BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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salesforce.com, inc. (CRM) EQ Review

Current EQ Rating*	Previous EQ Rating
4-	na

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 initiate earnings quality coverage of CRM with a 4- (Acceptable)

We have no major concerns with CRM's earnings quality at this point. On the surface, the company is displaying some red flags in the area of revenue recognition but at this point, we believe they have benign explanations and simply deserve attention in future quarters. Like most tech companies CRM adds back stock compensation and amortization of acquired intangibles. These adjustments are relatively high for CRM as they account for a large majority of adjusted profits. We also note the sensitivity of earnings to the company's selection of a benefit period for capitalized costs to obtain contracts. This report specifically discusses:

- Unearned revenue days of sales has been falling for the last several quarters. This is ordinarily a concern for a software company that recognizes ratably over its subscription terms as it can be an indication of either a slowdown in bookings or the company becoming more aggressive in recognizing revenue upfront. We do not see either as being the case with CRM and believe the decline is likely due to the acquisition of MuleSoft and Tableau. Both companies have a license component to their products which is recognized at the time of sale which could skew the percentage of CRM's revenue that is deferred. In addition, the remaining performance obligation under existing contracts continues to grow north of 20% which seems to rule out a slowdown in bookings. Nevertheless, the Tableau deal laps after the 10/20 quarter so we will view a continued decline in unearned revenue days after that with more concern.

- CRM's accounts receivable DSOs rose by 7.9 and 5.6 days, respectively. This is likely a reflection of the company extending payment times and slower collections in the COVID environment which the company has referenced multiple times.

- As required by accounting regulations, CRM capitalizes the costs of obtaining new contracts such as commissions paid to its sales force and bonuses paid to non-sales employees whose incentive pay is linked to contracts acquired. CRM amortizes these capitalized costs over 4 years for all contracts. This is longer than the average contract term as the estimate reflects the chance a customer will renew. CRM currently keeps 90% of its customers every year so a 4-year assumed benefit period does not seem unreasonable. This is a similar term utilized by some of CRM's peers. However, it is worth noting that if the company lowered the estimated benefit period to 3 years, it would take about 9 cps per quarter off EPS or an approximate 12% reduction.

- The amount of cost to obtain contracts that was capitalized in the first six months of 2020 rose to 4.8% of sales from 3.8% in the comparable year-ago period. Given that this could be impacted by the timing of signing contracts as well as the unusual nature of the current environment, we are not overly concerned about the change at this point. However, this should be monitored in future quarters.

- Like most tech companies, CRM chooses to add back stock-based compensation to its non-GAAP adjusted results. This adjustment is huge for CRM, amounting to 50-80% of non-GAAP operating income over the last few quarters. Also, if stock compensation was a cash expense, it would reduce free cash flow by about 60%. The share base grows by about 5% annually adjusted for acquisitions as the company does not currently buy back shares. This illustrates our point that stock option expense should be viewed as a cash expense as the company must choose to pay employees in cash, spend cash to buy back shares, or regularly dilute the shareholders.

- CRM also adds back the amortization of acquired intangibles to its non-GAAP results. This amounts to another 20-40% of adjusted earnings over the last few quarters. The bulk of these amounts are developed technology and customer relationships, assets which the company would have been required to spend its own cash on had it developed them internally. We are generally more concerned when we see amortization add-backs by a company that relies on acquisitions to post growth or where free cash flow can not cover distributions plus the acquisition spending. Neither is currently the case for CRM.

Revenue Recognition and DSO Increase

CEO Marc Benioff was one of the early promoters of the concept of "software as a service" under which companies would forego the old method of purchasing software to be installed on their servers and instead pay a subscription to access the service over the Web. In fact, CRM's first marketing statement was "The End of Software." It should therefore come as no surprise that the bulk of the company's revenue is in the form of Cloud services and support and update services. While the company's 2018 acquisition of MuleSoft and 2019 acquisition of Tableau Software did introduce some license software into the mix, licenses still represent less than 10% of CRM's revenue.

Under subscription services, the company books the revenue ratably over the subscription terms which typically run from 12-36 months. Customers are generally billed annually so the cash flow is received upfront while the associated revenue is deferred and recognized over time. The company has an excellent discussion in its SEC filings illustrating how the seasonality of billings and receipts impact revenue, receivables, unearned revenue, and operating cash flow. We also applaud the company for warning in its risk factor section that its revenue recognition method will result in a lag between business slowdowns and a slowdown in reported revenue growth:

