est. Q1 2018 GAAP EPS guidance = $0.02 Est. Q2 2018 GAAP EPS guidance = $0.05 Est. Q3 2018 GAAP EPS guidance = $0.21 Est. Q4 2018 GAAP EPS guidance = $0.26-$0.29	Actual Q4 2016 GAAP EPS = $0.31 **(35% miss)** Actual Q1 2017 GAAP EPS = $0.01 **(96% miss)** Actual Q2 2017 GAAP EPS = –$0.15 **($0.26 miss)** Actual Q3 2017 GAAP EPS = –$0.26 **($0.43 miss)** Actual Q4 2017 GAAP EPS = –$0.22 **($0.77 miss)** Actual GAAP Q1 2018 EPS = –$0.10 **($0.12 miss)** Actual GAAP Q2 2018 EPS = –$0.08 **($0.13 miss)** Actual GAAP Q3 2018 EPS = –$0.17 **($0.38 miss)** Actual???

01/15/19 Press Release CEO Jonathan Kennedy	Natus will consolidate its three business units, Neuro, Newborn, and Otometrics into "One Natus"… **The new structure provides for increased transparency,** efficiency and cross-functional collaboration across common technologies, processes and customer channels.	**Natus has one of the worst inventory and balance sheet positions we have ever seen researching public companies.** The fact that mgmt. has misled investors time and time again in a two-year span is frightening, to say the least. **Now mgmt. wants to consolidate segments to *increase* transparency? How does that make any sense?**

Updating our above GAAP guidance comment, let's break down what is actually going on here. Management has given *both* GAAP EPS and non-GAAP EPS estimates with a breakdown of the expected non-GAAP exclusions. Therefore, with both figures given, we would expect both figures in parallel (GAAP and non-GAAP) to beat or miss guidance if the exclusions are projected correctly. Obviously, this has not been the case with Natus.

Let's take a look at Q3 guidance given in the Q2 2018 earnings release:

	Quarter Ended September 30, 2018	Year Ended December 31, 2018
GAAP EPS Guidance	$0.19 - $0.23	$0.35 - $0.45
Amortization of Intangibles	0.21	0.85
Restructuring and other non-recurring costs	—	0.08
Litigation	—	0.03
Recall Accrual and Remediation Efforts	0.06	0.27
Direct cost of acquisitions	—	0.22
Tax effect	(0.06)	(0.30)
Non-GAAP EPS Guidance	$0.40 - $0.44	$1.50 - $1.60

We see that Natus was able to reach the lower end of the non-GAAP EPS guidance of $0.40. However, what happened to the $0.19-$0.23 of GAAP earnings? All of a sudden, the firm decided to report $0.41 of restructuring and "other non-recurring" costs and exclude them from non-GAAP earnings. Natus ended up reporting a GAAP loss of –$0.17. **These are actual cash expenses leaving the door for Natus, $13.8 million in Q3 to be exact**. We see this as a recurring theme regarding BABY's missed EPS estimates, where unexpected non-GAAP exclusions continue to unearth every period. We also point out that on 07/07/16, **CFO Jonathan**

Kennedy received a letter from the SEC that called out Natus' restructuring costs for "appearing to be normal, recurring operating expenses necessary to operate your business".

After every instance where management provided some sort of guidance, they persistently fell short of their endeavors. Whether the reasoning was nefarious in nature or due to incompetence, both reasons behind the incessant missed predictions remain unsatisfactory. Exacerbating things, these issues occurred while Mr. Kennedy orchestrated the plethora of accounting gimmicks that have yet to be unwound into BABY's future financials. **While current investors may believe the worst is behind Natus with Mr. Hawkins "retiring," we believe this is just the tip of the iceberg with CEO Jonathan Kennedy at the helm.**

Accounting Red Flags Are Set to Violently Reverse for Natus Medical in 2019

The bull case regarding Natus' stock price revolves around the following tenants that we believe the sell-side community has misunderstood:

1) Investors believe that Jonathan Kennedy is different from previous CEO Mr. Hawkins and under his leadership, Mr. Kennedy will be able to turn around the company based on his track record.
2) Analysts believe that gross and operating margins have room to expand and the result will propel the stock price upwards.
3) Investors believe that the company will now be able to grow the company organically with the focus now coming off acquisitions.

