BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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# IHS Markit Ltd (INFO) 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 INFO with a 4+ (Acceptable) rating.**

INFO provides software and information analytics for large companies and governments as well as creating benchmark indices. 85% of revenue is recurring. The company has about 6% organic growth with another 5% from acquisitions. Leveraging fixed costs allows margins to expand as well, and margins are rising 100-200bp annually to further bolster the growth rate.

The operating model is self-funding. Unless an acquisition is unusually large, it is also self-funding for current operations and acquisitions. INFO is initiating a dividend in 2020 of $0.17 per quarter and the cash flow easily supports that too. We take that as a positive sign as well.

Our primary concerns focus on the acquisition accounting. It uses longer amortization lives on some assets which boosts earnings. Also, adjusted figures for EPS and EBITDA are adding back the acquisition costs along with stock compensation which we believe is inflating results as many of those items require

cash outlays and are recurring. Reported EPS for 2019 was $1.23 vs. adjusted EPS of $2.63. We will focus on the adjusted EPS of $2.63 for much of this report when we discuss EPS impacts:

- **The business is self-funding and does not rely on stock compensation to make it free cash flow positive. Nor, does it require working capital to produce cash flow.** It even covers the cost of acquisitions out of free cash flow in most years We consider that a positive for a company that often makes deals.

- **INFO is starting to pay a dividend and return more capital to shareholders. Its current cash flow situation can easily cover the dividend and still allow for share repurchases or acquisitions.**

- **The only working capital situation that may be a negative is deferred revenue DSOs are declining as receivable DSO are rising. The spread between the two has shrunk from a $100 million source of cash to one that turned negative in the 4Q19.**

- **Tax volatility may be ending after the US tax code changes and adjustments last year.** Reported tax rates for INFO were understated in 2018 and overstated in 2019. This also exacerbated the spread between GAAP EPS and adjusted EPS by $0.37 last year.

- **Taxes pose a minor risk still due to jurisdiction.** INFO reports as a UK company with a large US presence. It seems to pass the basic tests for this and Ernst & Young agrees. We believe with the US rate now at 21% and UK at 19%, this poses a smaller potential problem. The company was only formed for 17 months before the US tax code changed. **We estimate the total risk here to be under $0.15 in EPS and consider the risk minimal.**

- **Acquisitions are still viewed as eternal lived assets compared to those built in-house. The bulk of assets at INFO are acquired intangibles. Goodwill is not expensed at all, while other intangibles are being amortized over 11-12 years vs. immediately or over 3-7 years for internally built assets.** Doubling the amortization would cut GAAP EPS by $0.92.

- **ROI is rising here but is not that high. Because INFO has profits it has a large equity balance and some debt. Using reported operating income, which may**

**be too low and the company's adjusted EBITDA, which we consider too high – the range of ROI is 7.3%-13.2%.** That's not a very high return to earn against valuing intangible tech assets as though they will last forever.

- **Adjusted results are adding back stock option expense. This is an on-going item and the company is spending real cash to buy back shares to limit dilution. In 2019, Adjusted EPS of $2.63 was boosted by $0.44 from adding back stock option expense.** INFO also boosted Adjusted EBITDA by 14% doing this.

- **Adjusted Results are adding back every bit of acquisition cost. That means the on-going amortization of intangibles, the transaction costs, incentive pay, and integration costs.** They are spending cash on acquisitions and integration. It is part of the on-going operating model. We find it aggressive to view a 5% organic growth company as a 10% grower with acquisitions but remove every trace of cost for the acquisitions. **Adjusted EPS is gaining $0.92 from adding back amortization and we estimate another $0.17 from adding back ongoing costs.**

- Capitalized Software is the largest part of PP&E. INFO uses a 3-7 year life to expense that asset which is longer than other companies we have reviewed. **The company is not underinvesting in new PP&E – but it may be understating the expense. We estimate Adjusted EPS is being helped by 5-9 cents here. It may also have added 2-cents last year from cutting A/R reserves.**

## Basic Cash Flow Set Up Works

Many times, when we see tech-related companies, especially those making acquisitions to further growth, the cash flow does not fully support the basic operating model. In the case of INFO, internally generated cash covers capital spending, most acquisitions and its new dividend of $0.17/quarter which will be $267 million per year:

| | 2019 | 2018 | 2017 |
|---|---|---|---|
| Cash from Ops | $1,251.3 | $1,289.5 | $961.5 |
| Cap-Ex | $278.1 | $222.7 | $260.2 |
| Free Cash Flow | $973.2 | $1,066.8 | $701.3 |
| Acquisitions | $136.5 | $1,876.2 | $401.1 |
| Adj. Free Cash Flow | $836.7 | -$809.4 | $300.2 |

