BEHIND THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers

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Wesco International, Inc. (WCC)
Earnings Quality Review

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are initiating earnings quality coverage of WCC with a 5- (Acceptable).

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

Summary

Wesco's (WCC) acquisition of Anixter in 2020 is an example of a merger that worked. WCC has been beating forecasts, but the size of the beat shrank in 3Q22 to only 7 cents:

- Adjusted EPS 3Q22 -- $4.49, beat by 7 cents
- Adjusted EPS 2Q22 -- $4.19, beat by 26 cents
- Adjusted EPS 1Q22 -- $3.63, beat by $1.39
- Adjusted EPS 4Q21 -- $3.17, beat by 62 cents

The guidance for 4Q22 calls for growth to remain strong for sales – about 7%-10% but that some of the normal seasonality (where 4Q is lower than 3Q) will return along with some added FX pressure, which wasn't the case in 4Q21. Also, EPS is expected to come in at $3.78 around a band of guidance for $3.51-$3.91. That also would be lower than 3Q and 2Q.

The accounting here is very clean, which is why we are starting it off with a '5' rating. The biggest issue is this appears to be a company close to a transition in its operating environment. WCC is historically a fairly low-margin company with EBITDA margins that range between 5%-7%. A low-margin company wants more margin points as that creates much more earnings leverage than more sales. WCC has successfully achieved both higher sales and margins in the last two years with sales growth of over 20% in some quarters and margins far above forecasts. The credit goes to both management and inflation.

There are red flags on working capital – DSIs for inventory and DSOs for receivables. That, in turn, has created negative cash flow for WCC. We see reasons to expect sales growth to slow such as reaching its goals on cross-selling from the merger, filling backlog demand, and slowing inflation. That should all help WCC to generate cash flow, but it could also reverse some of the margin gains and negatively impact EPS. In the near term, we would be valuing WCC on EPS of about $15 and over an intermediate term even $12, but if it reached $12, future growth should come with a positive CAGR of 3%-5%.

What to Watch

- There are other minor acquisitions here, but Anixter is the primary deal WCC made and the results have been strong. WCC and Anixter are similar companies and WCC didn't overpay. It had modest cost-cutting goals that have come in sooner and above forecast.

Its revenue synergy goals were also modest and WCC is beating those handily. **(See Below)**

- This is still a cyclical business and sales and margins can decline as both Anixter and WCC experienced between 2007-10. Currently, margins of 8.7% (about 150bp above forecasts) and sales growth of high-teens to 20% are far ahead of the combined company's forecasts. **(See Below)**

- Volume growth has been fueled by cross-selling the two companies' customers – adjusting for that, volume growth is already down from over 9% to just under 4%. WCC is touting backlog growth at record levels, but the rate of sequential growth has stalled. **(See Below)**

- Pricing has exceeded cost-inflation pressures and given WCC 80-120bp of gross margin expansion, which with cost-cutting measures fueled EBITDA margin expansion of 140-200bp. Pricing of 8% has also helped boost sales growth far above the normal 3%-5% level. If we adjust pricing to only up 7%, it hurts EBITDA margins by 80bp and cuts EPS by 15%-20%. It doesn't take a major recession to cause a sizeable hit to EPS. **(See Below)**

- Debt to EBITDA ratios are falling, but that is due to EBITDA rising, not actual debt repayment. It would not take much EBITDA margin compression to push WCC above its target range for debt. **(See Below)**

- Inflation is driving earnings but it is also driving up working capital needs, which is boosting debt and creating negative cash flow. DSIs for inventory moved from 60-62 days to 76, which hurts cash flow further. WCC sees this build as justified due to the rising backlog and expects it to reverse going forward. DSOs are also up from 55 to 61 days. **(See Below)**

- This is the transition we see building as volume growth from cross-selling ebbs, backlog growth stalls, and inflation slows to create tough comps all combine to squeeze sales growth and margins and reduce EPS. But, at the same time, WCC should release working capital and make its cash flow and debt in dollar terms look better. **(See Below)**

- We would also watch rebates. Volume rebates that WCC gives to clients reduce reported sales by about 200bp while volume rebates earned by WCC reduces its cost of sales. If both move in tandem, the margin change is only about +/- 10bp. However, if for competitive reasons, a situation develops where WCC boosts rebates it gives, while suppliers hold the line – this can be a much larger negative for margins. **(See Below)**

Anixter Deal Has Outperformed Expectations

We see so many poorly thought-out deals and overpayments that when one works well it is surprising more companies don't use this same game plan.

