BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Citrix Systems, Inc. (CTXS)
Earnings Quality Update- 6/21 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 on CTXS of 4- (Acceptable)

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

Summary

CTXS reported non-GAAP EPS of $1.24 which was well ahead of expectations of $1.19. However, sales fell 4% short of the consensus targets and the company lowered full-year 2021 revenue guidance by roughly 5%. The non-GAAP EPS outlook was lowered to $5.60-$5.80 which represents an approximate 15% decline from the previous guided range.

During the pandemic, the company's shift to its SaaS (software-as-a-service) model was delayed as it offered limited use, short-term licenses to help customers transitioning to remote presentation services for employees at home. These conditions have now passed and the company is seeing an unexpectedly strong acceleration in its existing customers switching from non-SaaS subscriptions (which are recognized upfront) to SaaS subscription services (which are recognized over time.) While this shift was a driving force behind the sales outlook downgrade, the company also admitted it was behind in signing up new SaaS business and would have to invest more than expected to refocus and expand its sales force.

The news was definitely a disappointment and the market reacted by driving the stock price down around 15%, in line with the earnings downgrade. CTXS' admission of problems with its salesforce and disappointing pace of signing up new SaaS customers raises some concern. However, while the pandemic has provided somewhat of a tailwind to the demand for its services, it has also complicated CTXS' move to its SaaS model, so we will give it some benefit of the doubt. Trends in ARR growth, short-term deferred revenue, and unbilled revenues indicate a positive trajectory for future business- at least for now. Finally, the stock price decline puts the company selling at 18 times the 2021 estimate, which is among the cheapest of the major software companies.

It may take the company 2-3 quarters to remedy the problems with its salesforce and to resume the addition of new SaaS customers. However, we are maintaining our 4- (Acceptable) EQ rating and will keep a close eye on the growth metrics for signs of weakness in signing new SaaS business.

- On the bright side, CTXS is seeing a reacceleration in shifting revenue to its SaaS model which was interrupted during the pandemic when it offered limited use, short-term licenses to help new customers move to an online work environment. During the second quarter, existing customers switched to SaaS subscriptions at a faster than anticipated pace, driving SaaS bookings as a percentage of total bookings to 63% from 41% in the March quarter and 34% a year ago. Guidance was for 50-55%. Strength was also testified to by SaaS ARR (annualized recurring revenue) YOY growth of 47%, up from 43% in the March quarter even after adjustment for the Wrike acquisition. While this is a positive step towards a more predictable long-term revenue stream, these revenues are booked over time rather than upfront which results in pressure to revenue growth.

- The major disappointment in the quarter was the company's admission that it was falling behind in its pace of selling SaaS licenses to new customers due to confusion in coordinating with its sales force and falling behind its goal in hiring new, quota-based sales reps. The lowered guidance reflects potential disruption and higher costs associated with remedying these problems.

- As we have noted in past reviews, reported sales growth understates true growth due to the change in revenue recognition dynamics between SaaS and non-SaaS revenues. However, looking at just the growth in SaaS ARR (noted above) overstates growth in overall business as it does not subtract out revenue that switched from non-SaaS contracts or left altogether. In the March quarter, CTXS began disclosing Total ARR which compiles the value of all SaaS and non-SaaS subscription contracts to give a better idea of the growth trajectory of the business. This metric rose by 15% in the 3/21 quarter and 13% in the 6/21 quarter after adjustment for the Wrike acquisition. Growth is expected to

fall to 10% for the full year given the sales force issues noted above. While a deceleration, this is still indicative of positive growth in the overall business.

- Deferred revenue days of revenue recognized over time fell by more than 12 days YOY in the 6/21 quarter. This is ordinarily a concern, but in CTXS's case, the new SaaS contracts are billed more frequently and in smaller amounts and therefore generate less deferred revenue than the older maintenance contracts they are replacing. Short-term deferred revenue days of sales, a better indication of deferred revenue related to new contracts, rose by 1.4 days.

