BEHIND THE NUMBERS
Quality of Earnings Analysis
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DocuSign, Inc. (DOCU) Earnings Quality Review

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

We initiate earnings quality coverage of DOCU at 4+ (Acceptable).

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

Summary

DocuSign has been a rapidly growing company that received an even greater boost in growth from COVID and more paperwork moving away from face-to-face and more digital with signatures and even notaries. The company handily beat forecasts the last four quarters – by 16-cents, 15-cents, 9-cents, and 9-cents. The Non-GAAP adjustments are not outrageous (primarily adding back stock compensation and acquired intangible amortization) and are actually more tame than we see from other tech companies. In 1Q, Non-GAAP subtracted 2.5 cents from EPS to remove an increase in valuation for strategic investments, and in 4Q, Non-GAAP added back 4.5 cents for the tax bill of a transfer of intellectual property to a foreign unit. So, the beat on Non-GAAP results looks solid. In some ways, the Non-GAAP figures are more conservative than GAAP because Non-GAAP uses a higher number of shares.

DocuSign is also self-funding on free cash flow. Our biggest issue with the company is dilution from huge share issues as wages and convertible notes that have been very expensive to repay given the value of the stock. Also, do employees require more cash pay after the run in the stock price? That could put pressure on Non-GAAP margins and EPS which add back stock compensation as a non-cash expense.

What is strong?

- Revenues are listed as a critical audit matter as management has to determine if a contract exists and if there are additional obligations remaining under ASC 606. We actually see little reason for concern. 95% of revenues come from subscriptions by clients to use the software. DOCU is paid in advance (typically one year upfront), the revenue is recognized over the contract term, and the company has the payment already in cash. Plus, by looking at billings and contract renewals – DOCU has a good roadmap to predict future revenues. Renewals should also make it easy to categorize the revenue. The remaining 5% of revenues commonly involves training and installation issues contracted for by the client.

- Free cash flow is a straightforward, very common definition for DOCU. It is also a positive figure. The metric used by DOCU is cash from operations less capital spending. Management does not add back restructuring or integration charges or asset sales. It makes acquisitions and other strategic investments that consume cash – but these have been manageable in size. It is important to note that free cash flow is penalized by working capital and paying commissions on new business – even though earnings are helped by capitalizing the cost and amortizing over time – there is still a net drain on FCF.

- Non-GAAP EPS actually uses a more realistic share count than GAAP. In a somewhat odd situation, DOCU has a significant amount of stock compensation which effectively causes GAAP income to be negative. (There are other issues at work such as amortization of acquired intangibles and amortization of debt discount too). But, there are effectively millions of shares represented by RSUs, options, and convertibles that are in the money, which GAAP excludes because they would cause GAAP EPS to improve by reducing the loss per share.

What is weak?

- Like many tech companies, share compensation is high. But, DOCU almost looks like it was founded to create share dilution. The large net losses under GAAP are largely due to high levels of stock compensation. DOCU lost $243 million last year and paid $321 million in stock compensation. In 1Q, the $8.4 million loss was heavily caused by stock compensation of $97.4 million. On top of that, DOCU allows employees to buy stock at a discount and issues convertible debt. The question going forward is can it keep employees happy with new stock options with strike prices > $300 per share vs. < $15?

- Many of the options, bonds, and RSUs are in the money and DOCU's share count should be rising even faster. However, because the company is reporting net losses, these

unexercised options are anti-dilutive, meaning putting more shares in the denominator would actually improve GAAP EPS by making the loss per share go down. If the company does earn a GAAP profit soon, the share count should rise noticeably. As noted above, Non-GAAP share count already recognizes these share equivalents.

- Non-GAAP earnings do add back amortization of acquired intangibles. However, the total amount of intangibles is relatively small (less than PP&E and less than even leased assets). This only added back 3-cents to Non-GAAP EPS to each of the last two quarters when the company reported 37-cents and 44-cents. The amortization period is also very quick and comparable to PP&E. Computers/Equipment are depreciated over 3-years, software at 3-5 years. Amortization of acquired tech is over 3-5 years, customer relationships over 5-10 years, and other over 1-5 years. Thus, the amortization amount should shrink fairly quickly and make an even smaller contribution to Non-GAAP EPS.

- Goodwill is not amortized at all which helps EPS too. There is more allocation to goodwill on deals than other intangibles. Even if it was being amortized over 40 years, goodwill would only be helping Non-GAAP EPS by 1-cent per quarter.

- DOCU capitalizes the commissions paid to internal salespeople and amortizes the cost over five years. That is longer than the average contract, but DOCU believes it will keep the business past the first contract. However, it amortizes third-party costs over the length of the contract and internal commissions on renewals are amortized over only two years. It does not break out the renewals from the initial capitalized costs. Last quarter, the amortization expense was approximately 10-quarters of the gross amount. One quarter shorter would have cost DOCU only 2-cents in quarterly EPS. That is fairly minor and the other amortization assumptions look fine. When renewals become a larger part of the business, that should bring down the blended amortization life too.

What to Watch?

