BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

December 11, 2020 | www.btnresearch.com

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

salesforce.com (CRM) EQ Update- 10/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3-	4-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are lowering our earnings quality rating to 3- (Minor Concern)

CRM posted non-GAAP EPS of $1.74 for the third fiscal quarter ended 10/20. This was well ahead of the company's post-2Q guidance of $0.73-$0.74. However, CRM's sizeable strategic investment portfolio must be marked to market every period as per ASU 2016-01, and the company does not attempt to estimate the quarterly gain or loss it will incur from investments when giving guidance. In the 10/20 quarter, the company enjoyed $0.86 per share in unrealized gains on investments, largely triggered by the IPO of Snowflake during the quarter. Even after this adjustment, the company soundly beat its original targets for the quarter by 12-14 cps. The company raised guidance for the full year to $4.62-$4.63, an approximate 3 cps increase after adjusting for the investment gain.

The reduction in our rating largely centers around the potential for the Slack deal to magnify the distortion caused by the company adding back the amortization of acquired intangibles to its non-GAAP results.

What deteriorated?

- We took issue with the company adding back amortization of acquired intangibles to its non-GAAP results in our original review. The announcement of the $27 billion Slack acquisition will only cause this practice to distort adjusted earnings more. CRM continues to post high teens organic revenue and RPO growth, so it is not a typical serial acquirer relying on acquisitions to drive the top line. However, the company admits that part of its innovation comes from the technology it picks up in its deals. If it had to develop Tableau's data analytics capabilities or Slack's messaging technology on its own, it would have incurred R&D expenses it could not add back to results. For perspective, the amortization of intangibles is trending about 25% of adjusted operating profits. Using the Tableau deal as a guide, our "back of the envelope" estimate for the developed technology amortization from the Slack deal exceeds $700 million per year with another $280 million for customer relationships.

- CRM bought Vlocity for $1.38 billion in July. Over $1 billion was assigned to goodwill and will not be amortized, and $473 million was assigned to intangibles. While the amortization periods of 4 years for developed technology and 8 years for customer relationships seem reasonable, the company will add back the amortization of intangibles to non-GAAP EPS.

- Also, CRM adds back stock-based compensation which amounts to another 50-60% of adjusted operating income. These amounts are also partly related to acquisitions as CRM issues options to the employees of companies it acquires.

What to watch

- We covered in our original review how unearned revenue days of sales were declining YOY. Our concern level was low given that the 8/19 acquisition of Tableau introduced more license revenue to the mix which is recognized upfront. Also, the company temporarily changed billing frequencies for new customers to help in the COVID environment. The YOY decline in unearned revenue days decelerated to 5 days from 8 and 12 in the previous two quarters. With the Tableau deal fully- lapped, we will be watching for the trend in deferred revenue days to normalize absent any other external impacts, although the likely consolidation of Slack in the back half of next year will make tracking the trend difficult.

- The Snowflake IPO-related gain in the 10/20 quarter serves as a reminder of how much the company's net earnings figures can be impacted by these non-operational amounts.

Slack Deal- Expensive, but Future Non-GAAP Will Not Reflect Cost

Recent CRM headlines have all focused on the company's December 1 announcement of its $27 billion cash and stock acquisition of Slack. Some talk of huge synergies and an ability to more aggressively challenge Microsoft. Some question whether an acquisition was necessary and wonder if a partnership would have sufficed. Such questions are beyond the scope of our EQ Review, but no one questions that the deal was expensive at over 30 times revenues and an almost 50% premium to the pre-announcement market price for Slack. Our concern is that like previous deals, the company's non-GAAP accounting will eliminate the actual cost of the deal to shareholders.

