BEHIND THE NUMBERS
Quality of Earnings Analysis

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

May 26, 2022

Cloudflare, Inc. (NET) Earnings Quality Review

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

We are initiating earnings quality coverage of NET with a 3- (Minor Concern) rating.

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

Summary

With tech thoroughly beaten up in the last few weeks, we wanted to spend some more time examining the accounting of popular software names in the security space to see if there are areas where the earnings quality risks may remain too high or if the market is discounting too much. Our basic conclusion is that NET's forecasts calling for a 20% non-GAAP operating margin may prove too aggressive. Also, at this time, NET is free cash flow negative.

Overall, NET's accounting policies are conservative including how it amortizes intangibles, capitalized software, and capitalized commissions. However, our concern centers on the degree to which NET's earnings and cash flow are dependent on stock options to reimburse employees. NET is certainly not the only tech company using stock options. However, NET and OKTA are disproportionately reliant on the practice compared to their security software peers. In addition, NET has started to make larger acquisitions using stock as a currency and settling the acquired company's stock awards to employees with considerably larger awards from NET.

Some other companies in the security software group appear to be posting stronger results in our view and achieving large capital gains on NET may require another company to acquire it.

What Is Strong:

- NET's handling of capitalized software is very conservative. The company capitalizes software development costs once a project becomes viable and then amortizes them over only 3 years. Most software companies amortize over 3-5 years. NET also does not add this non-cash amortization cost back to non-GAAP EPS.

- Capitalized sales commissions also look conservative. NET capitalizes commissions when a client is first signed up and amortizes them over the estimated time the customer is expected to remain with the company which is currently 3 years. On renewals, it capitalizes any commissions paid and amortizes those balances over the length of the contract. Some other software companies amortize capitalized commissions over 5 or more years. As the company grows its base of paying customers, we expect the growth of capitalized commissions to slow as more commissions are amortized over one year or less on renewal. There is some lumpiness in the rate of growth of capitalized commissions vs. sales growth, but we see little reason for concern. This is likely related to how many new customers are signed to a first contract vs. how many renew in a given quarter. First contracts represent higher commissions which is largely what is in play here:

	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Sales Growth	10.0%	12.4%	13.1%	10.4%	9.7%	38.0%
Cap Comm. Growth	8.1%	14.5%	7.9%	17.5%	10.3%	19.8%

- NET's customer retention rate is greater than 100% and has been growing. The company is also conservative here as it excludes customers who were using free services last year but switched to paid services during the period. NET only counts current paying customers who renew their commitment less those who do not renew. Many customers are adding additional services as well which adds to the value of the new contract and increases the level of the retention rate. This is a dollar-based growth figure comparing the value of the prior contract for the trailing-four quarters against the dollar figure for the renewal for the next four quarters. Here is the y/y retention rate for the last six quarters:

	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Retention rate	127%	125%	124%	124%	123%	119%

- NET collects from its customers in advance and records the prepayments as deferred revenues. The revenue is recognized on a prorated basis over the contract term. Disclosure is solid and we are seeing deferred revenues rising faster than sales at this point which is a positive. It should make the accuracy of revenue forecasting easier and it builds the cash balance at NET:

	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
Sales Growth	10.0%	12.4%	13.1%	10.4%	9.7%	38.0%
Deferred Rev Growth	13.2%	24.9%	14.7%	18.3%	25.9%	13.4%
Sales	$212.2	$193.6	$172.3	$152.4	$138.1	$125.9
Def. Revenue	$137.2	$121.2	$97.0	$84.6	$71.5	$56.8
Days of Sales	58.2	57.6	51.8	50.5	46.6	41.5

What Is Weak

- NET is simply not profitable and has negative free cash flow. While the company adds back stock compensation and intangible asset amortization to its non-GAAP EPS, its non-GAAP EPS is still essentially zero. Guidance is for only 3-4 cents of non-GAAP EPS in 2022.

