BEHIND THE NUMBERS
Quality of Earnings Analysis

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Okta, Inc. (OKTA)
Earnings Quality Update

We are maintaining our earnings quality rating of OKTA at 2- (Weak).

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

Summary

OKTA reported non-GAAP EPS of 63 cents for its 4Q24, which beat forecasts by 12 cents. OKTA continues to lose money on a GAAP basis as EPS was -$0.26 showing another huge spread between real earnings and adjusted EPS.

- Adding back stock compensation was 66 cents of OKTA's non-GAAP EPS.
- Adding back amortization of acquired intangibles was 8 cents of OKTA's non-GAAP EPS.
- Interest income was 10 cents of EPS. At 47x forward adjusted EPS, we doubt investors are buying OKTA stock for its interest income
- OKTA reported free cash flow of $166 million with $161 million of stock compensation providing nearly all of it. If it had to pay employees with more cash – free cash flow would be noticeably lower.
- OKTA said it intends to pay tax payments related to stock compensation with cash instead of stock going forward. That should further reduce free cash flow.

Earnings sound strong but the last four quarters saw beats of 21 cents, 10 cents, 10 cents, 15 cents, and now 12 cents. We believe there are multiple reasons to question the size of the 12-cent beat. One problem we see is that OKTA guided to flat sales sequentially for 1Q25, yet instead of guiding to 63 cents of non-GAAP EPS, it is forecasting only 54-55 cents:

- Guidance for 4Q was for non-GAAP operating income of $102-$104 million which implied non-GAAP costs of $483 million on flat sequential sales of $585-$587 million. Sales came in $18-$20 million above forecasts. Yet, total non-GAAP costs came in $7 million below forecast. That was worth 3 cents in EPS.

- We expect OKTA to be able to forecast its R&D spending and it cut the figure sequentially in 4Q24. Look at how much it is falling:

	4Q24	3Q24	2Q24	1Q24	4Q23	3Q23	2Q23	1Q23
R&D Exp	$156	$165	$172	$163	$154	$148	$156	$162
Stock Comp	$65	$70	$74	$68	$66	$69	$70	$70
Cash R&D	$91	$95	$98	$95	$88	$79	$86	$92
Cash RD % Sales	15.0%	16.3%	17.6%	18.3%	17.3%	16.4%	19.0%	22.2%

  - OKTA expected to it be 15.6% of sales of $585 million – that would still be the lowest level.
  - 1% of sales is worth $6 million, or 2.5 cents.
  - Quarterly sales are up $190 million since 1Q23, but R&D isn't growing.

- Sales and Marketing Expense is dropping too. We would expect this to leverage as a percentage of sales, but it is falling in dollar terms too.

	4Q24	3Q24	2Q24	1Q24	4Q23	3Q23	2Q23	1Q23
Sales & Mrk Exp.	$249	$270	$261	$256	$259	$291	$265	$252
Stock Comp	$37	$40	$41	$38	$40	$42	$39	$39
Cash S&M Exp	$212	$230	$220	$218	$219	$249	$226	$213
Cash S&M % Sales	35.0%	39.4%	39.6%	42.1%	42.9%	51.8%	50.0%	51.3%

Headcount	4Q	3Q	2Q	1Q
fiscal 24	5,908	5,913	5,806	5,683
fiscal 23	6,013	6,037	5,776	5,342
fiscal 22	5,030	4,584	4,176	3,056

  - In 1Q24, OKTA laid off about 300 employees – we would expect that to help Sales & Marketing expense. But notice, the cash expense was up y/y in 1Q24 and down by only $6 million in 2Q. Plus, new hires made the employee count almost flat by year-end with the employee count down by only 105 people.
  - In 1Q25, OKTA laid off 400 employees. We would expect that to reduce Sales & Marketing expense. Yet, non-GAAP total operating expenses were $476 million in 4Q24, and

guidance for 1Q25 is for operating expenses to rise to $495 million on flat sequential sales. That is an 8-cent headwind in OKTA's guidance. Either the cost-cutting in 4Q24 is not sustainable or OKTA could beat 1Q25 EPS guidance in this area.

- While capital spending is up from $0 in 1Q24, it still looks incredibly low to us. Shouldn't a software company need computers? OKTA says it depreciates computers and equipment over three years. However, it doesn't have any listed on the balance sheet. All the gross PP&E assets are furniture, fixtures, and leasehold improvements. In fiscal 2022 and fiscal 2021, OKTA only listed $1.3 million and $1.2 million of gross PP&E of computers and equipment. That still sounds very low to us.

	4Q24	3Q24	2Q24	1Q24	4Q23	3Q23	2Q23	1Q23
Depr/Amort/Accrec	$20	$21	$18	$25	$26	$27	$31	$30
Amort added back	$19	$18	$18	$23	$22	$21	$22	$20
Capital Spend	$3	$3	$2	$0	$3	$2	$2	$5

  - Also note that nearly all the expense related to depreciation, amortization, and accretion is added back in non-GAAP income. While this was only $1 million in non-GAAP expense last quarter, it wasn't long ago that it was $9-$10 million.

  - $8 million in lower expense is worth 3.3 cents in quarterly non-GAAP EPS for OKTA.

- Capitalized Sales Commissions are still worth watching. OKTA amortizes commissions related to new business over 5 years and renewals over 2 years. The amount of commissions capitalized jumped in 4Q24. The amortization figure didn't rise very much:

	4Q24	3Q24	2Q24	1Q24	4Q23	3Q23
New Commissions	$56	$37	$40	$25	$39	$33
Used Commissions	$28	$27	$26	$23	$23	$21
Earnings Help	$28	$10	$14	$2	$16	$12
EPS impact	$0.12	$0.04	$0.06	$0.01	$0.09	$0.07
Ending Commissions	$357	$324	$319	$303	$302	$280

  - The new commissions accrued reduce cash flow and the amortization of commissions reduces both GAAP and non-GAAP earnings.

  - OKTA's basis for all the adjustments it makes to non-GAAP EPS is that items like stock compensation and amortization of acquired intangibles are non-cash. Capitalized commissions are cash items, but do not impact earnings. If OKTA expensed these as cash items, EPS would have been 12 cents lower in 4Q24.

  - Also, note that the 5-year amortization period on commissions paid for new contracts is based on how long the new relationships is expected to benefit the company. The actual contracts have much shorter time frames. Any sales expenses incurred in signing the renewals on these deals will be amortized over the much shorter 2-year period and result in a greater percentage being expensed per year.

   - Note that the 5-year amortization period on new commissions used by OKTA is at the high end of the industry range with many peers electing 3-4 years.

   - We would expect the amortization figure to grow going forward and be a small headwind to EPS. However, higher capitalized commissions do represent more future business so overall this is a positive.

- Another big jump of $15 million in interest income y/y helped EPS by 6 cents. This is real income and it is cash. However, this source of growth is about to get smaller as easy comps vanish:

	4Q24	3Q24	2Q24	1Q24	4Q23	3Q23
Interest Income	$25	$21	$18	$17	$10	$5

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.

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