Regarding the above items, we have gone step by step to debunk many of these flawed reasonings for investors. With regards to Mr. Kennedy, Voce Capital sang his praises stating that he "mopped up CEO Hawkins mess" and that he "helped to expand both gross and operating margins". **Based on our analysis, Mr. Kennedy was only able to expand margins by consciously deciding not to write-off what we believe to be legacy and impaired inventories on the balance sheet.**

This segues into the second bullet point, the only way that Natus has been able to keep such consistent gross margins near 60% is because Mr. Hawkins and Mr. Kennedy orchestrated accounting games with inventories, receivables, AFDA, prepaids, and their warranty expense. Finally, now that the company will cease its acquisition strategy, we believe that in this current weak demand environment, Natus' true earnings will continue to report declines and losses with respect to revenues and earnings. All these items, we believe, will cause Natus' stock price to decline precipitously over the next twelve months. **Furthermore, we highly doubt that the sell-side community fully comprehends the magnitude of accounting headwinds (especially Natus' current inventory situation) that BABY faces over the next year.**

We at GHR believe the company's sustainable economic earnings can be better estimated using our accounting adjustments made in the previous sections. Adjustments made for Natus' inventory, prepaid expenses, and underfunded warranty and AFDA reserve need to be made in order to strip out any financial engineering gains. Furthermore, we believe the firm's reoccurring product remediation costs need to be added back to EPS to come to a sustainable EPS figure.

Below are our adjustments made to come to our sustainable EPS figure:

Table 5: Sustainable EPS Calculation

TTM Ended:	Q3 2018
Stated non-GAAP EPS	**$1.41**
Inventory Impact	-0.42
Prepaid Expenses Impact	-0.15
Warranty Reserve Reversal	-0.11
Allowance for Doubtful Accounts Reversal	-0.08
Recall Accrual and Remediation Effort Reversal	-0.16
Sustainable EPS	**$0.49**

Basing our valuation on our sustainable EPS value of $0.49, we believe a fair share-price for the firm stands currently at $9.80, which represents a 70.0% downside to the share-price. Based on Natus' non-existent growth and dire outlook, we believe a very conservative P/E multiple lies at 20x, which we used in our models.

In light of our concerns regarding the plethora of accounting and fundamental concerns laid out herein, GlassHouse finds the current stock price to be highly egregious. Accordingly, we are initiating coverage on Natus Medical Inc., (BABY) with a target price of $9.80.

Appendix

Exhibit 1: Natus Income Tax Footnotes (2017 10K)

Where Natus once kept a reasonable 39.1% of their earnings within the United States in 2015, the excerpt below illustrates that this drastically changed in 2016 and 2017. **Essentially reporting $0 of earnings within the U.S. in 2016 and then a large loss of $18.1 million in 2017, Mr. Kennedy basically engaged in transfer pricing of its products to shift profits overseas at an accelerated rate.** While this could fly with companies that possessed little tax nexus within the U.S., we find that Natus currently reports 54.1% and 45.9% of sales and assets within the United States in 2017, respectively. This material amount of Nexus leads us to believe that BABY is not out of the corner yet, as Natus discloses that its U.S. Federal taxes remain open to examination from 2014 through 2017. Thus, we believe the company is now at high risk of penalties, increases in uncertain tax positions (UTP), and higher future tax rates.