- Longer-term guidance of reaching non-GAAP margins of 20% looks suspect to us on several levels. It appears NET will need to push more of its cash costs to stock compensation to achieve that and with the stock down, do people want more of it? Also, the rate of growth is already slowing and there are many competitors who are seeing margins declining now. Even NET assumes it will see gross margins fall going forward. We believe margin expansion should occur, but over what time frame? And if it takes years and NET only hits 10% margins - EPS is likely to be a fraction of what is expected. Would 30-40 cents of non-GAAP EPS justify a $100 stock price?

- Stock compensation is heavily used by all of NET's security software peers to compensate employees. However, only NET and OKTA are still reporting non-GAAP losses after adding back stock compensation. Plus, NET is free cash flow negative even after adding back wages paid in shares. What happens if employees want more cash wages now that the stock price has declined and the outlook for tech shares is much less rosy than just a few months ago?

- NET is reporting that it is seeing non-GAAP margin improvement already – which is true. But investors should notice that sales growth is slower now than in the recent past **and NET boosted stock compensation from 13% of sales in 2019 to 20% now – that's 700bp of its margin gain. Among the major software security names, NET looks the most at risk if its stock cannot be used for currency.**

- Dilution is also a growing risk. If NET does become profitable, its share count from options, convertible debt, and other stock awards would be counted in dilutive shares. Currently, those shares have not been considered dilutive when calculating GAAP EPS due to posting losses and the larger share count would be anti-dilutive. Recent stock awards and options were done at much higher stock prices than the current share price. We believe employees will want greater volumes of stock if they continue forgoing cash wages.

- NET is also starting to make acquisitions a part of its growth strategy. One of the key features of these deals is replacing existing stock awards for the acquired company's employees with new NET stock awards. The size of these stock awards is enormous. We looked at four deals and each is resulting in more stock expense for NET than the actual purchase price for the acquisition. Since 2019, NET has recorded $202 million in stock compensation. It expects to recognize $300 million in stock compensation expense for the $162 million deal to buy Area 1 in April 2022.

- NET records all the purchase price of acquisitions as Goodwill (which is not expensed), Intangible assets (which are expensed rapidly but are added back to non-GAAP earnings), and stock compensation (which is also added back to non-GAAP earnings.) There is essentially no cost ever seen for any deal NET has made of late.

- NET adopted ASU 2020-06 on January 1, 2022 to account for its convertible notes. It now no longer recognizes the debt as having an equity component. That has lowered reported interest expense in 2022 because amortizing the equity-related discount is no longer included in interest expense – only the stated coupon rate which is 0% for the bulk of the bonds. Removing the equity discount also boosts the total debt level.

- Retiring $400 million of its 2025 convertible bonds cost NET $400 million in cash plus stock worth $921 million. It's tough to make a case that was a low interest rate to pay vs. issuing plain vanilla bonds at even 8%. It borrowed the $400 million by issuing 2026 convertible bonds – but they convert at $191.34 per share. NET may need to repay those in cash if the stock price does not recover.

- NET purchased capped calls to minimize dilution for both bonds. However, the cost of those calls was not expensed, it was recorded as a reduction to paid-in-capital. That helped boost recent EPS too by 22 cents in 2020 and 28 cents in 2021.

What To Watch

- Because NET is losing money, it has a large number of tax-loss carryforwards that can be used to offset future income. It has valuation allowances against those carryforwards now. The effective tax rate may become erratic at times if the company starts to make GAAP income and the valuation allowances start to decline.

- We noticed that NET is reporting profits in foreign markets. This is a small item at the moment. It lost $273 million in the US, but reported $25 million of foreign profits and paid income tax overseas. This has been the case for three years now with the US losses growing while the foreign profits are rising. We could envision some inquiries into transaction splitting methods from the IRS arguing that revenue allocation of a transaction is too high in a lower tax-rate foreign market and cost allocation is too high in the US market for these foreign sales.

