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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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GoDaddy (GDDY) EQ Review

Current EQ Rating*	Previous EQ Rating
4-	na

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 initiate earnings quality coverage of GDDY at 4- (Acceptable)

GDDY is the world's largest registrar of internet domain names and associated services for website development, online marketing, and tools to manage online businesses. GDDY is somewhat unique in that it not only does not present a non-GAAP EPS figure, it never highlights any form of EPS in its presentations, conference calls or its outlook. Instead, it focuses investors' attention on "Unlevered Free Cash Flow" (uFCF) as the main metric to gauge performance and recently brought back a "Normalized EBITDA" metric to its fourth-quarter earnings presentation material. We see both pros and cons to uFCF which we will discuss below. Overall, we do not see huge warnings signs with the reliability of the company's reported results although there some items we believe investors should be aware of.

- GDDY touts its recent booking growth in the mid-teens range. However, customer growth in the most recent quarter was a much more modest 4%. The difference has been due to a 7-10% increase in average revenue per user (ARPU) courtesy of greater adoption of the company's hosting, marketing, and business tools add-ons. It is beyond the scope of this report to determine how long this can continue, but investors should be aware of the dependence on this trend.

- The company's domain contracts are typically one year in length. Cash is received upfront and the company recognizes the revenue evenly over the year. We do note that Domain deferred revenue days has been declining slightly. We are not concerned by this from a revenue recognition standpoint given the simplicity of the contracts, but this may be an indication of a deterioration in the pricing of new domain contracts. More concerning is the approximate 10-day decline in Business Application deferred days despite this being the fastest-growing segment in the company. We are not especially concerned at this point but we will monitor this going forward.

- GDDY focuses investor attention on "Unlevered Free Cash Flow" (uFCF) and essentially ignores earnings. While this metric does offer the benefits of minimizing any distortion of deferred revenue or expense recognition, we do see several drawbacks with it. First, it does not reflect stock-based compensation which provides an approximate 20% boost to the measure and understates the true cost to the firm. (Note that GDDY also adds back stock-based compensation to its "Normalized EBITDA" figure.) Interest expense is also ignored. Interest expense has been declining as the company paid off debt from a 2017 acquisition, but ignoring interest expense will become a problem if the company begins to take on more acquisitions or borrows to fund share repurchases. Adding back acquisition-related expenses is also currently not a major issue in our mind but this could change if the pace of large deals picks up. The measure is also subject to distortion through payables extension, and lumpy capex can complicate quarterly growth analysis.

- GDDY has tax liabilities (TRAs) relating to its pre-IPO ownership. The value of the liability is based on many estimates relating to future revenue, profits and tax situations. The value changes over time as the estimates change and such changes are reflected in profits. GDDY adds the impact of this back to its Normalized EBITDA figure. We are not concerned by this given the non-cash nature of the transaction.

Overview of the Business and Trends

GDDY manages the largest collection of internet domain with an estimated 22% of the worldwide number of domain names. When customers wish to lay claim to an internet domain name to set up a website, they can check with an internet registrar such as GDDY to see if the name is available. If so, the customer pays GDDY a subscription fee (typically annual). GDDY then pays a fee to the appropriate registry to gain access to the name. Domain fees account for about 45% of total revenues. GDDY also offers services in the area of website development and market as well as business applications that can be utilized to run web-based businesses. The Hosting and Service Segment accounts for about 35% of revenue while Business Applications accounts for a little over 15%. The following table shows the trend in revenue growth in each one of these categories:

	12/31/2019	9/30/2019	6/30/2019	3/31/2019	12/31/2018	9/30/2018	6/30/2018
Domains Revenue	$352	$345	$334	$320	$314	$310	$305
	12.1%	11.6%	9.7%	9.6%	11.6%	14.0%	15.8%
Hosting and Presence Revenue	$293	$285	$280	$269	$270	$263	$245
	8.4%	8.3%	14.4%	12.1%	18.0%	16.5%	13.8%
Business Applications Revenue	$135	$130	$123	$122	$112	$107	$102
	21.3%	21.9%	20.4%	19.5%	21.5%	25.9%	28.4%
Total Revenue	$780	$761	$737	$710	$696	$680	$652
	12.2%	11.9%	13.1%	12.1%	15.5%	16.7%	16.8%