- Unbilled revenue (value of all contracts signed but not yet billed or recognized) rose by 33% YOY in the 6/21 quarter. While this was down from over 50% growth in the 3/21 quarter and was boosted by the Wrike acquisition, growth was still strong and well ahead of the 10% growth in revenue recognized over time. This bodes well for future positive growth. Still, this metric should be watched closely along with Total ARR for signs of significant deceleration.

- We estimate a lower provision expense as a percentage of revenues added about 1.7 cps to earnings in the quarter. Lower stock-based compensation added about 2 cps which would have boosted GAAP results, but CTXS adds back stock compensation to non-GAAP results.

- Of the $2.25 billion purchase price, $1.7 billion was assigned to goodwill and will not be amortized under GAAP. Another $825 million was allocated to intangible assets. Of that, a little less than half was designated as technology and is being amortized over 6 years. This is longer than the more typical 3-year time frame we usually see. In addition, the company adds back amortization to non-GAAP results which effectively ignores the cost of the acquisition and the value of the technology which the company would have had to expense if it developed it in-house.

Company Lowers Guidance and Identifies Salesforce Problems

In the 3/21 quarter, CTXS missed EPS estimates by a penny and fell short of revenue targets. The company had hoped to convert its limited use licenses offered during the pandemic to longer-term contracts but was disappointed that more customers than expected renewed the shorter-term deals which resulted in less revenue recognized in the quarter. This led to the stock falling from the $140 range to the $115 range through the second quarter.

While CTXS exceeded EPS targets in the 6/21 quarter, the stock suffered another 15% hit due to it reducing revenue guidance for the full year by approximately 5% and non-GAAP EPS guidance by 15%. On the bright side, the move towards the SaaS model has resumed with SaaS bookings as a percentage of total subscription bookings rising to 63% from just 41% in the previous quarter and 34% last year. CTXS had predicted 50-55%. The company also raised its full-year outlook for the SaaS bookings percentage to 60-70% from the previous 50-60%. This has a muting effect on revenue growth given SaaS subscriptions are booked over time rather than upfront. However, the real concern in the quarter was the company's admission that it is not signing up new SaaS customers as quickly as hoped which it blamed on problems with its sales force. We will discuss that in more detail below.

On the Bright Side-Dramatic Re-Acceleration in Move to SaaS Revenues

As we have discussed in the past, CTXS has been in a multi-year process of moving its products to a Cloud-based, SaaS model and away from software licenses and on-premise subscriptions. This puts short-term pressure on revenue and cash flow growth due to the accounting for the different revenue streams and the timing of cash flow receipts, but should result in a company with a more predictable long-term revenue stream.

The pandemic somewhat disrupted the move to SaaS sales. CTXS's products are designed to enable remote work which was in high demand as companies were unexpectedly forced to move employees off-site after Covid hit. CTXS responded by offering limited us, short-term license deals which resulted in a boost to its non-SaaS subscription revenues. The hope was that it would convert many of these clients over to SaaS products or at least longer-term license deals upon expiration. The company noted in the first quarter that more customers than expected elected to roll over the short-term deals than sign new longer-term deals. However, during the second-quarter call, management seemed to indicate that its contract durations were now back to normal. Additionally, SaaS bookings as a percentage of total subscription bookings jumped to 63% from 41% in the previous quarter and 34% a year ago. Management also increased the SaaS bookings percentage outlook for all of 2021 to 60-70% from the previous 50-60% range. This will result in downward pressure on revenue growth as SaaS revenue is recognized over time while license and on-premise deals are recognized upfront. It also can pressure cash flow growth as the company converts an older license deal that previously was billed two or three years upfront to an SaaS subscription that is billed in smaller amounts more frequently.

To give an idea of the growth in the value of contracts the company is signing, it discloses SaaS ARR (annualized recurring revenue) which is the annualized value of all SaaS contracts in effect at the end of the period. The following table shows the growth in SaaS ARR for the last eight quarters with the 6/21 and 3/21 periods adjusted for the Wrike acquisition.