- Both companies dealt with some cyclical industries but were growing their top line and it was with volume growth. WCC was getting 2%-6% growth and removing acquisitions at Anixter, it was growing about 4%-5%.

- Both companies had some modest acquisitions, but it wasn't their primary source of growth or reason for being in business. And, the businesses were very complimentary in products, production, distribution, and end markets. This wasn't IBM buying into telecom or AT&T buying into computers (both of which happened at the same time in the past.)

- There were very achievable cost-cutting plans. Before the deal, the two companies had $17.2 billion in sales and $16.35 billion in costs. WCC was forecasting only $200 million in cost savings within 3 years. It could easily outline the focus as much of this would come from eliminating overlapping branch offices and cutting duplicate management and back office functions. They were only forecasting a cut of 1.2% of total costs.

- WCC didn't overpay. At the time of the deal, WCC was trading for 7.6x EBITDA and about 9x EPS. It bought Anixter for 10x trailing EBITDA or only 7x with the $200 million in synergies. Anixter was bought for 13.3x EPS or 8.3x after the synergies.

The deal closed in June 2020 and so far from an operating standpoint – the combined company has exceeded forecasts:

- Cost savings were expected to be $140 million within two years and $200 million within three years. WCC hit the $200 million goal ($197 million) in nine quarters and now expects to reach $315 by the end of 2023.

- It is worth noting that the obvious cost-cutting of duplicate costs by combining the HR department, accounting department, and having fewer managers than the company had as two separate firms was expected to generate $90 million of the expected $200 million in three year years. It has already hit $135 million with $5 million to go. Rationalizing real estate was the other easy target and merging duplicate locations was supposed to produce $40 million in cost savings. It now is expected to hit $60 million and the original $40 million has been achieved.

- When the deal was announced, WCC predicted that cross-selling each company's product to the other set of customers would lead to 100bp of higher organic growth. That would be roughly $170-$180 million in higher annual sales that grew organically after that. This too has been vastly exceeded at this point.

- The first year of cross-selling added only $77 million to sales. But the next six months added $288 million and each following three-month period added $160 million, $204 million, and $237 million. With $966 million achieved, WCC's forecast for cross-selling revenues is now $1.4 billion.

- The final forecast was that WCC would have its Net Debt to EBITDA figure decline from 5.7x to a range of 2.0-3.5x within three years and they hit that figure by the end of two years. It is currently at 3.2x. We will discuss this more below, but we do not consider this to be part of the success story. The debt figure dropped from $4.8 billion to $4.3 billion from 2Q20 to 1Q21. It is back to $5.0 billion now. Thus, the ratio is declining solely due to the higher cross-selling, cost synergies, and inflation impacts, in our view. WCC likely still has some cyclicality to it from sales into construction markets as well as some of the new growth trends for broadband, data centers, network security, and modernization of electrical grids.

History, Baseline Forecast, Unsustainable Areas for Sales and Margins

We looked back at the period of 2006-2010 for both Anixter and Wesco. That period included commodity inflation and deflation as well as rising demand and falling demand. The short way to say that is this is still a cyclical industry even though investment in broadband and electrical grid updates may ultimately prove less cyclical over the next 4-5 years than other areas of demand.

- Both companies pointed to falling commodity prices as hurting sales and margins in 2009 before rebounding to drive sales and margins in 2010.

- We believe the bigger picture is that even Anixter which was selling more into the technology sector experienced sales declines and margin contraction too.

	2010	2009	2008	2007	2006
Anixter Sales	$5,472	$4,984	$6,137	$5,853	$4,939
Anixter EBITDA	$320	$251	$464	$465	$359
Margin	5.8%	5.0%	7.6%	7.9%	7.3%
Wesco Sales	$5,064	$4,624	$6,111	$6,004	$5,321
Wesco EBITDA	$211	$180	$346	$394	$365
Margin	4.7%	4.5%	6.1%	7.2%	7.4%

From the discussions in the 10-K's, both companies benefited from acquisitions – that was the bulk of Wesco's growth in 2007. Anixter had stronger organic growth with 13% in 2007. Wesco noted that lower volume rebates it earned in 2009 helped push earnings down even more. (We discuss rebates below as a risk item to watch.)