The more sizeable Ipreo deal in 2018 was larger than others and the company is likely to complete more acquisitions in the future. Also, INFO is not dependent on stock compensation or rising deferred revenue to make the cash flow work like many other tech companies. Looking at the components of cash from operations, INFO's are solid too:

| | 2019 | 2018 | 2017 |
|---|---|---|---|
| Net Income +/- Gains/Losses | $384.1 | $539.2 | $417.0 |
| Deprec/Amort. | $573.1 | $541.2 | $492.5 |
| Change in Def. Tax | -$49.6 | -$211.7 | -$100.1 |
| Basic Cash from Ops | $907.6 | $868.7 | $809.4 |
| Stock Comp. | $223.8 | $241.7 | $261.9 |
| Chg. In Assets/Liab. | $118.7 | $188.1 | -$116.2 |
| Reported CFO | $1,251.3 | $1,289.5 | $961.5 |

Stock compensation and working capital are providing some cash flow to be sure. But even stripping those out, INFO has about $900 million in cash flow with under $300 million in capital spending and just under $270 million in a new dividend. It still has over $300 million per year to make acquisitions too.

**The company's goal is to return between 50%-75% of annual capital to shareholders via dividends and stock repurchases and the rest on acquisitions.** With total free cash flow in the range of $1 billion (adding in the cash flow from stock compensation and working capital less capital spending), paying $270 million in dividends and $830 million split between acquisitions and repurchases looks doable. **There is one minor concern here – debt is currently 2.8x adjusted EBITDA. INFO will borrow money to make a larger acquisition, but it wants to stay at the higher end of a range of 2.0-3.0x on its debt. It's already there.** Thus, we believe share repurchases could be lumpy as that is where the final amount of free cash flow appears will be allocated. Cash flow may also be directed toward debt retirement should the company make a large acquisition that requires more borrowing upfront.

We are going to give INFO high marks for this basic model that is self-funding. Many companies are addicted to accelerating growth to keep the cash flow coming in via increasing stock compensation and rising liabilities. INFO is actually seeing stock compensation fall as a component of cash flow.

Also, the tax situation has been the largest moving part for income of late. In 2017 and 2018, income taxes were a benefit to earnings with tax reform and in 2019, the company had a $150 million retroactive expense. That is why the net income and deferred tax situation moved so much. There are some other tax issues that pose risks we will discuss below.

INFO is planning to annuitize its pension plans. The shortfall was only $25 million between assets and obligations. We do not see this plan creating a cash flow issue in 2020. Finally, its purchase of aM in 2017 allowed the owners to retain a minority equity stake. INFO expects to cash them out completely by 2022 at a cost of $70-$75 million.

## Working Capital Does Not Have Many Material Components - Falling Deferred Revenues a Minor Concern

There is no inventory at INFO and items like deferred subscription costs are amortized over the subscription period which is normally one-year or less. Those are under 2% of sales. Other current assets include deferred commissions amortized over the life of the contract and derivatives largely for FX hedging. Those are under 2.5% of sales. Those are minor and are conservatively addressed in our view.

That really only leaves Accounts Receivable and Deferred Revenues as the primary components of working capital. In general, these accounts peak in 1Q with Deferred Revenues declining through the year while Receivables start to rise again in 4Q. So, the cash flow is actually front-loaded to start the year, which should also help INFO forecast its cash needs.

| 2019 | 4Q | 3Q | 2Q | 1Q |
|---|---|---|---|---|
| Sales | $1,120.4 | $1,112.3 | $1,135.5 | $1,046.4 |
| A/R | $890.7 | $862.7 | $854.0 | $980.4 |
| Def. Rev. | $879.7 | $896.5 | $938.7 | $1,026.3 |
| A/R DSOs | 72.5 | 70.8 | 68.6 | 85.5 |
| Def. Rev. DSOs | 71.7 | 73.6 | 75.4 | 89.5 |

| 2018 | 4Q | 3Q | 2Q | 1Q |
|---|---|---|---|---|
| Sales | $1,067.8 | $1,001.0 | $1,008.3 | $932.1 |
| A/R | $792.9 | $760.6 | $704.2 | $802.7 |
| Def. Rev. | $886.8 | $897.0 | $872.0 | $919.3 |
| A/R DSOs | 67.8 | 69.3 | 63.7 | 78.6 |
| Def. Rev. DSOs | 75.8 | 81.8 | 78.9 | 90.0 |