	6/30/2021	3/31/2021	12/31/2020	9/30/2020	6/30/2020	3/31/2020	12/31/2019	9/30/2019
SaaS ARR Growth (ex-Wrike)	47.0%	43.0%	*39.4%*	*36.1%*	*41.1%*	*48.0%*	*48.6%*	*51.8%*

We can see that the growth in the value of SaaS contracts decelerated slightly during the pandemic as customers opted for the temporary shorter-term license deals. However, it has since returned to the 40%+ range in the last two quarters which is on par with pre-pandemic growth. Note that including the Wrike acquisition, SaaS ARR growth was 74.2% and 69.9% in the 6/21 and 3/21 quarters, respectively.

Total ARR Growth Still Positive, but Guidance Lowered

Starting in the 3/21 quarter, the company began disclosing Total ARR which it defines as *"the contracted recurring value of all termed subscriptions and perpetual maintenance agreements normalized to a one-year period. Total ARR includes only active contractually committed, fixed fees and consists of the following components: Subscription ARR and Maintenance ARR."* As noted above, as CTXS converts existing non-SaaS subscription customers to SaaS subscriptions it is seeing its revenue growth pressured as revenue from the old contracts were recognized upfront while revenue under new contracts is recognized over time. In addition, new contracts are billed more frequently for smaller amounts which pressures revenue and cash flow growth. This means the sales figure on the income statement understates how fast the company's future core business is growing while the SaaS ARR growth overstates it by not accounting for the offsetting impact of existing customers that switched or left altogether. Total ARR is intended to take the lost revenue from the older model into consideration by counting both SaaS subscriptions along with non-SaaS subscriptions.

Total ARR growth adjusting out the impact of the Wrike acquisition was 13% and 15% in the 6/21 and 3/21 quarters, respectively. However, the company warned that this could fall to 10% for full-year 2021. While CTXS is seeing growth in SaaS revenues from converting existing customers from non-SaaS revenues, it is not signing up new customers to SaaS as quickly as it hoped. It blamed this on a combination of "sales complexity" which relates to how it has communicated its goals to its multi-channel sales force. It also indicated that it was behind in its goal of hiring new sales reps. Management made the following prepared statement on the call:

> *"After analyzing our performance at the end of the quarter, we currently believe that this recent performance primarily is the result of three factors. First, unexpected sales process complexity in effectively supporting multiple, simultaneous selling motions for Workspace*

cloud and on-premises solutions, which has created bookings mix uncertainty. Second, we are behind our capacity plan for direct quota carrying sales representatives. Finally, given our direct selling motions, we have lacked focus in driving transactional volume through indirect channels."

Here is the more impromptu explanation during the Q&A section of the call:

"I think that we, obviously, are coming off a record year in 2020 across many of the metrics of the business. COVID has certainly been a secular tailwind to the types of solutions that we sell. When you rattle off all the different transition metrics, I mean, we're not -- we're doing extremely well on that part. We've just had problems with really managing and accurately forecasting a lot of these new business areas. And so that's what we're focused on taking actions for to really align, not just to drive a lot more consistency, which has to be an outcome, but also really focus on where customers are going over the long-term and embracing that model."

CTXS plans to realign its sales activity as well as move more aggressively to hire quota-based sales personnel in the remainder of the year. The reduction in the outlook for Total ARR growth to 10% takes into account the potential interruption in sales. The company also expects to incur additional expenses which is part of the drive behind the lower profit outlook for the year.

Deferred Revenue and Unbilled Revenue Are Still Pointing to Positive Growth for Now

CTXS discloses both short and long-term deferred revenue which represents amounts that have been received from customers but have not been recognized as revenue. The following table shows short, long, and total deferred revenue days of sales calculated using the company's disclosed revenue recognized over time. We use revenue recognized over time as revenue received upfront has no deferred revenue associated with it.