Based on the updated merger forecasts and where WCC is operating now, we would warn that the company is far ahead of its baseline on margin and sales. The baseline adds in the expected cross-selling of $1.4 billion and cost savings of $315 million by 2023.

	TTM	Base	Start
Sales	$18,220	$18,600	$17,200
EBITDA	$1,594	$1,165	$850
Margin	8.7%	6.3%	4.9%

If we look at the reported organic growth, we see that sales growth has been running in the high teens to 20%+ in recent quarters:

Organic Growth	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Pricing	8.0%	8.0%	8.0%	6.0%	5.0%	8.0%	2.0%
Volume	8.9%	12.9%	13.2%	9.8%	8.6%	13.6%	1.2%

Much of this is due to the cross-selling picking up. If we adjust the cross-selling out, volume growth is already slowing. Suddenly there is no 20% quarter:

Organic Growth	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Pricing	8.0%	8.0%	8.0%	6.0%	5.0%	8.0%	2.0%
Volume	8.9%	12.9%	13.2%	9.8%	8.6%	13.6%	1.2%
Cross-Selling Vol.	5.0%	4.4%	4.0%	3.5%	2.5%	n/a	n/a
Adj. Volume	3.9%	8.5%	9.2%	6.3%	6.1%	n/a	n/a

We don't expect the cross-selling volume to vanish, but per guidance, there is only $434 million to go and they just realized $237 last quarter. It looks like that growth rate should start to move toward zero going forward.

WCC has not quantified its backlog in dollar terms that we have seen. However, it has touted that it has reached a new record level each quarter for much of this period. It has also pointed out that it is not seeing cancellations on the backlog. That should preserve volume growth even if the base figure on volume declines further or becomes negative. However, the sequential growth for backlog is starting to stall here too: The CSS unit's backlog was up 7% sequentially in 2Q22 but 0% in 3Q22; ESS unit was up 6% sequentially in 2Q22 but 2% in 3Q22; UBS was up 25% sequentially in 2Q22 and 14% in 3Q22. We believe the volume figure is more likely to become low-single digit than holding at high-single digit within two to three quarters.

That leaves pricing as the more powerful sales and margin driver. Pricing has been exceeding the cost increases and helping margin grow. We can see this in gross margin being a big part of the EBITDA gains:

	3Q22	2Q22	1Q22	4Q21	3Q21
Gross Margin Gain b.p.	80	70	120	120	170
Adj. EBITDA Margin Gain b.p.	160	140	200	140	90

We know two things: the current EBITDA margin exceeds the company's baseline forecasts and pricing of raw materials can decline as happened in 2009 and 2010 vs. 2007 and 2008 levels. Normally, a lower-margin business is very sensitive to changes in margin and WCC is not an exception here. Here are the recent results and then we adjusted them assuming 100bp of pricing didn't occur. This would create a large drop in EBITDA margin and EPS:

	3Q22	2Q22	1Q22	4Q21	3Q21
Price Hike	8.0%	8.0%	8.0%	6.0%	5.0%
Sales	$5,446	$5,484	$4,932	$4,852	$4,728
Adj. EBITDA	$466	$444	$364	$320	$330
Margin	8.6%	8.1%	7.4%	6.6%	7.0%
Assume Pricing	7.00%	7.00%	7.00%	5.00%	4.00%
New Sales	$5,399	$5,438	$4,892	$4,811	$4,686
New EBITDA	$419	$398	$324	$279	$288
Margin	7.8%	7.3%	6.6%	5.8%	6.1%
Reported Adj. EPS	$4.49	$4.19	$3.63	$3.17	$2.74
EPS impact 1% cut in Px	$0.66	$0.65	$0.63	$0.66	$0.59
Lower Adj. EPS	$3.83	$3.55	$3.00	$2.51	$2.15

The top of this table shows the actual results reported by WCC. In the second part, we cut 100bp off the price increase from the prior year's quarter – this only cut $40-$47 million off the reported sales of about $5 billion. However, it cut the same amount off EBITDA and results in WCC losing about 90bp of margin. **The last part of the table shows how much EPS is at risk from having pricing weaken just a little bit. This is the biggest near-term risk we see. It's why EPS could fall from the current forecast for 2022 of just over $16 toward $15 fairly quickly.**