> *"We generally recognize revenue from customers ratably over the terms of their subscription and support agreements, which are typically 12 to 36 months. As a result, most of the revenue we report in each quarter is the result of subscription and support agreements entered into during previous quarters. Consequently, a decline in new or renewed subscriptions in any one quarter may not be reflected in our revenue results for that quarter. Any such decline, however, will negatively impact our revenue in future quarters. Accordingly, the effect of significant downturns in sales and market acceptance of our services, and potential changes in our attrition rate, may not be fully reflected in our results of operations until future periods. Our subscription model also makes it difficult for us to rapidly increase our revenue through additional sales in any period, as revenue from new customers must be recognized over the applicable subscription and support term."*

As with most software companies, the early warning signs which could be indicating an upcoming revenue slowdown would include a sudden increase in accounts receivable or contract assets, a decline in unearned revenue days of sales, and/or a drop off in remaining performance obligation (RPO). We will evaluate these measures below:

Unearned Revenue

Most of the company's subscription agreements are on a calendar year time frame. Therefore, the company sends most of its bills in the fourth quarter and cash is received in the first quarter. When the bill goes out, a receivable is recorded with an offset to unearned revenue. A contract asset is recognized when the amount of revenue recognized under a contract exceeds what is billed. The unearned revenue account is reduced as revenue is recognized ratably over the subscription period. Cash flow is weighted towards the first quarter as the receivables are paid.

A decline in unearned revenue relative to sales could be an indication that either the company has signed up less contracted revenue to be booked in the future, or it has become more aggressive in recognizing revenue upfront. The following table shows deferred revenue on a days of sales basis for the last eight quarters:

Table 1

	7/31/2020	4/30/2020	1/31/2020	10/31/2019
Sales	$5,151	$4,865	$4,851	$4,513
Unearned Revenue	$8,711	$9,112	$10,662	$6,858
Unearned Revenue Days of Sales	155.6	168.6	202.2	139.8

	7/31/2019	4/30/2019	1/31/2019	10/31/2018
Sales	$3,997	$3,737	$3,603	$3,392
Unearned Revenue	$7,142	$7,585	$8,564	$5,376
Unearned Revenue Days of Sales	164.4	180.6	218.7	145.8

	7/31/2018	4/30/2018	1/31/2018	10/31/2017
Sales	$3,281	$3,006	$2,865	$2,701
Unearned Revenue	$5,883	$6,201	$6,995	$4,392
Unearned Revenue Days of Sales	165.0	183.6	224.6	149.6

We can see that deferred revenue days of sales has been declining for the last several quarters. While this would ordinarily be a red flag, one must consider that in the 7/18 quarter the company acquired MuleSoft and in the 10/19 quarter it acquired Tableau

Software. Both of these companies' models include both software licenses and service and support services with the license components being booked upfront and the service and support components being booked over time. Sales associated with these acquired operations would naturally have a smaller amount of deferred revenue associated with them which would depress the company's overall deferred revenue days calculation. Therefore, we are not overly alarmed by the sustained decline in unearned revenue, but note that the Tableau deal will lap itself after the 10/20 quarter so a continued decline in deferred days after that will generate much more concern.

Accounts Receivable:

Accounts Receivable arise when the company has sent a bill for new subscriptions or renewals but the cash has not been received. Most subscriptions are on a calendar year, so receivables rise in the fourth quarter as the company sends bills out to customers. For most industries, the main concern from an increase in accounts receivable relative to sales is that the company is pulling revenue into the current quarter at the expense of future quarters by offering more attractive payment terms. Given that CRM bills a year in advance this is much less of a concern. In CRM's case, a rise in DSOs more likely indicates delays in collection. The company's DSOs have, in fact, been increasing for the last two quarters, rising 7.9 days and 5.6 days year-over-year in the 7/20 and 4/20 quarters, respectively. The company has stated that it offered "financial flexibility" to customers in the first quarter to help with conditions created by COVID. Also, it made the following disclosure in the 7/20 10-Q:

> *"In the second quarter, payment delays from some of our customers affected by the COVID-19 pandemic continued. These delays in payments, in addition to changes in billing frequency for new business and investments in our go-to-market efforts, resulted in a negative impact to our operating cash flows during the quarter."*

We expect that most of these receivables will be collected and are not overly concerned by the increase in receivables at this point. The company does not disclose the allowance for doubtful accounts so we do not know the extent to which it has reserved for uncollectible accounts.

Capitalization of Costs to Obtain New Contracts

Under ASC 606 and ASC 340-40, CRM must capitalize all incremental costs to obtain a new contract. Consider the description in the company's 7/20 10-Q:

> *"The Company capitalizes incremental costs of obtaining a non-cancelable subscription and support revenue contract. The capitalized amounts consist primarily of sales commissions paid to the Company's direct sales force. Capitalized amounts also include (1) amounts paid to employees other than the direct sales force who earn incentive payouts under annual compensation plans that are tied to the value of contracts acquired, (2) commissions paid to employees upon renewals of subscription and support contracts, (3) the associated payroll taxes and fringe benefit costs associated with the payments to the Company's employees, and to a lesser extent (4) success fees paid to partners in emerging markets where the Company has a limited presence."*

CRM also has leeway in selecting the amortization period for these capitalized costs. The following excerpt from the 7/20 10-Q discusses the company's selection of an amortization period.