- NET has a large base of customers who use its products for free. It sees this as a way to transition more people into paying them for other products in the future. The company is boosting its advertising in this area to increase awareness. However, the percentage of sales spent is declining. This is worth watching as the amount of spending may need to rise even if the rate of revenue growth slows:

	2021	**2020**	**2019**
Advertising	$36.2	$25.0	$18.8
% of Revenue	5.5%	5.8%	6.6%

Big Picture: Neither GAAP nor non-GAAP Earnings Are Impressive and Free Cash Flow Is Negative

NET's stock was trading between $110 and $130 in recent weeks before the sell-off pushed it to $58. GAAP earnings are negative, which isn't unique for many tech companies. However non-GAAP earnings are virtually non-existent too. Margins are very low and so is the free cash flow defined as cash from operations less capex and capitalized software costs:

	1Q22	4Q21	3Q21	2Q21	1Q21	4Q20
GAAP EPS	-0.13	-0.24	-0.34	-0.12	-0.13	-0.11
Non-GAAP EPS	0.01	0.00	0.00	-0.02	-0.03	-0.02
GAAP share count	323.3	320.3	314.5	308.3	305.9	303.8
Non-GAAP shares	341.6	345.8	342.4	308.3	305.9	303.8
GAAP Op. Margin	-18.9%	-21.2%	-15.4%	-18.9%	-22.6%	-19.6%
Non-GAAP Op Marg.	2.3%	1.2%	1.3%	-2.6%	-5.4%	4.3%
Cash from Ops	-$35.5	$40.6	-$6.9	$7.5	$23.5	-$8.8
Cap Exp	-$24.5	-$28.3	-$28.7	-$13.3	-$22.3	-$10.4
Software Inv	-$4.5	-$3.7	-$4.0	-$3.7	-$3.4	-$3.9
Free Cash Flow	-$64.5	$8.6	-$39.6	-$9.5	-$2.2	-$23.1

Here is what we see as the big picture:

- Adjustments to non-GAAP EPS are typical for a tech company: NET is adding back stock compensation, amortization of acquired intangibles, and amortization of debt discounts and issuance costs. Even after adding all that back, NET is essentially not making money and guidance is for non-GAAP EPS of 3-4 cents in 2022.

- All the shares issued for compensation and for convertible debt are anti-dilutive because of the GAAP losses. If NET divided the GAAP loss by a higher number of shares the loss per share would drop so GAAP leaves them out. For the barely profitable non-GAAP earnings, the share count rises 6%-8% reducing the level of profit per share.

- Guidance calls for rapid revenue growth to leverage expenses and result in a 20% non-GAAP operating margin. NET expects gross margin to fall 2%-4% as a headwind and R&D as a percentage of sales to stay flat. But, it sees Sales and Marketing costs falling 13-15 points and G&A by 5-7 points as a percentage of sales. 0% margins are expected to become 20% going forward. We will explore this further but already see:

    - NET is forecasting the size of the total market to rise 400% from mid-2019 to the end of 2024. However, that growth is only 17% from 2022-2024. The Law of Large Numbers may already be in play here.

    - NET is showing the market rising from $32 billion in 2018 to $115 billion in 2022 and it does not expect to be profitable with the market at $115 billion. Is rising to $135 billion in 2024 going to generate that much operating leverage?

    - There are numerous competitors already and NET says its smaller customers are getting these products for free.

- NET and the competitors are already growing via acquisition, which isn't organic growth.

- We agree that margin leverage is likely to occur here. But how quickly? Assuming NET grows at twice the industry forecast it gave for Investor Day, 34% higher sales from 2022-24 means a revenue figure of $1.28 billion. EPS assuming no taxes would be about 37 cents at a 10% margin and 56 cents at a 15% margin. That still sounds difficult to justify a $100 stock price.

