BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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GoDaddy (GDDY) EQ Update- 9/20 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 upgrading our earnings quality rating to 4+ (Acceptable)

GDDY has warned of weakening demand for some of its higher-end services, but overall, COVID has spiked interest in website development as people move more activities and businesses online. Revenue and bookings growth has remained in the 9-11% range. Our upgrade largely reflects the increase in Hosting and Business Application segment deferred revenue days.

What deteriorated?

- GDDY recorded a $39 million restructuring charge in the 6/20 quarter followed by a $6.3 million charge in the 9/20 quarter. These charges were comprised mostly of $14.7 million in severance expense and professional fees, as well as $27.9 million in impairment of operating leases. They were all primarily related to the restructuring of the company's outbound sales force to adopt to changes in the marketplace caused by COVID. The charges are relatively small and focused, but we suspect that when the COVID environment improves, the company will likely begin replacing many of these positions, incurring expenses in future quarters. (Concern level: LOW)

What Improved?

- Total deferred revenue days of sales fell by 2.5 days. Increases in deferred revenue days for the Hosting & Presence segment and the Business Applications segments did not quite offset declines in the Domains segment. We believe this could be driven by shorter contract terms or lower pricing for certain domain contracts. We view the and the increase in Hosting and Applications deferreds as well as bookings growth as a positive for future revenues.

What to watch

- GDDY no longer discloses ARPU or number of customers in its quarterly presentations. As we discussed in our original review, the company was generating a significant part of its organic growth through realizing higher average prices which was, in large part, being driven by offering higher value add-on services. Bookings and revenue both rose by 11% while the number of domains under management rose by just over 4%, implying growth is still coming largely from customers adopting higher value offerings.

- GDDY paid $850 million in the 9/20 quarter to settle the Tax Receivable Agreement liabilities stemming from estimated future tax benefits it owed to its pre-IPO owner. This will eliminate the TRA value adjustment which is a regular feature on the income statement and in the non-GAAP adjustments. The company painted this as a positive in that the deal reportedly represented an attractive discount on the $1.8 billion in payments the company was expected to owe in the future beginning in 2023. However, it does introduce the risk that if the IRS was to disallow the NOLs, GDDY will have to pay the full amount of the taxes without any refund of the $850 million.

- GDDY made a large investment in marketing in the last two quarters. Marketing and advertising expense climbed to 13.7% of revenue in the 9/20 quarter versus 10.5% in the year-ago period. Meanwhile, customer care expense as a percentage of revenue fell from 11.3% to 8.7%, almost offsetting the increase in marketing. The decline in customer care reflected the reduced headcount from restructuring actions noted above. The increase in marketing may help boost the top line, but customer care expense will rebound whenever the COVID situation improves.

Settlement of Tax Receivable Agreement

We discussed in our original review that when GDDY went public in 2015, Desert Newco LLC, the owner of GDDY's asset exchanged its LLC units for Class A share of the new GDDY. This produced a favorable tax benefit for GDDY which it was expected to pay 85% of to Desert Newco as realized with payments expected to commence in 2023. This has required the company to regularly revalue and mark the liability to estimated value every quarter with the resulting gain or loss being adjusted out of non-GAAP results.

In the 9/20 quarter, the company paid $850 million to settle the agreement, booking a $675 million adjustment expense (taken out of non-GAAP) representing the difference between the payment and the $175 million liability on the balance sheet at the time of settlement. GDDY financed the payment with cash and the issuance of the 2027 Term Loans.

The $850 million represented a sizeable discount to the expected $1.8 billion in payments the company was expected to make over the life of the TRA. However, the only downside we see is if the IRS were to disallow the NOLs, GDDY will have to pay any resulting taxes and the arrangement does not allow for any reimbursement to GDDY of the $850 million settlement payment.

Deferred Revenue Days Down Slightly- Hosting and Applications Improved

Total deferred revenue days of sales fell by 2.5 days YOY in the 9/20 quarter. The following table shows the calculation of deferred revenue days by segment for the last eight quarters:

	9/30/2020	6/30/2020	3/31/2020	12/31/2019
Domains Revenue	$387	$370	$356	$352
Hosting and Presence Revenue	$302	$292	$297	$293
Business Applications Revenue	$155	$145	$139	$135
Domain Deferred Revenue	$1,215	$1,192	$1,167	$1,135
Hosting and Presence Deferred Revenue	$787	$772	$748	$714
Business Applications Deferred Revenue	$414	$393	$377	$350
Domain Deferred Revenue Days	288.5	293.5	298.3	296.4
Hosting and Presence Deferred Revenue Days	239.5	240.3	229.0	224.3
Business Applications Deferred Revenue Days	246.1	247.3	246.9	238.0

	9/30/2019	6/30/2019	3/31/2019	12/31/2018
Domains Revenue	$345	$334	$320	$314
Hosting and Presence Revenue	$285	$280	$269	$270
Business Applications Revenue	$130	$123	$122	$112
Domain Deferred Revenue	$1,133	$1,130	$1,106	$1,052
Hosting and Presence Deferred Revenue	$718	$709	$695	$664
Business Applications Deferred Revenue	$346	$334	$322	$302
Domain Deferred Revenue Days	301.8	307.6	311.4	308.0
Hosting and Presence Deferred Revenue Days	231.6	230.7	232.5	226.2
Business Applications Deferred Revenue Days	244.4	247.0	238.7	248.8

We noted in our original review that Hosting and Business Application deferred days were declining YOY but hypothesized that was a result of acquisitions impacting the numbers. These trends reversed in the 6/20 quarter which we view as a positive sign for new business signings and the quality of revenue recognition.

The trend of declining Domains deferred days continues although the deferred revenue balance itself continues to grow. We remain unconcerned as this could be explained by signing shorter-term or lower-priced domain contracts which result in less cash received upfront. Also, bookings, which represent cash received upfront for contracts signed, continues to grow in the 11% range which bodes well for revenue recognition in upcoming quarters.

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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