BEHIND
THE NUMBERS
Quality of Earnings Analysis
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Behind the Numbers

Companies in this Issue

DocuSign, Inc. (DOCU)
Earnings Quality Update

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

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

Summary

DOCU's adjusted EPS of $0.72 beat estimates by 16 cents. Sequentially, interest income rose by $4.9 million which is 1.9 cents, but we do not consider that an operational gain. We are impressed that GAAP EPS was $0.00 but included an 11-cent restructuring charge so we again see DOCU posting positive GAAP EPS.

However, nearly the entire beat for 1Q looks like it came from the timing of recognizing expenses and the layoffs helping results. There are still some growing pains here and management is noting that the sales cycle is longer and larger clients have been watching their expenses and have been slower to add new products.

Nevertheless, we are keeping DOCU on our Top Value list as we see several positive signs that it is about to turn the corner. DOCU is gaining new ground overseas and is rolling out new products along with its sales force now having had time on the job. Thus, we see the room to report growth and open new markets. We still expect lumpy quarters through much of this year. DOCU did raise guidance on revenues by $18 million for the year and operating margin by 100bp on the low and high end. We want to see the margin grow without adding back a larger percentage of stock compensation. We are still impressed that GAAP earnings are positive.

Specifically we note:

- A big boost to Adjusted EPS came from DOCU spending less than expected. Non-GAAP operating margin was 27% vs. guidance of 21%-22% coming into the quarter. Selling and Marketing expense was down and R&D was flat in dollar terms. DOCU noted that in 1Q, it expected to spend more and still expects that spending to occur throughout the year. Guidance for non-GAAP operating margin for the year is now up 100bp to 22%-24% - significantly lower than 1Q results. Every 100bp in 1Q was 2.5 cents in EPS. So 12.5-15.0 cents of the 16-cent beat came right here. **(Negative)**

- We know the recent layoffs also helped earnings, but that was expected. Still, non-GAAP gross profit margin came in at 83% vs. guidance of 81%-82% and updated guidance is holding at 81%-82% for the year. DOCU was specifically asked about this after 4Q results as guidance may be too low. This is still part of the operating margin improvement, but it does look like DOCU kept guidance lower than justified coming into 1Q. **(Negative)**

- Revenue also beat by $20 million. This added 2 cents to EPS as well. That is despite the negative of fewer customers spending more than the year before and DOCU expects that headwind to continue. Retention, which shows y/y change in spending by existing customers, came in at only 105% (it has been in the 120s) and management expects that to decline further. We think this represents a solid result, given that the key real estate sector is still weaker, and larger clients are not adding services/users at prior rates. **(Positive)**

- The beat also came despite another loss in Professional Services – which again involves training and software set up for clients.

	4/30/23	1/31/23	10/31/22	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21
Professional Sales	$22.1	$15.9	$21.4	$17.0	$19.4	$16.8	$16.9	$19.1	$17.1
non-GAAP Pro Income	($5.5)	($8.9)	$1.6	($5.0)	($2.5)	($9.6)	($6.3)	($2.6)	($3.2)

This was a $3 million larger loss y/y for 1 cent of EPS headwind.

- Stock compensation came in below the 4Q level, but that is common. It was still above the 20% of sales forecast at 21.8%, which added 4.6 cents to adjusted EPS. **(Negative)**

	4/30/23	1/31/23	10/31/22	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21
Sales	$661.4	$659.6	$645.5	$622.2	$588.7	$580.8	$545.5	$511.8	$469.1
Stock Comp	$139.8	$145.9	$135.2	$141.2	$110.7	$118.0	$109.4	$100.0	$81.1
Taxes on Exercise	$4.2	$1.9	$2.5	$3.4	$5.1	$4.2	$10.1	$11.6	$16.3
Total	$144.0	$147.9	$137.7	$144.6	$115.8	$122.2	$119.5	$111.5	$97.4
% of Sales	21.8%	22.4%	21.3%	23.2%	19.7%	21.0%	21.9%	21.8%	20.8%
Stock Comp %	21.1%	22.1%	20.9%	22.7%	18.8%	20.3%	20.1%	19.5%	17.3%

We expect this percentage to decline as sales rise – that may prove to be a headwind.

