BEHIND THE NUMBERS
Quality of Earnings Analysis

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DocuSign, Inc. (DOCU)- Earnings Quality Update

Rating
6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are reducing our earnings quality rating of DOCU to 4- (Acceptable).

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

Summary

DOCU became one of the high-profile casualties of the market rout two weeks ago after missing EPS targets in its fiscal first quarter and issuing disappointing guidance for billings growth in its upcoming second quarter. The stock was down nearly 40% with the whole episode leading to the departure of the CEO. However, we believe DOCU is a "real" tech company with a product customers need and the company is worthy of careful consideration as a potential value at these levels.

Looking back, DOCU saw Covid jumpstart its growth in a huge way and is now seeing growth rates moderate. We concluded in our initial review of DOCU that the accounting was clean with the exception of a huge amount of stock compensation that is added back for non-GAAP results. When we first wrote DocuSign, we highlighted that while high levels of stock compensation may be common for a tech company, DOCU almost seemed set up to create share dilution, paying with stock options and RSUs, issuing convertible debt, and even letting employees buy additional shares at a 15% discount to market prices.

We believe this is a real company with a real market. It has software tie-ins with the platforms for Google, Microsoft, Oracle, Salesforce, and SAP to name a few. Its electronic documentation and signature process is designed to speed the sales process, payment process, renewal, and security. All of that seems likely to allow it to continue to grow. DOCU still sees itself on a path to reach $5 billion in sales from a total market of $50 billion and a non-GAAP operating margin of 20%-25% which adds back stock compensation and acquired intangible amortization. It did $2.1 billion in revenue for fiscal 2022 (ending in January) with a non-GAAP margin of 20%, so that is not a stretch. However, the red flag to us was the 20% margin came from adding back stock compensation that totaled 21.4% of sales.

Long-term guidance would be in the neighborhood of $4-$5 in non-GAAP EPS assuming a share count of 225 million shares and a 10% effective tax rate (at a 20% tax rate, non-GAAP EPS is $3.50-4.50). With the stock at $60, down from $300, forecasting revenues to more than double may have some appeal to many investors. It may also become a takeover target for one of the larger software companies.

The market is more focused on weak guidance for 2Q23 ending in July. We think that can be overcome and new infrastructure is in place to help restart the sales pipeline. There are still important areas of growth being seen at DOCU with guidance for the year of 17%-18% topline gains. However, questions remain surrounding stock compensation:

- Many employees left already – can DOCU bounce back if new RSUs are offered at lower price points?

- DOCU is free cash flow positive, but only rarely would it be without using stock compensation.

- Will employees insist on many more shares creating more future dilution? Or will the market penalize DOCU for paying more cash wages, which would not be added back and thus reduce the non-GAAP margin?

- DOCU does not need to reduce stock compensation to zero – but if it reduced it from 19%-20% of sales to something closer to 10% or below - the earnings quality and sustainability of the results would improve considerably and cash flow would still be strong.

There still appears to be considerable top-line growth coming. Also, some of the potential sales growth could come from expanding usage at existing customers which may be cheaper business to land and help margins overall too.

What Is Weak:

- The market is more focused on the growth rate coming down post-Covid and guidance was poor for the 2Q23 that ends in July. We thought that the slowdown at DOCU would be seen in billings and it is. Guidance is for billings to be even with revenues or only exceed by 1% this quarter and only exceed revenues by 2% for the fiscal year.

- DOCU has lost many sales reps as they see making new sales becoming more difficult or requiring more expertise than it did during Covid when the work-at-home movement made signing new accounts much easier. In the early stages of the pandemic, the company had administrative staff taking almost as many orders as its regular salespeople were. DOCU believes it was not fully training salespeople during Covid and the turnover in staff has hurt its backlog.

- Non-GAAP margin forecasts of 20%-25% rely heavily on leveraging sales & marketing for about 400-500bp and G&A costs by about 300bp. Gross margin already appears to be in the planned range which reduces a lever to pull to hit longer-term forecasts.

- Capitalized commissions related to renewals are amortized over only 2 years instead of 5 years for new contracts. That may create a headwind to cutting marketing spend as a percentage of sales. However, we give this accounting policy a “thumbs up” for being conservative.

What Is Strong:

- Retention figures have come down from Covid highs of 125% but remain strong in our view. Retention measures the new contract value in dollars for an existing client vs. the prior year in dollar terms. It does not reflect the addition of new customers at all. Before Covid, this was 112% and was 114% last quarter. This compounds over time into large dollar gains for revenue. A customer paying $1,000, would now be paying $1,596 after three years of 112%, 125%, and 114% retention rates.