This growth can be further broken down by looking at bookings (cash receipts collected from customers in the period) adjusted for refunds granted in the period, as well as the number of users and the average revenue per user (ARPU):

	12/31/2019	09/30/2019	06/30/2019	03/31/2019	12/31/2018	09/30/2018	06/30/2018
Total Bookings	$833.6	$851.0	$846.1	$870.5	$732.4	$741.8	$754.2
	13.8%	14.7%	12.2%	11.2%	11.3%	11.0%	13.0%
Total Customers at Period End	19,274	19,110	18,968	18,841	18,518	18,267	17,980
	4.1%	4.6%	5.5%	6.4%	6.8%	6.7%	6.5%
ARPU	$158	$155	$153	$150	$148	$145	$142
	6.8%	6.9%	7.7%	8.7%	6.5%	8.2%	10.1%

While total bookings tend to mirror the growth in total revenue, the customer count growth has trended down to a more modest mid-single-digit range with an aggressive rise in ARPU making up the difference. The higher ARPU is being driven largely by increased adoption of add-on hosting, marketing, and business application services.

The ability of the company to continue to boost ARPU is a key point for GDDY and a thorough examination of this issue is beyond the scope of this EQ Review. We do observe that the 2018 acquisition of Main Street Hub for $182 million, a social media and reputation company, was cited as a factor in the rise in ARPU in 2019. In addition, the company recently purchased Over as well as the registry businesses of Neustar and Uniregistry. Investors should be monitoring what the company is spending to obtain and develop the technology to provide incremental services to continue boosting ARPU.

Main Components of the Accounting

GDDY sells most of its services through subscription arrangements, most of which are on an annual basis and cash is received upfront. Revenue is deferred and recognized over time. GDDY discloses deferred revenue by segment so we can track deferred revenue days for each which is seen in the following table:

	12/31/2019	09/30/2019	06/30/2019	03/31/2019
Domains Revenue	$352	$345	$334	$320
Hosting and Presence Revenue	$293	$285	$280	$269
Business Applications Revenue	$135	$130	$123	$122
Domain Deferred Revenue	$1,135	$1,133	$1,130	$1,106
Hosting and Presence Deferred Revenue	$714	$718	$709	$695
Business Applications Deferred Revenue	$350	$346	$334	$322
Domain Deferred Revenue Days	*296.4*	*301.8*	*307.6*	*311.4*
Hosting and Presence Deferred Revenue Days	*224.3*	*231.6*	*230.7*	*232.5*
Business Applications Deferred Revenue Days	*238.0*	*244.4*	*247.0*	*238.7*

	12/31/2018	09/30/2018	06/30/2018	03/31/2018
Domains Revenue	$314	$310	$305	$292
Hosting and Presence Revenue	$270	$263	$245	$240
Business Applications Revenue	$112	$107	$102	$102
Domain Deferred Revenue	$1,052	$1,058	$1,056	$1,031
Hosting and Presence Deferred Revenue	$664	$675	$669	$659

Business Applications Deferred Revenue	$302	$297	$290	$278
Domain Deferred Revenue Days	*308.0*	*314.4*	*315.2*	*318.2*
Hosting and Presence Deferred Revenue Days	*226.2*	*236.0*	*248.7*	*247.3*
Business Applications Deferred Revenue Days	*248.8*	*255.5*	*258.0*	*246.1*

Domain deferred revenues days have been declining slightly for some time. Given the simplicity of the contracts involved with domains, we are not especially concerned that the company is becoming more aggressive in recognizing that revenue. Instead, we believe it may be a sign of deteriorating pricing as new lower-priced contracts result in smaller cash receipts being deferred in a given quarter compared to revenue that is still being recognized under higher-priced contracts.