One of our concerns with CRM was its industry-typical practice of adding back both amortization of acquired intangibles and stock based-compensation to its adjusted earnings figures. The organic revenue growth rate and growth in its remaining performance obligation (RPO) remain in the high teens, but CRM is still making sizeable acquisitions to drive growth and add capabilities. These have included the $15 billion Tableau deal in 2019, the $7 billion Mulesoft deal in 2018, and the recent $1.4 billion Vlocity deal. While CRM is not a typical serial acquirer that has no organic growth without buying it, acquisitions are an obvious part of its strategy and it depends on them to give it access to the technology it needs to drive its overall growth strategy. The company admitted this in its recent 10-Q:

> *"**We drive innovation organically and, to a lesser extent, through acquisitions,** such as our recent acquisition of Vlocity in June 2020 and our pending acquisition of Slack Technologies, Inc. ("Slack"), which was signed in December 2020 and is expected to close in the second quarter of fiscal 2022.*"

At approximately 17% of sales, CRM's R&D spending is already among the highest in the software space. However, if it had to develop the messaging technology of Slack or the data analytics capability of Tableau, it would have had to spend even more on R&D. Therefore, ignoring the estimated cost of this technology in the form of intangible amortization by adding this back to GAAP earnings is overstating the company's true earnings.

Consider amortization of intangibles relative to non-GAAP operating income for the last eight quarters:

	10/31/2020	7/31/2020	4/30/2020	1/31/2020
Non-GAAP Operating Income	$1,073	$1,040	$635	$745
Amortization of Intangible Assets	$283	$284	$271	$270
% of Non-GAAP Operating Income	26.4%	27.3%	42.7%	36.2%

	10/31/2019	7/31/2019	4/30/2019	1/31/2019
Non-GAAP Operating Income	$874	$573	$682	$596
Amortization of Intangible Assets	$266	$127	$129	$130
% of Non-GAAP Operating Income	30.4%	22.2%	18.9%	21.8%

Operating profit would be much lower if we viewed the cost of acquiring the technology that is vitally important to the company's strategy as a real expense.

The Slack acquisition is not set to close until 2Q' 22 so we do not know how the purchase price will be allocated to various asset classes, but we think it is interesting to consider. The $26 billion equity value of the deal is almost $25 billion larger than the current book value of Slack which is a decent estimate of the value of goodwill and intangibles the deal will create. This is similar to the percentage of the Tableau purchase price that was allocated to intangible assets. In that deal, 23% of the purchase price was allocated to intangible assets with 62% of that allocated to developed technology. This is being amortized over 5 years (which we would argue is on the long side). Utilizing similar percentages for Slack, we get a "back of the envelope" estimate for the amortization of Slack technology assets of $700 million per year. In our scenario, another $280 million of amortization would be generated by customer relationship assets which we would argue the company would have to spend if it had to develop these from the ground up. It seems clear to us that these amounts should be considered real costs when assessing what the company is earning for shareholders.

One positive thing we note about the company's non-GAAP results as it pertains to acquisitions is that CRM does not constantly add back restructuring and integration costs related to acquired operations. We will view it as a definite negative if we begin to see such charges pop up going forward.

Stock-Based Compensation Continues to Rise

CRM also adds back stock-based compensation expense to non-GAAP results. This amount is even larger relative to adjusted operating income than amortization- and it is rising:

	10/31/2020	7/31/2020	4/30/2020	1/31/2020
Non-GAAP Operating Income	$1,073	$1,040	$635	$745
Stock-based expense	$566	$578	$504	$511
% of Non-GAAP Operating Income	52.7%	55.6%	79.4%	68.6%

	10/31/2019	7/31/2019	4/30/2019	1/31/2019
Non-GAAP Operating Income	$874	$573	$682	$596
Stock-based expense	$543	$388	$343	$329
% of Non-GAAP Operating Income	62.1%	67.7%	50.3%	55.2%

This expense can also be viewed as partially related to acquisitions as the company adopts the options programs of the companies it acquires. We can see the increase in expense generated by the Tableau deal in the 10/19 quarter above. Our argument regarding whether options are real expenses is to consider what would happen if the company took them away from employees and did not replace them with cash compensation.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

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

Key Points to Understand About the EQ Score

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

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

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.