- The jump in deferred revenues (contract liabilities at DOCU) was again a positive. Management noted a 20% increase in clients over $300,000. Billings to Revenue was mixed as both saw a solid increase of 10% and 12% respectively.

	4/30/23	1/31/23	10/31/22	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21
Retention	105%	107%	108%	110%	114%	119%	121%	124%	125%
Billings/Revenue	102%	112%	102%	104%	104%	115%	104%	116%	112%
Deferred Rev DSOs	168	166	157	162	162	166	162	169	163

Coming into 1Q, guidance was for billings to revenues to come in under 100% so the 102% figure was viewed as positive. On the call, DOCU noted that it had a solid number for renewals being confirmed on time during 1Q. That enabled billings to come in at $675 million vs. guidance of $615-$625 million. Management said it is common for more renewals to slip into the next period. Guidance for 2Q is $646-$656 million in billings against $675-$679 million on revenues. That guidance again sets up a forecast for billings/revenues under 100% and for the year it is expected to be 101%. We also wonder if a higher level of renewals for 1Q happened in 1Q, could 2Q be hurt more?

Okta, Inc (OKTA)
Earnings Quality Update

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

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

Summary

We cannot begin a discussion of OKTA without bringing up the ever-changing definitions of non-GAAP results. The items that are being added back continue to grow and are helping boost non-GAAP results:

- Fiscal 2021 – OKTA added back only stock compensation and amortization of acquired intangibles

- Fiscal 2022 – OKTA keeps adding back those items, but now adds back non-cash charitable contributions, acquisition/integration costs, debt related costs for issuing, repaying early, and converting.

- In 3Q23 – OKTA's definition now included adding back restructuring costs related to leases in addition to the prior list of adjustments.

- In 4Q23 – OKTA changed the definition to also add back restructuring for impairments, severance, and termination costs.

- In 1Q24 – OKTA kept all of the above adjustments and now assumes a 26% tax rate when in adjusting non-GAAP results. This is actually a conservative change.

If we look at the last four quarters, we can see that OKTA has been beating results:

	1Q24	4Q23	3Q23	2Q23
Non-GAAP	$0.22	$0.30	$0.00	-$0.10
Beat	$0.10	$0.21	$0.24	$0.20
GAAP EPS	-$0.74	-$0.95	-$1.32	-$1.34

- **We see that headcount is up, but adjusted R&D has dropped** as much as 500bp as a percentage of sales – adding 8c, 14c, and 17c to adjusted EPS the last three quarters. ***(See below for details)***

- The EPS pick-up from capitalizing sales commissions and amortizing them over time is shrinking. However, OKTA still picked up 1c, 9c, and 7c from this area in the last three quarters. ***(See below for details)***

- Selling & Marketing expenses dropped noticeably as a percentage of sales in the last two quarters. Some of that is sales leverage. Some of that is less of an increase in amortizing capitalized commissions. However, in 1Q24, it was also a $13 million drop in marketing worth 5.5 cps in EPS. In 4Q23, there was a $4 million cut in marketing adding 2.3 cps in EPS. There were also $8.5 million in consulting fees in early 2023, which were not mentioned for 4Q23 which should have helped EPS too. ***(See below for details)***

- Interest income jumped from $2 million to $17 million y/y in 1Q24 and up from $10 million in 4Q23. This was not entirely unexpected given interest rates increasing, **but this was 6 cents of adjusted EPS for 1Q24 or up 3 cents from 4Q23, which probably was a surprise.**

We don't consider the beats of the last three quarters to be high quality at all. Without some likely short-lived cuts in expenses – we think OKTA would have missed each one.

The company is still unprofitable and free cash flow negative if it cannot pay employees with stock compensation at more than 30% of sales. It is seeing retention rate still at 117%, but falling due to decreasing upsell rates and a lack of expanding the number of seats which OKTA sees continuing. Guidance calls for flat non-GAAP EPS for 2Q24 with another very subdued sequential revenue growth rate of just over 2-3%. OKTA sees the macro headwinds getting worse and more deals taking longer to close.

We are adding OKTA to our Top Risk List given the low-quality earnings, the likely unsustainable marketing cuts, and slowing growth of new business.

What to Watch

- Adjusted R&D spending continues to look low, which is driving non-GAAP EPS. The big merger happened in 2Q23, which added to sales going forward, but cash R&D spending has been flat despite becoming a larger company. This does not look sustainable.

