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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Citrix Systems (CTXS) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4-	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 maintaining our earnings quality rating of 4- (Acceptable)

Despite CTXS soundly beating EPS and revenue estimates in the quarter, the market hammered the stock largely due to a 3% sequential decline in *Citrix Cloud* subscribers. Management noted that this was due to one of its largest customers, a healthcare company, delaying its shift to a cloud model citing other priorities in the current environment. Adjusting for this, management claimed *Citrix Cloud* subscribers rose "modestly". Regardless, we note that annualized recurring subscription revenue rose by 13% sequentially and 55% YOY. We continue to view the company's earnings quality as acceptable and have the following observations about the quarter:

- Deferred revenue days of sales were flat with the year-ago level after several quarters of declines. As we discussed in our original review, deferred revenue at CTXS has been declining despite this fact that the company is shifting to a subscription model which sees revenue paid over time and away from perpetual licenses where the revenue is recognized upfront. This is because maintenance contracts tied to the perpetual licenses are recognized over time and declines in deferred revenue associated with these contracts are offsetting the rise in revenues deferred under new subscription deals. We view this as a positive sign that the progress to the subscription model is progressing.

- In another positive sign, cash from operations rose in each of the last two quarters. Cash flow has been declining as the shift to subscriptions leads to customers paying over time rather than all at once at the beginning of a perpetual license. Management stated at the end of 2019 that the headwind to cash flow growth from the shift to subscriptions was almost gone. While we view the return to positive cash flow growth as a positive, keep in mind that COVID almost certainly accelerated the return to positive cash flow growth by pulling demand into the first half of the year.

- Having noted the positives of stabilized deferred revenue and growing cash flow, investors should be braced for these trends to see some deterioration in the back half of the year. On October 1, CTXS will no longer offer perpetual licenses of its *Citrix Workspace* products that will likely drive an acceleration of subscription license adoptions. Revenue will be recognized over time on these deals with less cash flow received upfront versus the perpetual deals they replace, which will likely increase pressure on cash flow and revenue growth. Management indicated on the conference call that this is reflected in its guidance for the back half of the year, but we could still see this being a source of disappointment, especially when linked with the possibility that COVID-induced demand cools.

- Stock-based compensation increased by 25% or about 17 cps over the year-ago quarter. However, stock-based compensation declined in the 3/20 quarter, so on a trailing six-month basis, it was up only about 7%. However, we note that on a trailing 12-month basis, stock compensation expense has steadily risen to over 9% in the most recent quarter, up from the 5% range in 2017. As we addressed in our original review, this is increasing the distortion of adding back this key expense category to non-GAAP EPS figures. We will continue to watch for a sustained trend in the company paying more compensation expense with stock rather than cash.

- Sales, marketing, and services expense declined due to the cancellation of trips and events due to COVID including the company's largest event of the year. We estimate that if this expense category had remained constant as a percentage of revenue, it would have cost the company over 17 cps in earnings. The timing of this is out of the company's control, but future quarters will certainly be penalized as these important expenses are shifted into the future.

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.

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