Hosting and Presence Deferred Revenue days were declining, but the pace decelerated in the 12/19 quarter. The 7/18 acquisition of Main Street Hub was a likely cause of the distortion there.

The decline in Business Application deferred days is a little more of a concern. Given it is the fastest-growing area of the business, we would expect to see the addition of new contracts drive up the cash being deferred relative to revenue being recognized. This is an area on which to focus in upcoming quarters.

On the expense side, one of the main components of the cost of revenue are the licensing fees the GDDY pays domain registries. When a customer licenses the name from GDDY, it enters a mirroring contract to license the name from the registry. Similar to the revenue recognition method, GDDY capitalizes the license fee under the "Prepaid Domain Name Registry Fees" account on the balances sheet and amortizes the balance into the cost of revenue over the life of the contract. We can track the amortization rate by quarter and have seen no material concerns in recent quarters.

GDDY Focuses on Unlevered Free Cash Flow

GDDY is somewhat unique in that it not only does not present a non-GAAP EPS figure, it never highlights any form of EPS in its presentations, conference calls or its outlook. Instead, it focuses investors' attention on "Unlevered Free Cash Flow" and "Normalized EBITDA". In general, we view this as a positive from the standpoint of quality of reporting, but both of these measures still have their drawbacks and potential for distortion which we will discuss below:

Unlevered Free Cash Flow

GDDY's calculation of "Unlevered Free Cash Flow" (uFCF) is shown in the table below for the last three years:

Table 1

	2019	2018	2017
Net Cash Provided by Operating Activities	$723.4	$559.8	$475.6
Impact of Disc Ops		$23.8	-$3.5
Cash Paid for Interest	$80.3	$84.1	$80.8
Cash Paid for Acquisitions Related-Costs	$19.5	$32.2	$35.8
Capital Expenditures	-$87.6	-$87.7	-$83.2
Cash Paid for Indirect Taxes	-	$7.3	-$10.0
Unlevered Free Cash Flow	$735.6	$619.5	$495.5

GDDY describes uFCF as follows:

> *"Unlevered free cash flow is a measure of our liquidity used by management to evaluate our business prior to the impact of our capital structure and purchases of property and equipment, such as data center and infrastructure investments, that can be used by us for strategic opportunities and strengthening our balance sheet. However, given our debt obligations, unlevered free cash flow does not represent residual cash flow available for discretionary expenses."*

Like the traditional free cash flow calculation, uFCF starts with operating cash flow and takes out the full amount of capex shown on the cash flow statement rather than an estimated maintenance capex amount. However, to adjust for company-specific financing, it adds back cash paid for interest. It also adds back cash paid for acquisition-related costs. Note that this is not cash paid for acquisitions, but rather costs associated with consolidating previously-acquired operations. In addition, there are other periodic adjustments for one-time items which are typically not material.

The advantage of using uFCF is that it gets around many of the pitfalls of accrual accounting such as the deferral and recognition of revenue and expenses and potential manipulation of depreciation and amortization policies.

However, we see several problems with using uFCF as presented by the company:

1) uFCF ignores stock-based compensation

Since uFCF begins with operating cash flow and stock-based compensation is a non-cash expense, uFCF does not reflect the size or sudden increases to stock-based compensation. The following table shows stock-based compensation relative to uFCF for the last eight quarters:

Table 2

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Unlevered Free Cash Flow	$177.7	$191.3	$167.8	$198.8
growth	40.1%	8.9%	8.5%	22.4%
Equity Based Compensation	$40.8	$17.7	$41.6	$46.9
uFCF Adjusted for Equity Comp	$136.9	$173.6	$126.2	$151.9
growth	49.5%	19.7%	-0.2%	16.0%

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Unlevered Free Cash Flow	$126.8	$175.6	$154.7	$162.4
Equity Based Compensation	$35.2	$30.6	$28.2	$31.5
uFCF Adjusted for Equity Comp	$91.6	$145.0	$126.5	$130.9

Removing stock-based compensation boosts uFCF by well more than 20% in many periods. However, the company would likely have to pay employees cash if it didn't compensate with options and it does incur cash costs to buy back shares to counter dilution from option exercises. Thus, we believe it is unrealistic to completely ignore stock-based compensation when evaluating profitability and returns.