- There is much inertia in the operating model. When it is growing by adding new clients and expanding penetration at existing clients, the 1-3 year contracts make revenues and cash flows grow, with billings exceeding revenues. If growth turns negative, it should show up in billings first. It is likely that revenues could still continue to rise for several quarters before the lower billings have a negative impact on results.

- In recent quarters, DOCU is firing on all cylinders. It has been getting renewals, existing customers adding more users and services to their contracts, and finding new

customers. Growth was explosive during COVID. Thus far, this trend is continuing. Tracking billing should give clues as to how strong it remains going forward.

- Operating costs are leveraging with the higher revenue growth. Non-GAAP operating margin was 5% in fiscal 2020. It rose to 12% last year and is forecast to be 16%-18% this year. This looks doable given first-quarter results and still assumes a significant increase in dollars spent on overhead costs of 32%. Given the forward picture the billings vs. revenue situation lays out, DOCU should have insight into whether its overhead spending is rising too fast to too slow as well.

Supporting Details

Billings and Revenues Show Growth and Produce Cash

DOCU bills clients a year in advance for using its software services. This results in cash coming in the door up front and the company sets up a deferred revenue account called Contract Liabilities. It then converts that account into revenues through the year. We think this gives DOCU a strong insight into forecasting its revenue. Cash at $519 million gives the company significant liquidity.

DOCU also reports a Non-GAAP metric for billings which adds the net change in Contract Liabilities and Receivables over the same period as revenues to the revenue figure. If the resulting billings figure is higher than revenues, it indicates the company is still growing.

Revenue vs Billings	1Q22	1Q21	2021	2020	2019
GAAP Revenue	$469.1	$297.0	$1,453.0	$974.0	$701.0
+ Contr Liab. End period	$858.0	$568.5	$800.9	$522.2	$390.9
- Contr Liab. Beg period	-$800.9	-$522.2	-$522.2	-$390.9	-$282.9
+ A/R End Period	$21.0	$15.1	$15.1	$13.4	$16.9
- A/R Beg period	-$19.7	-$16.4	-$21.0	-$15.1	-$13.3
Acquisitions Net	$0.0	$0.0	-$2.8	$0.0	-$11.0
Non-GAAP Billings	$527.4	$342.1	$1,723.1	$1,103.6	$801.4

During 2021 and COVID, the rate of growth accelerated with Billings becoming 119% of Revenues vs. 113% in fiscal 2020. Current guidance has this contining to grow in both dollar terms and faster than fiscal 2020:

	22 Hi est	22 Lo est	2021	2020	2019
GAAP Revenue	$2,039.0	$2,027.0	$1,453.0	$974.0	$701.0
Non-GAAP Billings	$2,362.0	$2,338.0	$1,723.1	$1,103.6	$801.4
Ratio of Growth	115.8%	115.3%	118.6%	113.3%	114.3%
Dollar Growth	$323.0	$311.0	$270.1	$129.6	$100.4

There was clearly an acceleration with COVID. However, DOCU is reporting that it is seeing growth continue as it signs up new clients and also from existing clients expanding their usage of DOCU services in both usage per employee and the number of employees with DOCU tools available.

Dollar growth in billings of $41-53 million y/y is definitely a slower rate of growth than 2021. However, it is still positive after a huge year. They also raised the billing forecast for fiscal 2022 by $80 million from 4Q21 to 1Q22. Given where the stock trades in terms of valuation, DOCU may need to see growth accelerate even more. This should be the area to track to monitor that.

In addition, Non-GAAP gross margin (without stock compensation and amortization of acquired intangibles) is already 80% and that is forecast to remain that high. However, DOCU's higher revenue growth is beginning to leverage operating costs. Non-GAAP operating margin was 12%, up from 5% in fiscal 2021 vs. fiscal 2020. Even with some travel expenses returning in 2022, the company is forecasting 16%-18% for operating margin. That is all expected to come from operating leverage with costs falling from 67% of sales to 63%. The growth rate of overhead costs is still expected to be 32%-33% or just over $300 million. But the revenue growth should be close to $600 million with about $460 million being higher gross profit. So, it appears DOCU has crossed the line where it gains revenue growth and margin leverage at this time. That is the second key point to follow here. 1Q22 posted a 20% Non-GAAP operating margin up from 8% y/y.

Free Cash Flow Is Positive

We like DOCU uses a standard definition of free cash flow. They do not adjust the figure for one-time items or Non-GAAP reasons:

Cash Flow Items	1Q22	1Q21	2021	2020	2019
Cash from Ops	$135.6	$59.1	$297.0	$115.7	$76.1
Capital Spending	$12.6	$26.4	$82.4	$72.1	$30.4
Free Cash Flow	$123.0	$32.7	$214.6	$43.6	$45.7
Acquisitions	$0.0	$0.0	$180.4	$0.0	$218.8
Strategic Investments	-$0.5	$0.0	$5.3	$15.5	$0.0
Deferred Contract Costs	-$46.2	-$41.0	-$208.5	-$115.7	-$80.9
Amort. Def. Contr. Costs	$30.9	$21.4	$99.4	$69.7	$42.1
Net Cash	-$15.3	-$19.6	-$109.1	-$46.0	-$38.8
A/R change	$73.2	$17.2	-$73.9	-$63.3	-$42.6

When we look at what is happening – we are impressed:

- Free Cash Flow is positive even with some large working capital negatives.