- DOCU is building and professionalizing the sales staff more to concentrate on selling to larger clients and it brought in a former head of SAP’s Global Sales. Some of its fastest growth is still coming from activating larger customers worth $300,000 or more. Growth here has been about 2%-3% higher than total revenue growth each quarter in the last year.

- Boosting revenue from existing larger clients and growing the retention rate should create easier growth overall for more dollars. Adding additional employees and services to different departments within an existing client should be a much faster close and likely costs less in commission overall on the higher sales figure.

- The maturation and larger scale of the company made it free cash flow positive even if all stock compensation became a cash expense. It would definitely lower free cash flow, but in fiscal 2021 and fiscal 2020, there was no hope for positive free cash flow if employees were paid higher cash wages.

- Maturation may also help free cash flow because commissions on renewals are amortized over two years rather than five years. Free cash flow is hurt by cash payments for commissions but helped by adding back the non-cash amortization. Amortization may start to rise faster now as more customers renew.

- DOCU still does not make many acquisitions. It is growing internally which helps preserve free cash flow and improves earnings quality compared to an acquisitive company that adds back acquired intangible asset amortization and allocates much of the purchase price to goodwill which is not expensed at all. It also means that free cash flow is a more realistic figure.

- DOCU is not issuing new stock options – it is focused more on RSUs that vest over time, which can mean fewer shares issued overall. The remaining 2023 convertible notes with a conversion price of $71.50 only have $37 million outstanding now, representing just under 520,000 shares. The $690 million of 2024 convertible notes appear less likely to convert at $420.24 per share and could be repaid with cash. DOCU also has a $200 million share repurchase program in place that could retire over 3 million shares.

- Debt does not look like an issue at this point. The bank line is not drawn and the ratios used for the revolver let DOCU add back stock compensation for an adjusted EBITDA figure and debt does not include deferred revenues. Debt net of cash over adjusted EBITDA needs to be less than 4x, but currently, cash exceeds all debt.

Poor Guidance after April Results (1Q23) Spooked the Market

The majority of DOCU's revenue comes from selling software and it bills clients in advance. It sets up a deferred revenue liability and amortizes it into revenues over the term of the contract. DOCU defines billings as GAAP revenue + the change in deferred revenue + the change in receivables. When growth is strong, billings should exceed revenues:

	Apr 22	Jan 22	Oct 21	Jul 21
Revenues	$588.7	$580.8	$545.5	$511.8
Chg in Def. Rev	$25.4	$87.9	$21.4	$80.8
Chg in A/R	-$0.5	$1.4	-$1.6	$1.6
Acquisitions	$0.0	$0.0	$0.0	$0.0
Billings	$613.6	$670.1	$565.2	$595.4
Billings/Rev	104.2%	115.4%	103.6%	116.3%
	Apr 21	**Jan 21**	**Oct 20**	**Jul 20**
Revenues	$469.1	$430.9	$382.9	$342.2
Chg in Def. Rev	$57.1	$98.3	$63.9	$70.3
Chg in A/R	$1.3	$5.8	-$6.4	-$4.0
Acquisitions	$0.0	$0.0	$0.0	-$2.8
Billings	$527.4	$534.9	$440.4	$405.7
Billings/Rev	112.4%	124.1%	115.0%	118.6%
	Apr 20	**Jan 20**	**Oct 19**	**Jul 19**
Revenues	$297.0	$274.9	$249.5	$235.6
Chg in Def. Rev	$46.3	$86.3	$23.0	$17.7
Chg in A/R	-$1.3	$5.7	-$3.1	-$0.9
Acquisitions	$0.0	$0.0	$0.0	$0.0
Billings	$342.1	$366.9	$269.4	$252.4
Billings/Rev	115.2%	133.5%	108.0%	107.1%

Last quarter saw billings fall to only 104% of revenue AND revenue growth sequentially only rose by 1.4%. That is after slowing to 6% in the previous two quarters.

Plus, DOCU guided to July 2022 revenue of $600-$604 million (1.9%-2.6% growth) with billings of only $599-$609 million. That would make the billings to sales ratio at best 101.5% and it could come in equal to revenue indicating that deferred revenues may grow very little and that is the future revenue.

What Caused the Slowdown? How is DOCU Addressing It?

DOCU grows by signing up new customers and seeing existing customers use the products more frequently, spreading use to other areas of their companies, and adding more features. Two-thirds of DOCU employees are focused on sales and marketing and other interactions with customers.