| 2017 | 4Q | 3Q | 2Q | 1Q |
|---|---|---|---|---|
| Sales | $944.7 | $904.7 | $906.1 | $844.2 |
| A/R | $693.5 | $655.5 | $669.7 | $668.8 |
| Def. Rev. | $790.8 | $814.1 | $869.4 | $906.9 |
| A/R DSOs | 67.0 | 66.1 | 67.4 | 72.3 |
| Def. Rev. DSOs | 76.4 | 82.1 | 87.6 | 98.0 |

The one concern we have is Receivables DSOs have generally been increasing slightly while Deferred Revenue DSOs are declining. In fact, receivables exceeded deferred revenues in 4Q19. This source of cash flow may be gone. When revenues were $900-$950 million and Deferred revenues exceeded receivables by 10-12 days – it produced $100-$120 million in cash for INFO. At -1 to 3 days now it's consuming $10 million or only producing $30 million.

## Tax Volatility May Be Over

The tax rate has been volatile at INFO for the last few years. This has been tied to the both the US tax rate change in 2017 impacting deferred taxes and then final provisions in 2019 being applied retroactively to 2018:

| Taxes | 2019 | 2018 | 2017 |
|---|---|---|---|
| UK Statutory Rate | $141.1 | $80.6 | $71.9 |
| Foreign tax Diff | -$53.8 | -$38.9 | -$45.5 |
| Stk Comp Shield | -$43.7 | -$39.2 | -$61.2 |
| Tax Law Chg. | $179.6 | -$178.3 | $1.2 |
| * Total Taxes | $242.6 | -$115.4 | -$49.9 |
| Effective Rate | 32.7% | -27.2% | -13.4% |

• Total Taxes include some additional valuation allowances and costs not listed here.

For what happened, in 2018 and 2019 – INFO gave the following explanation:

> *"Our effective tax rate for continuing operations for the year ended November 30, 2019 was 32.7 percent, compared to negative 27.2 percent in 2018 and negative 13.4 percent in 2017. The increase in our tax rate for 2019, compared to 2018, is primarily due to net tax expense associated with U.S. Treasury regulations retroactive to 2018 of approximately $150 million. The reduction in our tax rate for 2018, compared to 2017, is primarily due to net tax benefits associated with U.S. tax reform of $141 million."*

Making these adjustments of lowering 2019 by $150 million and raising 2018 by $141 million, makes the effective tax rate in 2019 into 12.4%. That is much more in-line for guidance in 2020 of 14%-16% for the GAAP tax rate. GAAP EPS in 2019 would have been $0.37 higher without this tax transition. The GAAP and Adjusted tax rate are more in line for 2020 with the adjusted rate only 400bp apart at 18%-20%.

Also, it is worth pointing out that INFO has potential tax risks by being based in Bermuda, operating in the UK, and having a large operation in the US including listing on the NYSE – but it splits its tax exposure. There are two potential risks: 1) does the US argue that this is a US company and should be fully taxed in the US? 2) does INFO get investigated on transaction splitting where it may record higher costs and lower income in the higher tax areas.

The company addresses these risks in a couple of areas:

- If the US shareholders after the merger into a foreign company still control 80% or more of the shares – the US could treat it as a US company for taxation under section 7874. INFO believes that US shareholders prior to the merger own less than 60% of the total company.

- Also, intercompany transactions and income that is broken down by geography can be audited and subject to more review by the government.

- Ernst & Young also addressed the complexity of the tax structure and the number of assumptions used to determine the tax bill.

In general, we believe the size of this risk is diminished because the UK's tax rate is 19% and the US is now 21%. If any transaction needs to be adjusted regarding 2019 or 2018, it's only a 2% difference in tax rates. As a combined company, INFO was formed in July 2016. So, when the tax differential 19% vs. 35%, the potential problem should have a review of only about 18 months.

If we look at the taxable income figure for 2017 and adjust for the full tax differential – the maximum exposure may be under $60 million or about $0.15 per share. We are going to rate this as a very modest risk that would likely have a minor impact.