Debt Repayment Goal Does Not Look as Good as Other Targets

While WCC is exceeding initial forecasts for sales growth and margins which is driving adjusted EBITDA, it is not retiring debt. In fact, it is borrowing more. All that is happening is EBITDA has grown to make the debt ratio look better:

	3Q22	2Q22	1Q22	4Q21	2Q20
Cash	$234	$237	$202	$213	$265
L-T Debt	$5,262	$5,111	$4,907	$4,711	$5,096
Net Debt	$5,028	$4,874	$4,705	$4,499	$4,831
TTM Adj. EBITDA	$1,594	$1,459	$1,323	$1,176	$850
Debt Ratio	3.2	3.3	3.6	3.8	5.7

- We started this off with the proforma EBITDA of the two merged companies of $850 million and the starting debt figure after the deal.

- The target range WCC wants is between 2.0-3.5x.

Throughout the earnings presentations, WCC talks about its rapid deleveraging. What we are seeing is they are benefiting from the cost-cutting and the price hikes from inflation. We believe the company should keep much of its cross-selling and expense cuts from the integration process. But can it keep all the price increases?

- The baseline for EBITDA at the low end assuming just the cross-selling and cost-cutting we showed above is $1.165 billion. That would make the current debt ratio 4.3x and assumes no other growth from other volume or pricing growth.

- If we look at what trailing EBITDA would have been had pricing been only 100bp lower, it falls to $1.420 billion. That would make the current debt ratio just above 3.5x.

- Reality is likely somewhere in between those two figures. We want to give kudos for the exceeding guidance on growth and cost-cutting, but recognize that it wouldn't take much of a sales decline to put WCC out of its target range on debt.

It's also worth noting that the areas where the debt growth is occurring are the Receivables Securitization Facility and the Credit Revolver. This is also an issue with inflation driving pricing higher:

	3Q22	2Q22	1Q22	4Q21
A/R Securitization Line	$883	$883	$758	$597
Revolver	$1,525	$1,375	$1,300	$1,270

Higher Prices and Raw Material Costs Are Hurting Cash Flow

Inflation helps earnings and margins, but it also causes the balance sheet to expand because assets cost more. As good as WCC's sales and EBITDA growth appear, the mirror opposite is its cash flow statement:

	3Q22	2Q22	1Q22	4Q21	3Q21
Working Capital	-$499	-$426	-$411	-$230	-$123
Cash from Operations	-$106	-$133	-$172	-$106	$70
Capital Spending	$28	$16	$15	$30	$5
Free Cash Flow	-$134	-$149	-$187	-$135	$65

This is being driven by higher selling prices causing receivables to rise and higher costs from suppliers causing inventories to rise. At the same point, payables are not rising at the same pace:

- Trade Receivables have increased from $2.5 billion after the merger to $3.6 billion now. WCC notes that receivables are paid in less than 60 days. We are seeing the DSO increase at this point too from 55 days normally to 61 now:

	3Q22	2Q22	1Q22	4Q21	3Q21
Trade A/R	$3,622	$3,636	$3,284	$2,758	$2,956
DSOs	61.2	60.3	59.9	56.1	57.6

- Inventories have grown from $2.35 billion after the merger to $3.5 billion now. DSIs have also increased from 60-62 days to 76. WCC attributes the rise in DSI to its growing backlog and sees that as solid business that will occur and as it is fulfilled the inventory and DSI figures should decline:

	3Q22	2Q22	1Q22	4Q21	3Q21
Inventories	$3,490	$3,166	$2,881	$2,666	$2,570
DSIs	75.7	67.1	66.8	63.5	61.1

- Payables have increased with inflation from $1.7 billion after the merger to $2.6 billion now, but days outstanding have stayed fairly constant in mid-50-day range:

	3Q22	2Q22	1Q22	4Q21	3Q21
Payables	$2,579	$2,652	$2,341	$2,140	$2,246
DPOs	55.9	56.2	54.3	51.2	55.6

In addition to using cash to build up working capital and not retire debt – WCC has announced it will start paying a dividend in 2023 and has authorized a $1 billion stock repurchase. The question is where is this cash coming from?

- If pricing does not fall – then the only source of new cash would be lowering the DSIs as it fulfills the backlog. 10-15 days of inventory would release about $450-$675 million in cash flow. We wouldn't argue much about forecasting that DSOs and receivables could fall back 2-3 days and produce another $150-$170 million – which would likely lower the receivable securitization debt too.