Covid was a huge tailwind. Before Covid, DOCU was growing revenues at 6% (the same as October 2021 and January 2020) and its retention rate was 112%-117%. Retention measures the dollars contracted from existing customers for the following year. Retention is not impacted by new customers signing up.

Salespeople work largely on commission often after earning a draw/salary early on as they learn the ropes and then the draw goes away. They like something easy to sell. DOCU products were in high demand with many people working at home. Look at the surge in headcount and retention rate during Covid:

	Apr 22	**Jan 22**	**Oct 21**	**Jul 21**
Retention	114%	119%	121%	124%
Headcount	7,642	7,461	7,056	6,551

	Apr 21	**Jan 21**	**Oct 20**	**Jul 20**
Retention	125%	123%	122%	120%
Headcount	6,080	5,630	5,364	5,008

	Apr 20	**Jan 20**	**Oct 19**	**Jul 19**
Retention	119%	117%	117%	113%
Headcount	4,281	3,909	3,723	3,489

Salespeople flocked to DOCU. The company was seeing customers sign up more quickly, the next year they were renewing early according to some of the conference call transcripts, and the customers were renewing at 20%+ higher rates than the prior year. That attracts new salespeople and look at how quickly new staff was running in the door. DOCU was adding 200 people per quarter and that suddenly became 400-700 per quarter.

DOCU has seen churn within its sales force. The numbers are still rising, but they are seeing churn within the totals. We think the CEO Dan Springer summed up the churn here very well on the last conference call:

*“We also had a significant number of people that we added during those two years of the very dramatic COVID growth. And they kind of knew only one DocuSign, which was, quite frankly****, achieving the sales success was a heck of a lot easier than it had been previously. And definitely, a lot easier than is now.***

*And for some of those folks, I said****, the market is telling me that I can get guaranteed compensation someplace else. And since I'm no longer brand new at DocuSign, I don't have that opportunity.*** *And so from a compensation standpoint, they said, I think I'd be better off trying some place new, particularly a lot of the start-ups, up until at least recently have saying, we'll guarantee your first year of compensation.”*

We would also add, that there are likely many sales reps who left for signing bonuses elsewhere by showing strong growth rates they posted at DOCU-sort of like the basketball player wanting a raise after a 50-point game.

Mr. Springer also noted that during Covid, many of the newer reps were more focused on the quick sale and not the full enterprise system sales which take longer and require more expertise to complete. That is where much of the future growth that DOCU expects is located:

“Yes. CLM, thanks for asking, was a bright spot in Q1. ***We were over 100% of our goal for what we wanted to see in terms of growth there. As you may recall, CLM had before the pandemic started to look like it was really picking up*** *and then across that entire space of other CLM providers.* ***During the pandemic, it got much tougher as people sort of tried to focus on those shorter-term ROI wins*** *that you see in something like Signature, right, which really took off during the pandemic.* ***And some of those longer cycle deals in CLM where you take more implementation time, you need to have some sort of systems integration work, as a sort of a requirement to execute on installing that software.***

Now ***we're seeing that there's a lot of enthusiasm for that****. And I would tell you, particularly bright spot is we just launched CLM Essentials, and we already have dozens of wins there with people that are saying, this is the way that says we say, democratize CLM.* ***So we're quite bullish on the momentum that's going there.”***

In addition, DOCU is becoming more disciplined on how they hire people and is refocusing on training people and giving better supervision. We consider this a positive and it may create better returns on their commission dollars.

“Last quarter, I shared that we would be bringing in a world-class sales and success leader and I'm very pleased to note that we made an important hire with Steve Shute [fromer head of global sales for SAP], as our new President of Worldwide Field Operations. Also, as I mentioned last quarter, we onboarded a number of outstanding

sales leaders in our North American commercial and SMB segments who now have been in their seats for a quarter.

Finally, we just hired a new North American enterprise team leader, rounding out our Initiative to scale our go-to-market leadership. This seasoned team has hit the ground running, focused on recruiting, training and enablement, and with a laser focus on driving DocuSign to $5 billion in revenue and beyond."

DOCU is still seeing the number of customers who are paying annual contract revenues > $300,000 increase. We think that is a legitimate target given that it should be easier to cross-sell to other departments within a larger company as well as interest them in additional products per user. Even DOCU agrees that this is a longer-term cycle to close the deal, but it should help drive the retention rate up and commissions are likely lower on renewal and new services added.