NET Does Not Compare Favorably to Peer Group on Stock Compensation

All of the security software companies are heavy users of stock compensation to pay employees. It is one of the biggest adjustments between GAAP and non-GAAP results as companies add it back as a non-cash expense. Of the group, only FTNT (Fortinet) could report positive earnings without adding back stock compensation. NET would be near the bottom. These are all pretax figures:

OKTA	**1Q22**	**4Q21**	**3Q21**	**2Q21**	**1Q21**	**4Q20**
Non-GAAP Pretax Inc.	NA	-$23.0	-$9.9	-$23.8	-$13.0	$8.8
Stock Comp	NA	$157.9	$155.8	$187.7	$64.1	$56.4

NET	**1Q22**	**4Q21**	**3Q21**	**2Q21**	**1Q21**	**4Q20**
Non-GAAP Pretax Inc.	$5.1	$2.1	$2.9	-$5.8	-$8.1	-$5.8
Stock Comp	$41.8	$42.1	$28.0	$24.1	$23.1	$18.3

ZS	**1Q22**	**4Q21**	**3Q21**	**2Q21**	**1Q21**	**4Q20**
Non-GAAP Pretax Inc.	NA	$21.7	$23.5	$21.1	$23.2	$15.7
Stock Comp	NA	$104.0	$96.1	$85.9	$65.2	$67.1

CRWD	**1Q22**	**4Q21**	**3Q21**	**2Q21**	**1Q21**	**4Q20**
Non-GAAP Pretax Inc.	NA	$75.8	$45.5	$30.2	$26.7	$34.4
Stock Comp	NA	$92.6	$86.7	$76.3	$54.4	$47.7

PANW	**1Q22**	**4Q21**	**3Q21**	**2Q21**	**1Q21**	**4Q20**
Non-GAAP Pretax Inc.	$247.5	$237.1	$218.4	$207.5	$178.8	$197.8
Stock Comp	$267.2	$283.3	$270.2	$239.2	$247.2	$238.6

FTNT	**1Q22**	**4Q21**	**3Q21**	**2Q21**	**1Q21**	**4Q20**
Non-GAAP Pretax Inc.	$198.0	$267.0	$215.0	$201.0	$172.0	$222.0
Stock Comp	$54.0	$54.0	$54.0	$54.0	$50.0	$49.0

- Only FTNT would be profitable if it did not add back its stock compensation

- Both FTNT and PANW are reporting non-GAAP margins like NET is predicting. However, FTNT is predicting $4.3 billion in revenue this year and PANW $5.5 billion. And both are seeing margins falling y/y – FTNT dropped from 24% to 21% last quarter and PANW fell from 18% to 17%.

- We believe the competition is part of the reason even NET is predicting its gross profit will drop 200-400bp.

- The smaller ZS (Zscaler) at $1.05 billion in revenue saw non-GAAP margins drop y/y the last two quarters and it is still at 8% now vs. 10% the year before.

As we noted above, NET is not producing free cash flow. In computing free cash flow and cash from operations, amortization and stock compensation are already added back. But what if a company's stock is no longer seen as a great currency? Would employees be as willing to accept it or want more cash wages? Unlike basic economics for corn or toys – when stock prices fall – many people don't want more stock. Who is at greater risk of seeing free cash flow fall much further if more of the current stock compensation became cash wages? Because cash flow can have some larger swings in items like capital spending and working capital changes – we show the trailing twelve months for the last six quarters for these companies below:

	Q1 22	Q4 21	Q3 21	Q2 21	Q1 21	Q4 20
NET						
T12 Free Cash Flow	-$105.3	-$43.1	-$75.2	-$53.3	-$63.7	-$92.1
T12 Stock Compensation	$136.1	$117.3	$93.6	$81.5	$72.0	$63.5
OKTA						
T12 Free Cash Flow	NA	$87.5	$114.9	$123.1	$133.8	$110.7
T12 Stock Compensation	NA	$565.5	$464.0	$361.9	$222.6	$196.2
ZS						
T12 Free Cash Flow	NA	$155.4	$144.4	$103.2	$66.9	$40.7
T12 Stock Compensation	NA	$351.3	$314.3	$278.6	$248.6	$212.5
CRWD						
T12 Free Cash Flow	NA	$441.8	$411.8	$364.4	$323.2	$292.9
T12 Stock Compensation	NA	$310.0	$265.0	$219.0	$180.4	$149.7
PANW						
T12 Free Cash Flow	$1,605.8	$1,505.5	$1,436.0	$1,387.0	$1,390.5	$1,223.2
T12 Stock Compensation	$1,059.9	$1,039.9	$995.2	$936.5	$878.6	$804.9
FTNT						
T12 Free Cash Flow	$1,125	$1,072	$1,002	$946	$915	$869
T12 Stock Compensation	$216	$212	$207	$202	$199	$194