- If pricing does decline – then the sales, margins, and EBITDA figures come down as working capital is released. We could easily see $1.0-$1.3 billion in cash produced from working capital. However, we have already shown that just getting 1% less in price increases costs WCC $175 million in annual EBITDA, which starts to lower net income and offset how much cash is released. This should still be a net cash-generating activity for a quarter or two, then the lower margins and sales would be the issue.

We don't see this company in a horrible situation. When inflation grows, WCC can grow sales and margins and EPS takes off as WCC's balance sheet grows and consumes cash. On the positive side, it has an accordion feature on its debt that allows WCC to finance the higher working capital. When inflation slows or turns negative, the balance sheet releases considerable cash that first retires accordion-style debt and while WCC's sales and margins drop and EPS with it, the company probably generates more cash flow overall.

Wall Street loves income growth – even if it produces negative cash flow. As WCC transitions from hyper-growth (for it) to lower volume growth as it fulfills backlog and laps the cross-selling volume gains as well as pricing loses some steam, it likely produces more cash flow but lower earnings and a CAGR of 3%-5%.

Sales, Costs, and Margins are Impacted by Rebates and Shipping

WCC reports the following organic growth figures:

Organic Growth	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Pricing	8.0%	8.0%	8.0%	6.0%	5.0%	8.0%	2.0%
Volume	8.9%	12.9%	13.2%	9.8%	8.6%	13.6%	1.2%

Organic Growth has been strong, driven by inflation pricing and volume growth helped by cross-selling WCC products to Anixter customers and vice versa. WCC gives its clients volume rebates. These are recorded net of sales and therefore impact net pricing.

	3Q22	2Q22	1Q22	4Q21	3Q21	2Q21	1Q21
Rebates to Clients	$120.5	$102.3	$115.2	$129.8	$85.8	$112.4	$105.4
Sales	$5,445.9	$5,483.5	$4,932.2	$4,851.9	$4,728.3	$4,595.8	$4,041.5
% Sales - hurts pricing	2.2%	1.9%	2.3%	2.7%	1.8%	2.5%	2.6%

The case can be made that WCC's pricing is rising at over 10% but is being offset by the large rebates being given to customers.

WCC also earns volume rebates from its suppliers. These are recorded as reductions to Cost of Goods Sold. They do not list this by quarter – only annual results. In 2021 it was 1.4% of sales and it was 1.2% of sales in 2019. (2020 was 1.1% but that was Covid). We would estimate that 2022 is about 1.4-1.5% of sales too. Thus, rebates are a net negative to pricing but result in higher volume overall which helps sales and margins. What happens if volume growth slows? **We know WCC had a gross margin gain of 80bp in 3Q22 vs. 3Q21 to 22.1% from 21.7%.**

- Without any rebates, gross margin would have been 22.3% for 3Q22.
- If the size of both rebates are cut in half – Sales rise to $5,506 million and COGS to $4,283 and margin gross margin rises to 22.2%.
- If the rebates rise 50% - Sales would fall to $5,386 million and COGS to $4,201 million and gross margin would decline to 22.0%.

This is fairly minor and **we could envision a scenario where WCC expands rebates to clients as a percentage of sales for competitive reasons without its suppliers increasing their rebates. That would pressure margins overall and it appears that happened in 2009. That is probably the bigger risk as boosting rebates from $120 million to $160 million while**

supplier rebates are flat would drop 3Q22 gross margins to 21.5%. That's a much larger change than when these items move in the same direction.

WCC also has shipping charges that are billed to clients in revenues and are expensed in SG&A. These have been rising too due to higher volumes, fuel costs, and other issues with supply chains. When we look at 3Q22, shipping costs were $77.9 million and the company's EBITDA was $465.9 million for a margin of 8.6%. While this is a pass-through item that has no impact on income, it does move sales. If the shipping costs rise, revenues grow and EBITDA is flat so margins drops. This looks immaterial as if we double the shipping cost, margins fall 12bp. If we remove them completely, margins rise 12bp.

DocuSign, Inc.
(DOCU) Earnings Quality Update

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are maintaining our earnings quality rating of DOCU at 4- (Acceptable).

