BEHIND THE NUMBERS
Quality of Earnings Analysis
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Citrix Systems (CTXS) Earnings Quality Update 12/20 Qtr.

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 4- (Acceptable)

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

Summary

CTXS reported EPS of $1.46 in the 12/20 quarter which was 12 cps ahead of targets. Management also gave full-year 2021 guidance ahead of the consensus. The market liked the quarter as growth in SaaS analyzed recurring revenue signed during the quarter accelerated after a deceleration in the 9/20 period.

We do not have any major concerns with the company's earnings quality and revenue recognition metrics seem to support management's story. Still, we were unable to upgrade our current earnings quality rating due to some concern over a jump in capitalized contract acquisition costs.

What is strong?

- CTXS has now discontinued selling new perpetual *Workspace* licenses. It has also transitioned away from the short-term license deals it implemented in the first half of 2020 to help new customers set up their remote access capabilities at the onset of the pandemic. Management stated in the call that it has already seen one large customer convert its short-term license to a longer-term cloud-based subscription deal. Signs are initially positive as SaaS ARR was up 39%, a reacceleration from the previous quarter's 36%. In another positive sign, subscription bookings as a percentage of the total increased to 85% in the 12/20 quarter from 69% a year ago.

- Deferred revenue days of sales recognized over time rose by 11 days, continuing the positive trend as perpetual license deals continue to decline in the mix. This is more positive evidence of the company successfully transitioning to the SaaS subscription model.

What is weak?

- There was a 22% sequential increase ($36 million) in capitalized contract acquisition costs in the 12/20 quarter which the company indirectly attributed to higher subscription sales. We know that subscription revenues are growing, but the size of the jump relative to previous quarters appears unusual. For reference, a $10 million increase in capitalized costs would add about 6 cps to EPS.

- CTXS's buyback has been reducing the share count by more than 5% YOY for several quarters. Management indicated that it will take it a couple of years to pay down debt to target levels after the Wrike acquisition. During that time, the buyback will presumably be scaled down which will reduce the EPS tailwind from declining share count.

- Accounts receivable days of sales rose by 15 days versus the year-ago quarter following a 14-day YOY increase in the 9/20 quarter. As noted above, the uptick in longer-term subscription deals which resulted in the rising deferred revenue is likely increasing the size of the average invoice. This could explain the increase in receivables relative to the increase in revenue recognized in this quarter. We will continue to monitor this trend but are still not overly concerned.

- On the subject of receivables, we note that the allowance for doubtful accounts rose to 3% of gross receivables, up from 2.7% in the 9/20 quarter and 1.3% in the 12/19 quarter. We would expect the reserve percentage to be above last year's level given the pandemic, but the sequential increase is noteworthy as it could be an indication of collection issues and should be monitored in the first quarter.

What to watch

- CTXS announced during the quarter that it will acquire Wrike, a leading provider of SaaS collaborative work solutions for $2.25 billion in cash. CTXS will pay for the deal with cash on hand plus debt financing and the deal is expected to close in the first half of the year. Wrike had annualized recurring revenue of only $140 million. CTXS stated that it expects the transaction to be neutral to non-GAAP earnings for 2022 and accretive thereafter. We assume that the company will add back amortization of intangibles to non-GAAP along with incremental stock-based compensation related to the deal. Management statements seemed to imply that purchase accounting and integration charges would dilute non-GAAP EPS although we will very surprised if the company does not end up adding those costs back to non-GAAP results. This leaves interest on the debt as the only major dilutive impact we can see. The fact it will take a year to reach accretion on a non-GAAP level indicates how much the deal depends on cross-selling to work.

Supporting Detail

Increase in Capitalized Contract Acquisition Costs

Like most software companies and as allowed under ASC 606, the company capitalizes the costs to obtain contracts that are considered incremental and amortizes them over the expect benefit period. These costs include such items as sales commissions. The following table shows capitalized contract costs, the amortization of the balances, and amortization expense as a percentage of the average outstanding balance during the quarter:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Capitalized Contract Acq Costs	$196.2	$160.3	$150.0	$142.2	$131.4	$114.7
Amortization of Contract Costs	$15.9	$14.7	$13.8	$13.1	$11.8	$11.4
% of Avg. Contract Cost Balances	8.9%	9.5%	9.4%	9.6%	9.6%	10.1%

We note the sharp sequential increase in capitalized balances in the 12/20 quarter. The company stated in the liquidity section of the 10-K that operating cash flow for the full year was pressured by the “increase in capitalized commissions from higher subscription sales.” We know that there was an uptick in subscription revenue in the quarter, but the 22% sequential increase in the balance still looks unusual. For reference, a $10 million increase in expenses capitalized rather than expensed would boost EPS by about 6 cps.

Another item that stands out is the decline in amortization expense as a percentage of the average capitalized balance. This could result from an increase in the duration of new contracts compared to those signed in past quarters. This is not particularly material as the sequential decline in the amortization percentage would have added less than a penny per share to EPS in the period.

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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