17—INCOME TAXES

Income before provision for income tax is as follows (in thousands):

	Years Ended December 31,		
	2017	2016	2015
U.S.	$ (18,059)	$ 68	$ 20,507
Foreign	23,209	54,835	31,902
Income before provision for income tax	$ 5,150	$ 54,903	$ 52,409

The components of income tax expense for the years ended December 31, 2017, 2016 and 2015 (in thousands):

Table of Contents

NATUS MEDICAL INCORPORATED
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS-(Continued)
Years Ended December 31, 2017, 2016 and 2015

	Years Ended December 31,		
	2017	2016	2015
Federal statutory tax expense	$ 1,802	$ 19,216	$ 18,343
State tax expense	(318)	188	1,249
Foreign taxes at rates less than U.S. rates	(3,101)	(6,838)	(1,760)

The Company's tax returns remain open to examination as follows: U.S. federal, 2014 through 2017; U.S. states, generally 2013 through 2017; and significant foreign jurisdictions, generally 2013 through 2017.

Exhibit 2: Natus Calculated Return on Invested Capital – 06/22/17 Investor Day

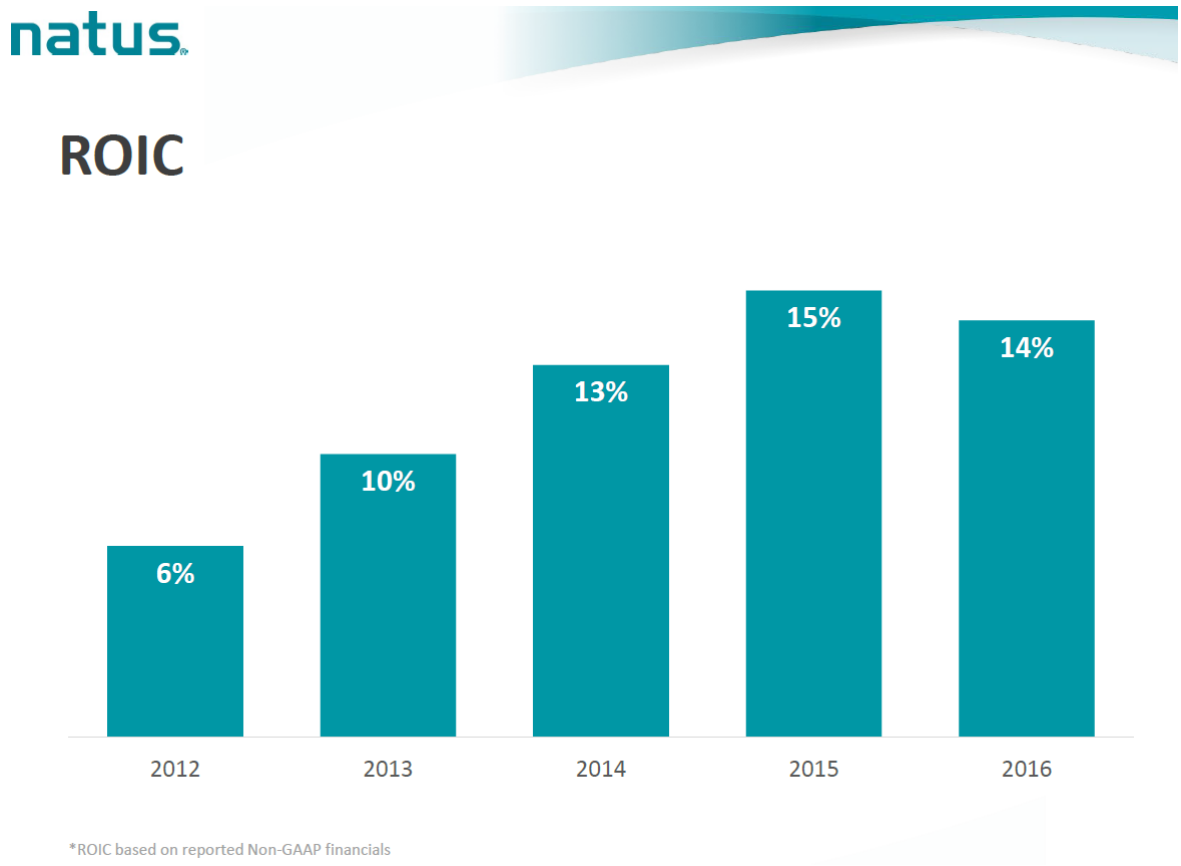


Exhibit 3: Natus GAAP Earnings Vs Consensus Estimates

Fiscal Quarters	FQ4 2016 - Dec 2016	FQ1 2017 - Mar 2017	FQ2 2017 - Jun 2017	FQ3 2017 - Sep 2017	FQ4 2017 - Dec 2017	FQ1 2018 - Mar 2018	FQ2 2018 - Jun 2018	FQ3 2018 - Sep 2018	FQ4 2018 - Dec 2018
NasdaqGS:BABY (USD)									
EPS Normalized	0.51 A	0.30 A	0.34 A	0.40 A	0.42 A	0.24 A	0.35 A	0.40 A	0.49 E
EPS (GAAP)	0.31 A	0.01 A	(0.15 A)	(0.26 A)	(0.22 A)	(0.10 A)	(0.08 A)	(0.17 A)	0.31 E
Final Est.	0.46 E	0.23 E	0.14 E	0.21 E	0.29 E	0.06 E	0.08 E	0.24 E	-
Median	0.46 E	0.23 E	0.16 E	0.21 E	0.29 E	0.06 E	0.08 E	0.24 E	0.31 E
High	0.46 E	0.26 E	0.21 E	0.25 E	0.40 E	0.08 E	0.10 E	0.26 E	0.35 E
Low	0.45 E	0.21 E	0.06 E	0.17 E	0.17 E	0.03 E	0.06 E	0.21 E	0.27 E
Std. Dev.	0.00	0.02	0.06	0.04	0.12	0.03	0.02	0.03	0.04
No. of Estimates	3/3	3/3	3/3	2/2	2/2	2/3	2/2	2/2	2/2

Full Legal Disclaimer: As of the publication date of this report, GlassHouse, LLC and others that contributed research to this report and others that we have shared our research with (collectively, the "Authors") have short positions in, and own put option positions on, the stock of Natus Medical Inc. (BABY), and stand to realize gains in the event that the price of the stock decreases. Following publication of the report, the Authors may transact in the securities of the company covered herein. All content in this report represent the opinions of GlassHouse. The Authors have obtained all information herein from sources they believe to be accurate and reliable. However, such information is presented "as is," without