	6/30/2021	3/31/2021	12/31/2020	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Current Deferred Revenue Days	209.6	210.1	221.8	197.5	207.9	209.8	211.6
YOY increase	*1.7*	*0.3*	*10.2*	*4.9*	*2.3*	*-1.1*	*-7.6*
Long-Term Deferred Revenue Days	47.6	51.6	57.6	56.9	61.8	64.8	69.4
YOY increase	-14.2	-13.2	-11.8	-9.7	-10.9	-8.5	-10.3
Total Deferred Revenue Days	257.2	261.7	279.5	254.4	269.7	274.6	281.0
YOY increase	-12.4	-12.9	-1.5	-4.8	-8.6	-9.7	-17.9

We see that total deferred revenue days fell by more than 12 days YOY in the last two quarters. In general, a decline in deferred revenue days is an earnings quality concern as it indicates that either the company is signing up less new business which will result in lower future revenues, or it is becoming more aggressive in recognizing revenue. However, as we have noted in past reviews that CTXS' switch to the SaaS model is pressuring deferred revenue growth partly because revenues under old license contracts related to service and support have always been deferred and recognized over time. However, service and support is included in SaaS contracts which are billed on shorter time frames, so a contract that was billed 2 years upfront is now billed for a smaller amount but a more frequent time frame. We believe the accelerating decline in long-term deferred revenue days is a reflection of these longer-term maintenance contracts going away. Short-term deferred revenue days gives more of an indication of the growth in SaaS contracts and that metric is still showing positive growth. We can see these impacts in the company's discussion in its 10-Q regarding the decline in deferred revenue during the first six months of the year:

> *"Deferred revenues decreased $10.6 million as of June 30, 2021 compared to December 31, 2020 primarily due to a decrease in maintenance and support of $178.1 million, mostly from Workspace perpetual software maintenance of $153.2 million and App Delivery and Security perpetual hardware maintenance of $23.1 million, partially offset by an increase from subscription of $168.9 million, which includes the Wrike acquisition. Unbilled revenue as of June 30, 2021 increased $119.1 million from December 31, 2020 primarily due to increased customer adoption of multi-year subscription agreements."*

Another indicator of future revenue growth is unbilled revenue which represents "*future billings under subscription agreements that have not been invoiced and, accordingly, are not recorded in accounts receivable or deferred revenue within condensed consolidated financial statements."* The following table shows unbilled revenue and the year-over-year growth rate for the last several quarters:

	6/30/2021	3/31/2021	12/31/2020	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Unbilled Revenue	$1,155	$1,197	$1,036	$916	$867	$779	$705
YOY growth rate	*33.2%*	*53.6%*	*47.0%*	*63.8%*	*79.0%*	*104.8%*	*108.2%*

Growth in unbilled revenue has decelerated as the comps have become more seasoned. Also keep in mind that the last two quarters include the impact of the Wrike acquisition so core growth is lower but still likely well above the 10% growth in revenue recognized over time. This still indicates a positive trajectory for business although this metric should be watched closely in upcoming quarters for any significant deterioration.

Wrike Acquisition Adds to Goodwill and Intangibles

CTXS closed its acquisition of Wrike on 2/26/21. Of the $2.25 billion purchase price, $1.7 billion was assigned to goodwill and will not be amortized under GAAP. Another $825 million was assigned to intangibles. Of that, $348 million was assigned to “Core and Product Technologies” and is being amortized over 6 years while $447 million was assigned to “Customer Relationships” and is being amortized over 7 years. While 7 years is reasonable for customer relationships, the 6-year technology period seems a little long as we more typically see technology-related amortization periods closer to 3 years. However, this is not relevant to non-GAAP results as the company adds back the amortization of acquired intangibles to its adjusted results. We believe this is misleading as the company gets the benefit of the acquired technology without any expense from the acquisition hitting the income statement. CTXS would have incurred development expenses which it would have expensed as incurred if it had built the technology in-house.

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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