As noted above, DOCU is forecasting that leveraging non-GAAP marketing cost (adding back stock compensation) should drive much of the margin gains if sales grow going forward. They see it dropping to 35%-39% of sales. The improvement stalled a bit in 1Q23:

	1Q23	1Q22	fiscal 22	fiscal 21	fiscal 20
Non-GAAP Marketing	42%	41%	41%	44%	49%

It was 42% in 4Q22 also vs. 41% the year before. That likely reflects some lower sales growth. We discuss below that maturation of the company may boost amortization of capitalized commissions so that is a headwind to watch. We think DOCU needs to show margin gains in this area most to reach forecasts and this is an area to monitor.

Quick Primer on DOCU's Non-GAAP Earnings

DOCU's Non-GAAP earnings adjustments are not unique for tech companies. Whether it's gross margin, operating margin, or net income, they add back: Stock Compensation plus the employer payroll tax, amortization of acquired intangibles and acquisition-related costs, amortization of debt discount and issue costs, and other special items.

DOCU has not made many recent acquisitions and its amortization period is not particularly long: 3-5 years for acquired existing technology and 5-10 years for customer contracts and relationships. With the accounting change to start fiscal 2022 (Feb 1, 2021 – Jan 31, 2022) for convertible debt, DOCU no longer breaks its convertible debt into debt and equity components which results in a larger debt discount to amortize. Now it works on amortization between cash

received and face amount. That makes Stock Compensation and related Payroll taxes the largest difference between GAAP and non-GAAP:

	1Q23	1Q22	fiscal 22	fiscal 21	fiscal 20
GAAP Income	-$27.4	-$8.4	-$70.0	-$243.3	-$208.4
Stock Comp	$110.7	$81.1	$408.5	$286.9	$206.4
Payroll Taxes	$5.1	$16.3	$42.2	$34.0	$16.7
Amortiz. Intang	$5.6	$6.5	$24.8	$25.6	$17.7
Acq Expenses	$0.0	$0.0	$0.4	$8.0	$0.0
Amortiz. Debt Discount/costs	$1.3	$1.3	$5.1	$28.0	$26.4
Loss on Exting. Debt	$0.0	$0.0	$0.0	$33.8	$0.0
Tax Impact Non-GAAP	-$17.5	$0.0	$0.0	$0.0	$0.0
Other	-$0.3	-$5.1	-$0.2	$9.3	$0.0
Non-GAAP Income	$77.5	$91.8	$410.8	$182.3	$58.9

Without adding back stock compensation and payroll taxes, DOCU would not be profitable. Here's where we have an issue with the long-term goal of 20%-25% operating margins for DOCU. The operating margins add back the stock compensation which is running > 20%. Thus, DOCU's GAAP earnings could turn profitable but would remain fairly low.

	1Q23	1Q22	fiscal 22	fiscal 21	fiscal 20
Revenue	$588.7	$469.1	$2,107.2	$1,453.0	$974.0
Stock Comp	$110.7	$81.1	$408.5	$286.9	$206.4
Payroll Taxes	$5.1	$16.3	$42.2	$34.0	$16.7
Stock Comp % Rev	18.8%	17.3%	19.4%	19.7%	21.2%
Payroll Taxes % Rev	0.9%	3.5%	2.0%	2.3%	1.7%
Total % Rev	19.7%	20.8%	21.4%	22.1%	22.9%

We do not have a problem with DOCU's forecast that the 20%-25% margins will come from leveraging Sales & Marketing and the G&A expenses over revenues that they are forecasting to double. What we would like to see and expect to see is stock compensation as a percentage of sales decline to 10% of sales rather than holding at 20%. That would narrow the spread between GAAP and non-GAAP earnings. That would slow the dilution of shares too.

It is interesting to note that post-Covid, the share count only rose 2% in fiscal 2022 (ending Jan 2022) and it fell 0.9% y/y in 1Q23 (ending in April 2022). The question is do employees want more RSUs going forward with the stock price down from $300?