Also, stock-based compensation can fluctuate from period to period so investors must consider this when examining a particular quarter. For example, we see growth in uFCF benefitted by removing stock-based compensation in the 6/19 quarter due to a large increase, but the reverse was true in the 9/19 quarter.

2) uFCF Ignores Interest Expense

While GDDY proposes uFCF as a way to analyze results independent of financing decisions, the fact that the company focuses its guidance on this metric gives the impression of a more earnings-based measure. Investors should therefore remove the interest expense to get a clearer picture of the true underlying growth rate. Interest expense has been declining as the company has worked off debt from the $1.8 billion, 2017 acquisition of HEG, so this has been less of an issue. However, if the company begins to take on debt to fund future acquisitions and its recent return to buying back shares, this will become more of a problem.

3) uFCF Is Impacted by Working Capital Fluctuations

While a cash flow-based measure is not distorted by changes in accrual assumptions, it can be distorted by working capital fluctuations. GDDY's business model carries a low level of receivables and inventory. However, payables are large enough that extending the time to pay suppliers could conceivably impact growth in uFCF. The following table shows days payable for the last eight quarters:

Table 3

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Trade Accounts Payable	$72.3	$71.4	$82.9	$99.5
Cost of Revenue	$270.8	$265.0	$254.6	$236.4
	24.6	24.8	29.6	37.9

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Trade Accounts Payable	$61.6	$45.7	$51.9	$57.9
Cost of Revenue	$230.4	$226.9	$221.3	$215.3
	24.6	18.5	21.3	24.2

While payable days were roughly flat in the 12/19 quarter, they were increasing on a year-over-year basis in the prior quarters. Using the 6/19 quarter as an example, if payables had increased in line with cost of revenue, they would have been roughly $23 million lower than reported which would have reduced operating cash flow by a like amount. However, uFCF only increased by $13.1 million in the 6/19 quarter implying a decline without the boost from higher payables.

We don't see evidence that GDDY is purposefully manipulating working capital to confuse investors. However, we believe many investors typically underutilize working capital analysis to determine a company's real level of a cash flow generation. While working capital metrics are always important, they become even more necessary in the case of GDDY where uFCF is utilized as a hurdle by which performance is being measured.

Capex Can Also Be Lumpy

A more obvious impact on quarterly uFCF is the company's level of capital spending. We see in table1 that capital spending has been relatively constant when viewed on a trailing 12-month basis. However, we can see below that on a quarterly basis, it can understandably be more volatile:

Table 4

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Net Cash Provided by Operating Activities	$162.2	$200.2	$161.3	$199.7
Impact of Disc Ops	$0.0	$0.0	$0.0	$0.0
Cash Paid for Interest	$26.9	$13.6	$18.4	$21.4
Cash Paid for Acquisitions and Costs	$5.1	$2.7	$4.6	$7.1
Capital Expenditures	**$16.5**	**$25.2**	**$16.5**	**$29.4**
Cash Paid for Indirect Taxes				
Unlevered Free Cash Flow	$177.7	$191.3	$167.8	$198.8

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Net Cash Provided by Operating Activities	$128.5	$154.0	$128.9	$148.4
Impact of Disc Ops	$0.0	$2.4	$21.4	$0.0
Cash Paid for Interest	$22.3	$21.3	$20.0	$20.5
Cash Paid for Acquisitions and Costs	$12.9	$5.5	$4.2	$9.6
Capital Expenditures	**$38.2**	**$13.6**	**$19.8**	**$16.1**
Cash Paid for Indirect Taxes	$1.3	$6.0		
Unlevered Free Cash Flow	$126.8	$175.6	$154.7	$162.4

Such volatility is exactly the reason for accrual accounting smooths the impact of capital spending over time through capitalization and depreciation. While these quarterly fluctuations are not to be viewed as management manipulation, investors must be careful to consider their impact when evaluation quarterly growth in uFCF.