## Acquisitions Are Being Given Eternal Life and that Helps Results, but ROI Still Isn't Too High

We see several positives for INFO's acquisition program. It has organic growth and some margin expansion without it:

| | 2019 | 2018 |
|---|---|---|
| Organic Growth | 6% | 6% |
| Total Growth | 10% | 11% |
| Operating Cost % | 65% | 67% |

It can pay for it with its own operating cash flow as shown above in the cash flow section. It also makes money and reasonable ROI calculations can be made because there is the balance sheet that doesn't have a multi-billion negative equity balance. Here is a range for ROI using operating income before one-time items and the company's adjusted EBITDA – which we think is inflated and will explore more below:

| | 2019 | 2018 |
|---|---|---|
| Net Debt | $5,014 | $5,559 |
| Equity | $8,416 | $8,020 |
| Total Capital | $13,430 | $13,579 |
| Op. Income | $987 | $780 |
| ROI Op Inc. | 7.3% | 5.7% |
| Adj. EBITDA | $1,779 | $1,565 |
| ROI Adj. EBITDA | 13.2% | 11.5% |

Where we have some issues is the size of the intangible assets and the amortization lives. Noncurrent assets are nearly $15 billion and PP&E is only $658 million of that. Intangibles are $14 billion. Clearly, the bulk of costs at INFO are wages, which are being expensed as incurred. Only some sales commissions are being amortized over the life of the contract and that was GAAP changing the policy – INFO used to expense that as incurred.

However, look at the time frame these assets are amortized vs. the rest of the assets:

| Acquired Assets | Lives | Built Assets | Lives |
|---|---|---|---|
| Goodwill | infinite | Buildings | 7-30 years |
| Info Database | 5-15 years | Cap. Software | 3-7 years |
| Customer Lists | 5-25 years | Computers/EQ | 3-10 years |
| Dev. Software | 9-10 years | | |
| Dev. Tech | 5-15 years | | |
| Trademarks | 3-15 years | | |

Software built by INFO is getting amortized over 3-7 years, but purchased software has a 9-10 year life? Goodwill has no amortization and the other assets all last longer than assets built in house or worked on by internal employees?

Also, INFO is allocating the bulk of these acquired assets to goodwill and they are not amortizing them at all. How many assets, products, or ideas does INFO work with that last forever?

| Acquisitions | 2019 | 2018 | 2017 |
|---|---|---|---|
| Purchase Price | $143.5 | $1,877.1 | $444.1 |
| Goodwill | $96.0 | $1,184.9 | $363.0 |
| Intangibles | $61.5 | $745.3 | $113.8 |
| Goodwill % | 66.9% | 63.1% | 81.7% |
| Intangibles % | 42.9% | 39.7% | 25.6% |

The amortization expense only applies to the intangibles at just over $4 billion while the nearly $10 billion in goodwill is not being expensed at all. By our estimates, these intangibles are being amortized over 11-12 years. You can ignore goodwill and just double the rest of amortization and that would still be an aggressive treatment. That would cut operating income by a fair amount as well as ROI:

| | 2019 | 2018 |
|---|---|---|
| Net Debt | $5,014 | $5,559 |
| Equity | $8,416 | $8,020 |
| Total Capital | $13,430 | $13,579 |
| Op. Income | $987 | $780 |
| Extra Amortization | $377 | $366 |
| Lower Op. Inc. | $610 | $414 |
| Lower Op. Inc. ROI | 4.5% | 3.0% |

Goodwill and other intangibles are being tested against cash flow generation and hurdle rates. They also are viewed against the stock price for impairment. Where this stands right now, the normally defined ROI is low in our opinion but increasing. Even under INFO's adjusted EBITDA measure – ROI isn't that strong, but a 13% figure is unlikely to trigger an impairment. The stock price is double than when many of these intangibles were created and that lowers the risk of an impairment. Overall, we think investors should be aware that a large part of EPS is the result of aggressive amortization schedules. Reported EPS of $1.23 is based on net income of $503 million. If amortization of only $4 billion of the $14 billion in intangibles was 6 years instead of 12, EPS would fall to $0.31 on income of $126 million. That should illustrate how much earnings depend on assumptions for such large assets.