> ***"Costs capitalized related to new revenue contracts are amortized on a straight-line basis over four years, which, although longer than the typical initial contract period, reflects the average period of benefit, including expected contract renewals.*** *In arriving at this average period of benefit, the Company evaluated both qualitative and quantitative factors which included the estimated life cycles of its offerings and its customer attrition.* ***Additionally, the Company amortizes capitalized costs for renewals and success fees paid to partners over two years.***
>
> *The capitalized amounts are recoverable through future revenue streams under all non-cancelable customer contracts. The Company periodically evaluates whether there have been any changes in its business, the market conditions in which it operates or other events which would indicate that its amortization period should be changed or if there are potential indicators of impairment."*

While accounting standards require the company to capitalize incremental commission costs, the company does have several areas of judgement which impact the expenses it recognizes.

First, standards do allow the company to immediately expense contract acquisition costs for terms less than one year. This is the case for software peer ANSYS. However, disclosures appear to indicate that CRM elects to capitalize all such costs. This likely has a limited impact for CRM given that most of its contracts run at least a year.

Also, the company must utilize judgment in the amortization period. In the case of CRM, it elects 4 years for all contracts. This is longer than the average subscription term, but takes into account the expected time that a new customer will continue to benefit the company by considering the likelihood of renewals. CRM disclosed that its attrition rate was less than 10% in the twelve months ended 7/30/20. If the company keeps more than 90% of its clients every year, then an estimated average benefit period for a new customer of 4 years does not seem unreasonable. By comparison, Citrix Systems' assumed benefit period for new customers is between 3-5 years. Note that CRM identifies the amortization period for capitalized contract costs as being a critical accounting estimate.

With this in mind, let's look at the development of the capitalized contract costs account for the last eight quarters which is shown in the table below:

Table 2

	7/31/2020	4/30/2020	1/31/2020	10/31/2019
Capitalized Contract Costs Beginning Balance	$2,052	$2,274	$1,916	$1,891
Capitalized New Contract Costs	$455	$25	$557	$246
Amortization of Costs to Obtain New Contracts	$250	$247	$253	$221
Capitalized Contract Costs Ending Balance	$2,257	$2,052	$2,274	$1,916

	7/31/2019	4/30/2019	1/31/2019	10/31/2018
Beginning Balance	$1,935	$2,020	$1,666	$1,668
Costs Capitalized to Obtain New Contracts	$173	$124	$550	$186
Amortization of Costs to Obtain New Contracts	$217	$209	$139	$190
Ending Balance of Capitalized Contract Costs	$1,891	$1,935	$2,020	$1,666

We are not overly concerned with the level of amortization expense for capitalized costs to obtain new contracts. As the following table shows, with the exception of an unusually low figure in the 1/19 quarter, amortization expense has remained fairly constant as a percentage of the average capitalized contract cost balance:

Table 3

	7/31/2020	4/30/2020	1/31/2020	10/31/2019
Amortization of Costs to Obtain New Contracts	$250	$247	$253	$221
Average Capitalized Contract Costs	$2,155	$2,163	$2,095	$1,904
Amortization % of Average Capitalized Costs	11.6%	11.4%	12.1%	11.6%

	7/31/2019	4/30/2019	1/31/2019	10/31/2018
Amortization of Costs to Obtain New Contracts	$217	$209	$139	$190
Average Capitalized Contract Costs	$1,913	$1,978	$1,843	$1,667
Amortization % of Average Capitalized Costs	11.3%	10.6%	7.5%	11.4%

This is a good place to point out that amortization of contract costs amounts to about 21 cps per quarter. Thus, cutting the amortization period to 3 from 4 years would shave about 9 cps off EPS each quarter which is about 12% of a typical quarter's adjusted EPS. Again, we are not arguing that CRM should be using 3 years, but this illustrates how material a change in assumption would be.

Also, it is important to monitor the amount of contract costs capitalized relative to sales. We can see from table 2 that the company capitalized an unusually low amount of contract costs in the 4/20 quarter which we suspect was related to COVID stalling new business signings. However, it made up for this with an unusually high amount of capitalization in the 7/20 quarter. Therefore, we will compare the amount capitalized for the six-month period ended 7/20 to the trailing 6-month sales to the comparable year-ago period:

Table 4

6 Months Ended:	7/31/2020	7/31/2019
Trailing 6-month Capitalized Costs to Obtain Contracts	$480	$297
Trailing 6-month Sales	$10,016	$7,734
% of Sales	4.8%	3.8%

CRM capitalized a larger amount of costs to obtain contracts as a percentage of sales in the most recent 6-month period compared to last year. However, this could be impacted by factors such as the timing of contract signings. Therefore, we are not especially alarmed by this for now, especially given the impact of COVID on the quarter. Nevertheless, this is an area to keep an eye on in the future.