As a side note, it is worth noting that before the COVID outbreak, the company was forecasting uFCF of $835 million which is a 13.5% growth rate versus 2019. However, 2020 contains an unusual extra pay period which will negatively impact operating cash flow. Adjusting for this, the forecasted growth rate was 16%.

Normalized EBITDA

Starting in its 12/19 quarterly investor presentation, GDDY began disclosing a new metric, "Normalized EBITDA", which it defines as follows:

> *"Normalized EBITDA is a supplemental measure of our operating performance used by management to evaluate our business. We believe that the inclusion or exclusion of certain recurring and non-recurring items is necessary to provide the most accurate measure of core operating results and permits period-over-period comparisons of our operations. We calculate Normalized EBITDA as net income excluding depreciation and amortization, interest expense (net), provision or benefit for income taxes and TRA adjustments, equity based compensation expense, acquisition-related costs and certain other certain items."*

The breakdown of Normalized EBITDA is shown below:

	12/31/2019	9/30/2019	6/30/2019	3/31/2019
Net Income	$61.1	$76.8	-$12.7	$13.2
Interest, Net	$17.6	$17.1	$16.6	$18.6
Benefit for Income Taxes and TRA Adjustments	-$4.6	-$2.7	-$0.8	-$12.6
Depreciation and Amortization	$48.8	$49.9	$53.8	$57.2
Equity Based Compensation	$40.8	$17.7	$41.6	$46.9
Acquisition Costs	$2.7	$1.5	$2.6	$2.6
Accrual for Legal Settlement	$0.0	$0.0	$18.1	$0.0
Debt Refinance Expense	$0.3	$0.0	$14.5	$0.0
Normalized EBITDA	$166.7	$160.3	$133.7	$125.9

	12/31/2018	9/30/2018	6/30/2018	3/31/2018
Net Income	$43.5	$14.1	$20.2	$4.2
Interest, Net	$20.4	$21.4	$22.1	$21.9
Benefit for Income Taxes and TRA Adjustments	-$21.6	-$0.9	-$1.2	-$0.2

Depreciation and Amortization	$58.0	$61.3	$57.0	$57.8
Equity Based Compensation	$35.2	$30.6	$28.2	$31.5
Acquisition Costs	$7.0	$9.2	$10.2	$6.3
Accrual for Legal Settlement	$0.0	$0.0	$0.0	$0.0
Debt Refinance Expense	$0.0	$0.0	$0.0	$0.0
Normalized EBITDA	$142.5	$135.7	$136.5	$121.5

We will discuss the TRA adjustments in a later section but we believe it is appropriate to neutralize their impact when analyzing core growth rates. Likewise, we do not have a problem with adding back acquisition-related costs given that ongoing acquisitions are currently not an especially material part of the company's growth strategy.

However, like uFCF discussed above, the company's definition of Normalized EBITDA ignores the impact of stock-based compensation which is a material amount.

Tax Receivable Liability Adjustment (TRAs)

GDDY went public in 2015 when Desert Newco LLC, the owner of essentially all of GDDY's assets, exchanged LLC Units for Class A common shares of the new GDDY. This produced favorable future tax benefits for GDDY of which GDDY must pay 85% to the pre-IPO owners. The ultimate liability related to future amounts GDDY will be required to pay is a product of many estimates regarding the future sales, profitability and tax status of the company. The value of the liability changes over time with updates to the adjustments and changes are reflected in the income statement. Given this is a non-cash transaction, it does not impact the company's uFCF calculation. However, it does impact earnings and hence the calculation of EBITDA. However, GDDY removes the impact from its Normalized EBITDA non-GAAP figure. Given the non-cash nature of the transaction, we do not object to this adjustment.

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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