Quick Primer on Free Cash Flow

DOCU's software model involves collecting much of its contracts in advance as cash. It sets up a deferred revenue liability and amortizes it into revenue over time – about two-thirds is recognized as revenue over 12 months or less. Much of the operating expenses are being paid in stock rather than cash and as a software company, its capital spending is fairly modest which makes for considerable free cash flow:

	1Q23	1Q22	fiscal 22	fiscal 21	fiscal 20
Cash from Ops	$196.3	$135.6	$506.5	$297.0	$115.7
Cap. Exp.	$21.7	$12.6	$61.4	$82.4	$72.0
Free Cash Flow	$174.6	$123.0	$445.1	$214.6	$43.7
Stock Comp.	$110.7	$81.1	$408.5	$286.9	$206.4
Commissions Paid	-$50.5	-$46.2	-$207.4	-$208.5	-$115.7
Amort Commissions	$44.0	$30.9	$144.4	$99.4	$69.7
Net cash Commissions	-$6.5	-$15.2	-$63.0	-$109.1	-$46.0
Acquisitions	$0.0	$0.0	$6.4	$180.4	$0.0

We want to emphasize three positives here:

- The surge in demand during Covid helped make total free cash flow positive even if stock compensation was a cash expense. Free cash flow would certainly be lower – but it does give DOCU some cushion if it does need to pay employees more with cash.

- DOCU pays commissions in cash in a line called "Deferred Contract Acquisition and Fulfillment Costs." It capitalizes these costs and amortizes them into GAAP income over 5 years for internal sales. Renewals are amortized over 2 years and sales through third parties over the length of the contract.

    - The amortization time is not out-of-line but is longer than some other software companies we follow.

    - This procedure boosts both GAAP and non-GAAP earnings when the company is growing as revenue is recognized over a year for new accounts while the associated commissions are expensed over 5 years on the income statement. (We will look at this in more detail below)

    - It also lowers cash from operations relative to earnings when the company is growing as commissions are paid upfront in cash but are again expensed over 5 years when calculating earnings. When growth slows, the spread between cash flow and earnings narrows as fewer commissions are paid out in cash. At the same time, the revenue mix will shift to renewals on which commissions are amortized over a 2-year period versus the 5 for new accounts.

- Acquisitions are not a major recurring theme here. In fiscal 2021 (almost two years ago), DOCU made acquisitions for $180.4 million, and in fiscal 2019 for $218.8 million. However, the company is not growing largely via acquisition and that also helps make the high free cash flow figure more meaningful.

A Closer Look at the Dynamics of Commission Amortization

One area we think investors should be aware of is as the company matures, the commission amortization should speed up as a greater percentage of revenue is generated through renewals than by obtaining new customers. Let’s look at a simple example.

Assume the company signs a new account for a rate of $10,000 per year. Let’s further assume that the company renews that account in the following four years with a 5% increase each year. The company recognizes the revenue over its typical 12-month period. We don’t know the company’s actual commission schedule, but we will use a 20% commission rate paid at contract origination and a 5% rate on subsequent renewals. The client does not renew after year 5.

The following table shows the impact of the hypothetical account on the company’s revenue, commissions paid, and commissions expensed on the income statement over the life of the contract.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Revenue	$10,000	$10,500	$11,025	$11,576	$12,155	
Origination Commission (20 %)	$2,000					
Amortization of Origination Commission (5 yrs)	$400	$400	$400	$400	$400	
Renewal Commission Year 2 (5%)		$525				
Amortization of Year 2 Renewal Commission (2 yrs)		$263	$263			
Renewal Commission Year 3 (5%)			$551			
Amortization of Year Renewal Commission (2 yrs)			$276	$276		
Renewal Commission Year 4 (5%)				$579		
Amortization of Year Renewal Commission (2 yrs)				$289	$289	
Renewal Commission Year 5 (5%)					$608	
Amortization of Year Renewal Commission (2 yrs)					$304	$304
Total Commissions Paid in Cash	$2,000	$525	$551	$579	$608	$0
Total Commissions Expensed	$400	$663	$938	$965	$993	$304*
Spread	-$1,600	$138	$387	$386	$386	$304
Commissions Expense % of Revenue	4.0%	6.3%	8.5%	8.3%	8.2%	

Key points to note:

- Commissions paid in cash are highest in the first years, fall off the second year due to the smaller renewal rate, and then grow in line with the increase in renewals thereafter.

- However, commission expense rises every year. This is because despite the smaller commission rate on renewals, these commissions are amortized over 2 years instead of 5 for the origination commission.

- This results in the spread between commissions paid in cash and commissions expensed on the income statement being negative the first year, but then turning positive and gradually widening. Thus, the gap between net income and cash flow will narrow which means better earnings quality.

- Importantly, commission expense rises faster than the revenue that is generating it. In our example, commission expense rises from 4% of revenue to over 8% during the later years of the contract. As the company matures, its mix of business will shift more towards

contract renewals and away from signing new customers which means commissions expense will rise relative to earnings and provide a headwind for operating margins.

**Note that in practice, the final commission amortization expense related to the Year 5 renewal would likely be recognized in Year 5 when the contract was not renewed.*

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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