Adding Back Stock Compensation Skews Profits

Like many tech companies, CRM chooses to add back stock-based compensation to its non-GAAP earnings figures. This expense is particularly large for CRM, and has ranged from 50-80% of non-GAAP operating income over the last eight quarters:

Table 5

	7/31/2020	4/30/2020	1/31/2020	10/31/2019
Non-GAAP Operating Income	$1,040	$635	$745	$874
Stock-based expense	$578	$504	$511	$543
% of Non-GAAP Operating Income	55.6%	79.4%	68.6%	62.1%

	7/31/2019	4/30/2019	1/31/2019	10/31/2018
Non-GAAP Operating Income	$573	$682	$596	$572
Stock-based expense	$388	$343	$329	$351
% of Non-GAAP Operating Income	67.7%	50.3%	55.2%	61.4%

In addition, the expense has been growing on a year-over-year basis for the last several quarters. This is likely due to the issuance of new shares in the 8/20 acquisition of Tableau for $14.8 billion making more employees eligible for stock-based compensation plans. CRM is currently not buying back shares, so even after adjusting for the shares issued in the acquisition, the share base increases by 10-20 million shares per quarter. This represents more than a 5% increase to the share base every year. While shareholders are being diluted by the increase in the share base, the company has more than adequate cash flow to buy back shares to offset the dilution if it chose to. However, this proves our point about stock-based compensation- it is a very real expense to shareholders. CRM will either have to pay the expense in cash, spend cash to buy back shares, or continue to dilute shareholders. Therefore, we consider the non-GAAP adjusted results to be very misleading as profits including this expense would be less than half what the adjusted results imply.

Also, let's consider what the company's cash flow would look like if it had to pay stock compensation in cash:

Table 6

	7/31/2020	7/31/2019	7/31/2018
T12 Operating Cash Flow	$4,218	$3,875	$3,101
T12 Capex	$743	$640	$541
T12 Free Cash Flow	$3,475	$3,235	$2,560
T12 Stock Compensation Expense	$2,136	$1,411	$841

In the most recent trailing 12-month period, free cash flow would have been reduced by 60%, versus 43% and 32% in the comparable 2019 and 2018 periods, respectively. As noted above, CRM does not spend cash buying back shares and it does not have a dividend. Cash and short-term investments exceed debt by more than $6 billion. Cash flow and liquidity are clearly not problems. However, the size of stock compensation expense relative to free cash flow indicates how unrealistic it is to simply ignore it when analyzing adjusted profits.

Acquisitions and Adding Back Amortization

In addition to adding back stock-based compensation to non-GAAP results, CRM also adds back the amortization of intangible assets from acquisitions. The following table shows the size of these add-backs relative to non-GAAP operating income:

Table 7

	7/31/2020	4/30/2020	1/31/2020	10/31/2019
Non-GAAP Operating Income	$1,040	$635	$745	$874
Amortization of Intangible Assets	$284	$271	$270	$266
% of Non-GAAP Operating Income	27.3%	42.7%	36.2%	30.4%

	7/31/2019	4/30/2019	1/31/2019	10/31/2018
Non-GAAP Operating Income	$573	$682	$596	$572
Amortization of Intangible Assets	$127	$129	$130	$129
% of Non-GAAP Operating Income	22.2%	18.9%	21.8%	22.6%

The acquired intangibles consist of both developed software technology and customer relationships. CRM would have incurred expenses if it had developed these assets in-house, so to exclude them when analyzing profits is very unrealistic in our opinion. In addition, over 80% of goodwill and intangibles is comprised of goodwill which is not amortized at all under GAAP.

We are most concerned by adding back amortization when a company relies on acquisitions to drive growth and when free cash flow is unable to fund shareholder distributions and the acquisition spending. Neither is the case for CRM. As we noted in the previous section, the company utilized stock to make its $14 billion acquisition of Tableau last year. In 2018, cash flow after acquisitions was negative due to the $6.4 billion acquisition of MuleSoft, but cash flow has been adequate to fund acquisition activity since and cash exceeds debt by over $6 billion.

As far as growth goes, the company's revenue growth after backing out revenue from acquisitions is still in the 20% range, so it is hardly reliant on driving growth through debt-driven acquisition spending.

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

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