	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22
Revenues	$518	$510	$481	$452	$415	$383	$351
Sequential Growth	1.60%	6.00%	6.50%	8.90%	8.30%	9.20%	11.20%
Adj. R&D Exp.	$95	$88	$79	$86	$93	$85	$74
Adj. R&D % Sales	18.30%	17.30%	16.50%	19.00%	22.30%	22.10%	21.00%
EPS help vs 22%	$0.08	$0.14	$0.17				

1Q24 is about flat in total spending with 1Q23. The same was true with 4Q23 vs 4Q22. Both of those y/y comparisons are before and after the merger. We will agree that there should be some operating leverage. But, the employee count is up:

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

And R&D employees are not being paid more in stock either:

	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22
R&D Stock Comp	$68	$66	$69	$70	$69	$63	$57

- **Capitalized Commission Growth has stalled.** OKTA capitalizes sales commissions and amortizes new business obtained over 5 years. Commissions paid on renewals are amortized over only 2 years. There is some seasonality with fewer deals signed in 1Q and more in 4Q, but the amount capitalized is not growing much recently:

	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22
Capitalized Comm	$303	$302	$280	$272	$266	$266	$206

The deferral and amortization is still producing EPS for both GAAP and non-GAAP EPS, but this too is becoming a smaller part of EPS:

	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22
New Cap. Comm	$25	$39	$33	$28	$21	$80	$36
Amortiz Cap. Comm	$23	$23	$21	$20	$19	$17	$15
Positive earnings	$2	$16	$11	$8	$2	$63	$21
EPS impact	$0.01	$0.09	$0.07				

Some of this is signaling to us that OKTA is getting a smaller part of sales from new customers. And, adjusted EPS is still benefitting from the longer amortization lives than some of the competitors. OKTA noted after 1Q24 and 4Q23 that it is seeing fewer new customers, has customers asking for shorter contracts, and upselling current people is the primary source of growth. All that points to more 2-year amortization.

- Adjusted Selling and Marketing Expenses have dropped noticeably in 1Q24 and 4Q23. We do not expect this to continue or to be so pronounced:

	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22
Adj Sales/Mrk	$218	$219	$249	$226	$213	$188	$165
% sales	42.1%	42.9%	51.7%	49.9%	51.3%	49.1%	47.0%
Stock comp	$38	$40	$42	$39	$39	$34	$39

As we can see in the table above on headcount – it declined from 4Q23 to 1Q24. We also know that the amortization of capitalized commissions is not growing very quickly now, as seen in the prior table. So that is leveraging from higher sales. We will also give OKTA credit for not ramping up stock compensation in this area. There was also $8.5 million in consulting in the first nine months of fiscal 2023 – that penalized EPS over that period by 5 cents and appears to be gone now, helping 1Q23.

However, marketing fell y/y in 1Q24 by $13 million and in 4Q23 by $4 million. That added 5.5 cents and 2.3 cents respectively. Even OKTA expects Sales & Marketing to rise in dollar terms – it was just flat sequentially and almost flat y/y in 1Q. It only takes about $5-$6 million in growth to squeeze quarterly margin by 100bp, which is 2.3 cents. Wage inflation is still happening and we doubt headcount falls much further.

- **Deferred Revenue remains at high levels, but is not growing at this point.** On a Days of Sales basis, it has been lower y/y for the last three quarters:

	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22
Deferred Rev.	$1,187	$1,260	$1,063	$1,011	$971	$996	$778
Sales	$518	$495	$481	$452	$415	$383	$351
Def. Rev. Days of Sales	204	234	203	206	208	239	204

It is tough for OKTA to miss revenue forecasts when it has more than 200 days of deferred revenue, but it probably should still be growing rather than sliding.

- **Shouldn't a cutting-edge software company be buying equipment like computers? Capital spending has been low, now it's zero:**

	1Q24	4Q23	3Q23	2Q23	1Q23	4Q22	3Q22
Capital Spend	$0	$3	$2	$2	$5	$7	$2
Cap. Software	$5	$1	$2	$3	$3	$2	$2

Net PP&E was $62.8 million in 4Q21 and $65.5 million in 4Q22 before their merger. Now it's $59 million for 4Q23 and $54 million for 1Q24.

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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