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

Summary

We like DOCU because the long-term guidance of reaching a non-GAAP operating margin of 20%-25% looks very reasonable and the bulk of the non-GAAP adjustment is stock compensation. For 3Q22, DOCU just had a 23% non-GAAP operating margin.

DOCU's adjusted EPS of $0.57 in 3Q23 beat estimates by 15 cents. There are negatives and positives, but we see the beat as real.

- Negative – DOCU low-balled margin guidance coming into the quarter forecasting a range of 16%-18% for non-GAAP operating margin. Even with issues in 1Q and 2Q, margin was still not that low. The high-end of guidance called for EPS of 44 cents and the Street was at 42 cents. The margin gain to 23% was 12 cents, and sales topping forecasts was 1.5 cents.

- Negative - Prepaid expenses jumped in 1Q23, remained high in 2Q23, and then dropped $10.3 million in 3Q23. This added 4 cents to EPS and 160bp to margin. The figure now looks in line.

	3Q23	2Q23	1Q23	4Q22	3Q22	2Q22
Prepaid Exp.	$68.8	$79.1	$80.7	$63.2	$67.8	$61.2

- Negative – DOCU took a $28.1 million restructuring charge in 3Q23. Nearly all of this is related to severance for terminating employees ($27.0 million) and all of it was added back to adjusted earnings. Pulling out the stock compensation of $5.6 million, this represents 350bp of margin:
  - Employees fell by a net 539, which means severance was over $50,000 each – which seems high.
  - Were employees notified they were being let go in 2 or 3 weeks, worked those few weeks, but had those final wages lumped into the charge? $6.5 million would be 100bp of margin and 2.5 cents of EPS.
- Positive - Stock compensation looks nearly back in line too after 2Q23 and 1Q23. This punished 1Q and made 2Q's non-GAAP earnings beat:

	10/31/22	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21
Sales	$645.5	$622.2	$588.7	$580.8	$545.5	$511.8	$469.1
Stock Comp	$135.2	$141.2	$110.7	$118.0	$109.4	$100.0	$81.1
Taxes on Exercise	$2.5	$3.4	$5.1	$4.2	$10.1	$11.6	$16.3
Total	$137.7	$144.6	$115.8	$122.2	$119.5	$111.5	$97.4
% of Sales	21.3%	23.2%	19.7%	21.0%	21.9%	21.8%	20.8%
Stock Comp %	20.9%	22.7%	18.8%	20.3%	20.1%	19.5%	17.3%

If stock compensation should be 20% of sales, this only added 2.3 cents to adjusted EPS. That's far better than 2Q when it added 7 cents and DOCU beat by 2 cents. We should note that there was an additional $5.6 million of stock compensation that was booked in the restructuring charge for terminated employees. That would have made the total percentage 21.8% and we would consider that out-of-line like 2Q23. We will need to monitor this going forward. The higher the percentage the lower the earnings quality.

- Positive – Professional Services turned profitable in the quarter at $1.6 million vs. a loss of $5.0 million in 2Q23 – That's worth 2.5 cents in EPS and 100bp of margin gain. Can this last? And did the restructuring lower the breakeven revenue figure enough?

	10/31/22	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21
Professional Sales	$21.4	$17.0	$19.4	$16.8	$16.9	$19.1	$17.1
non-GAAP Pro Income	$1.6	($5.0)	($2.5)	($9.6)	($6.3)	($2.6)	($3.2)

Going forward we still see some headwinds that may impact DOCU in the near term. Much of this relates to getting sales growth higher which will allow it to leverage cash costs. Guidance for 4Q didn't wow us except for billings rising sequentially from $659 million to $705-$715 million. The rest of 4Q calls for slightly lower sequential revenues and a non-GAAP margin of 20%-22% against the 23% DOCU just posted. Plus, we saw the CFO talk about early fiscal 2024 guidance of a margin closer to 20% of the 20%-25% long-term range and high-single-digit revenue growth.

At this point, DOCU needs more sales growth. We believe as employees finish more of the new training to help in selling and servicing clients, the new CEO gets up the learning curve, and employees gain experience with the new computer system that was only recently activated, DOCU should be able to grow sales at a faster rate. We still see several revenue-related figures slowing down:

	10/31/22	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21
Rentention	108%	110%	114%	119%	121%	124%	125%
Billings/Revenue	102%	104%	104%	115%	104%	116%	112%
Deferred Rev DSOs	157	162	162	166	162	169	163

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

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