## Adjusted Results Are Ignoring the Ongoing Costs of Stock Compensation and Cost of Acquisitions

We understand that there are actual one-time items like a gain or loss or a one-time insurance settlement. However, we do not consider expenses that occur every year as part of the operating model to be something to ignore. Stock options fit that bill at INFO in our view.

| | 2019 | 2018 |
|---|---|---|
| Stock Comp | $223.8 | $241.7 |
| Tax Shield | -$43.7 | -$39.2 |
| Net Stock Comp/Shr | $0.44 | $0.50 |
| GAAP EPS | $1.23 | $1.33 |
| Adj. EPS | $2.63 | $2.29 |

In the last two years, INFO has paid over $200 million in stock compensation which comes with a tax shield as well. Because it does not directly consume cash, it is added back on the cash flow statement. INFO along with many other companies is adding it back to earnings. The first problem if it's not a real expense – try not paying it to employees. That somehow never works. The second problem is there is good evidence on the cash flow statement that the stock options consume cash. In 2018, INFO spent $672 million and in 2019 $500 million to repurchase stock to limit dilution of shares. Even with that, the share count rose from 2018 to 2019.

In our view, this should not be added back to either EPS where it inflated adjusted EPS by $0.44 last year or to adjusted EBITDA where it rose by $233.8 million or 14%.

Both figures also add back every bit of the cost related to the acquisitions as well. The goodwill is already not being expensed and the intangibles are being expensed over a much longer time than other asset lives at the company would justify. That is getting to GAAP EPS. Then INFO adds back the amortization of the intangibles, restructuring charges, acquisition-related costs, acquisition-related performance compensation and financing fees. These are not one-time costs. The company very clearly lays out its view that acquisitions are part of its operating model and they also influence the degree to which cash is returned to shareholders. We still give the company credit for being able to fund the acquisitions with internal cash flow – but it is tough to say that a big upfront cash outlay isn't a cash expense.

We know the amortization of the intangibles is $377 million or $0.92 in EPS. We will estimate that the rest of the acquisition-related charges at a 20% tax shield so $87.6 million becomes $70.1 million or $0.17 in EPS for 2019.

On adjusted EPS of $2.63 – we estimate that adding back stock compensation, amortization of intangibles, and acquisition-related charges contributed $1.53 to that total. That does not even factor in that the amortization period seems too long as described above.

On adjusted EBITDA and normal EBITDA – the $377 million in amortization would be added back for both. But, of the adjusted EBITDA of $1,779 million it also added back $311 million of stock compensation and acquisition charges. It would come in at $1,468 million and the company's ROI under that level would be 10.9% instead of 13.2%. Moreover, Debt/EBITDA would already exceed the company's target range at 3.4x.

What this comes down to is without acquisitions, INFO has 5-6% growth. However, it is being viewed as a 10-11% growth story with them. But, it's tough to make the case that the 10-11% growth should be viewed without any of the additional costs.

## Depreciation and Reserves Giving Some Minor Increases to EPS

The bulk of the fixed assets at INFO are capitalized software. They are expensing them over 3-7 years. That is longer than many other firms we see. Anecdotally from our reviews, most companies are closer to 3 years with some being 2-3 and others at 3-5 years.

| PP&E | 2019 | 2018 | Lives |
|---|---|---|---|
| Buildings | $181.1 | $208.0 | 7-30 years |
| Cap. Software | $1,019.5 | $822.2 | 3-7 years |
| Computers/Equip. | $378.4 | $334.0 | 3-10 years |
| Gross PP&E | $1,579.0 | $1,364.2 | |
| Net PP&E | $658.2 | $579.6 | |

It looks clear to us that the bulk of the capital spending is going to software. Plus, the computers life span at 3-10 years is likely impacted by other equipment that lasts beyond 8 years. Total depreciation in 2019 was $196 million. If we look at net PP&E from 2018 and divide that by 3 ($580/3 = $193) and the $278 million in capital spending only had a half year's depreciation and we divide by 6 ($278/6 = $46). Depreciation should be closer to $239 million. Instead at $196 million, it looks to be above 4-years.

This may be overly picky because INFO is clearly reinvesting in the business. It is not using older equipment as capital spending is considerably higher than depreciation:

| | 2019 | 2018 | 2017 |
|---|---|---|---|
| Deprecation | $196.1 | $175.1 | $157.0 |
| Capital Spend | $278.1 | $222.7 | $260.2 |

However, if it is using slower depreciation, it is adding to EPS and adjusted EPS because INFO does not add back depreciation in the adjusted figure. Using an effective adjusted tax rate of 18%, there may be as much as 5-9 cents of EPS coming in this area.

We also noticed that the company cut its reserve for receivables to $25.6 million from $30.4 despite an increase in the total receivables last year. In 2019, the company wrote off more reserves than normal. If they had kept the reserve level at the same percentage, bad debt expense would have been $8.2 million higher. This added 2-cents to both EPS and adjusted EPS.

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# Explanation of EQ Rating Scale

| Rating | Description |
|---|---|
| 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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