- After the growth in the year ended 1/21 – free cash flow would basically have covered its acquisitions in any year as well.

- We know that they are paying commissions in cash called contract acquisition costs. These are capitalized and amortized over time. With the company growing, it is spending more on new contracts than amortization cost of existing commissions. As seen above, this is a sizeable net drag on cash from operations – yet free cash flow is still positive.

- Customers pay a year in advance and are billed once a year. Customers seem to be paying fairly quickly and the size of the company is reaching the point where receivables are being paid nearly as quickly as new ones are being recognized. In 2020, revenues grew $273 million with receivables growing $63 million. In 2021, revenues grew $479 million and receivables only grew $74 million.

- Cash flow is growing despite the working capital pressures. It looks like DOCU can continue to grow free cash flow and remain a largely self-funding business.

- Capital spending of only $12.6 million in the 1Q22 appears much too low. We expect that to rebound going forward.

Heavy Use of Stock Is Creating Dilution

DocuSign pays employees with stock in a huge way as both RSUs and Stock Options. It has employee programs to allow the purchase of more shares at a discount to the market price. Plus, shares have been issued in 2020's acquisition.

It issued convertible bonds with 0%-0.5% interest. The first round had a conversion price of only $71.50 per share on $575 million in debt, which the stock price blew through last year. Of the $575 million in 2023 convertible bonds, $78.3 million remain outstanding after 1Q22. To settle the other bonds, DOCU has already paid $495.9 million in cash and 5.1 million shares of stock valued at just under $1.3 billion. The cash was raised with a $690 million offering of new convertible bonds with a conversion price of $420.24 per share. Perhaps this one will not be as expensive to retire. DOCU already has notice of more 2023 bonds converting since 1Q22 ended.

Share Items	1Q22	1Q21	2021	2020	2019
GAAP Shares	194.3	183.0	185.8	176.7	135.2
Anti-Dilutive shares	13.5	14.0	17.9	14.1	23.5
Non-GAAP Shares	207.9	196.9	203.7	190.8	158.7
Dilution to GAAP EPS	-5.9%		-4.9%	-23.5%	
Dilution to Non-GAAP	-5.3%		-6.3%	-16.8%	
GAAP Net Loss	-$8.4	-$47.8	-$173.9	-$193.5	-$426.3
Stock Comp	$81.1	$53.6	$286.9	$206.4	$411.0
Payroll Tax	$16.3	$6.5	$34.0	$16.7	$15.7
Total Stock Comp	$97.4	$60.1	$320.9	$223.1	$426.7

There are several points to watch on the share count:

- The primary reason, DOCU posts a loss under GAAP is the high stock compensation figure. Amortization of acquired intangibles contributes to the loss also. But keep in mind, the quick amortization period of those assets causes that expense to vanish rapidly too and remove that difference between GAAP and Non-GAAP results.

- There are 13.5 million share equivalents that are in the money at this point. That's another 7% of GAAP stock that should be coming. At this time, the GAAP net loss makes these shares anti-dilutive – it would make the GAAP loss per share go down and thus improve results.

  - However, the GAAP loss is getting smaller and it is possible DOCU could see it swing to a net profit and trigger these share equivalents going into the share count.

  - When employees convert these RSUs and options, they become shares too – so the GAAP share count is likely to keep increasing.

- Kudos to DOCU in its Non-GAAP results for already converting these options to shares. They are effectively lowering their reported Non-GAAP earnings per share by doing this and illustrating a more realistic picture than GAAP rules in our view.

- Whether looking at dilution to GAAP or Non-GAAP EPS, there is a 5%-6% dilution rate in play here that offsets some of the reported revenue, margin, and earnings gains.

- DOCU is guiding to a share count on Non-GAAP of 205-210 million shares this year – indicating that the dilution may only be 1%-3% this year.

- A bigger risk may be employee retention. The company was giving stock compensation in the form of options with strike prices of under $20 and the stock is now $278. Future options and RSUs are going to have strike prices higher than the current stock figure. The risk/return model for employees may not look as lucrative to accept as much stock in the future.

  - Does that mean DOCU needs to boost cash pay over stock pay? If so, Non-GAAP earnings may come under pressure even if reported pay stays the same. The non-cash portion would fall and that would hurt both Non-GAAP margins and earnings.

  - We believe DOCU has an operating model that can handle a higher cash wage. However, anything that pressures that Non-GAAP margin, may pressure the stock price too. At 165x Non-GAAP earnings estimates of $1.68 for fiscal 2022, the stock is unlikely to handle signs of slowing growth.

  - Do employees leave and seek out the next start-up company where the stock option chain has the potential for 100-to-1 returns on the options again? Receiving new options on DOCU stock with a $300 strike price doesn't sound like that potential is realistic.

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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