warranty of any kind – whether express or implied. The Authors make no representation, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results obtained from its use. All expressions of opinion are subject to change without notice, and the Authors do not undertake to update or supplement this report, or any information contained herein. This document is for informational purposes only and it is not intended as an official confirmation of any transaction. All market prices, data and other information are not warranted as to completeness or accuracy and are subject to change without notice. The information included in this document is based upon selected public market data and reflects prevailing conditions and the Authors' views as of this date, all of which are accordingly subject to change.

This is not investment advice, nor should it be construed as such. Use of GlassHouse LLC's research is at your own risk. You should do your own research and due diligence before making any investment decision with respect to securities covered herein. Following publication of any report or letter, we intend to continue transacting in the securities covered therein, and we may be long, short, or neutral at any time hereafter regardless of our initial recommendation. This is not an offer to sell or a solicitation of an offer to buy any security, nor shall any security be offered or sold to any person, in any jurisdiction in which such offer would be unlawful under the securities laws of such jurisdiction. GlassHouse LLC is not registered as an investment advisor. To the best of our knowledge, information and belief, as of the date hereof, (a) all information contained herein is accurate and reliable and does not omit to state material facts necessary to make the statements herein not misleading, and all information has been obtained from public sources we believe to be accurate and reliable, and (b) who are not insiders or connected persons of the stock covered herein or who may otherwise owe any fiduciary duty or duty of confidentiality to the issuer, or to any other person or entity whose fiduciary duty was breached by the transmission of information to GlassHouse LLC. However, GlassHouse LLC recognizes that there may be non-public information in the possession of BABY that has not been publicly disclosed by the company. Therefore, such information contained herein is presented "as is," without warranty of any kind – whether express or implied. GlassHouse LLC makes no other representations, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results to be obtained from its use.