- Every company in the group would see a material drop in free cash flow if it could not use stock compensation. Even FTNT is picking up 19% of its free cash flow by paying employees with stock.

- NET is the only company NOT reporting positive free cash after adding back its stock compensation.

- OKTA and ZS would see their free cash flow turn negative if they had to pay employees in cash.

- CRWD and PANW would still have positive free cash flow if they couldn't pay with stock, but the decline would be about 70%.

NET's Long-Term Forecasts Look Suspect as They Appear to Rely Heavily on Paying More Cash Costs with Stock

Remember, NET's forecasts call for the company's non-GAAP operating margin to reach 20%+ eventually. Non-GAAP results adds back stock compensation. We can see above that competition is starting to hurt margins at its competitors already. Some of the competitors are seeing stock compensation decline as a percentage of revenue. That means they are improving the quality of their non-GAAP margins as they are adjusting less. Once again, the winners here are CRWD, PANW, and FTNT.

In the case of NET, its stock compensation as a percentage of sales is still rising:

NET	1Q22	4Q21	3Q21	2Q21	1Q21	2021	2020	2019
Revenue	$212.2	$193.6	$172.3	$152.4	$138.1	$656.4	$431.1	$287.0
Stock Comp	$41.8	$42.1	$28.0	$24.1	$23.1	$117.3	$63.5	$36.6
% of Revenue	19.7%	21.7%	16.3%	15.8%	16.7%	17.9%	14.7%	12.8%

The stock compensation figures above include the payroll tax savings. We would expect rapid revenue growth to leverage stock compensation too. Yet, NET saw stock compensation move from 13% of sales to 15% to 18% from 2019-21 and now it's at 20%. That's 700 basis points of non-GAAP margin NET has picked up in recent years. They still expect to pick up another 2,000 basis points in non-GAAP margin. We think stock compensation rising faster than sales could play a role in those forecasts. But now the stock price has been cut in half.

NET has an ESPP (Employee Stock Participation Plan) that allows employees to buy company stock at a 15% discount through a payroll deduction. It cannot sell the shares for a year. The amount of stock made available occurs twice a year starting May 15 and November 15. In 2020, employees bought 639,773 shares and another 260,334 in 2021. We think the availability was sold out early and there were no purchases in the March quarter for 2022 or 2021. The proceeds to NET from the cash payroll deductions were $10.9 million in 2020 and $15.0 million in 2021. These are recorded in the Financing Section of the cash flow statement. This would be a place for employees to voluntarily opt for more cash wages very quickly if they choose and hurt NET's cash flow.

Restricted Stock Units are more commonly handed out by NET. Recent awards have been lower volume at higher effective prices:

- 1Q22 863,000 RSUs at $102.87
- 2021 2.2 million RSUs at $108.87
- 2020 4.2 million RSUs at $33.13

The same is true with Restricted Stock:

- 1Q22 52,000 shares at $100.29
- 2021 48,000 shares at $167.69
- 2020 949,000 shares at $17.06

The awards are now for stock that is worth half those recent prices. We think employees will look for either more cash wages or many more shares going forward. They may also leave for another firm. The new firm may pay for some of the unvested shares at NET with new RSUs for their company's stock. Recent acquisitions by NET show that they gave employees of acquired firms new stock awards in NET stock:

- 2020 948,000 shares largely Restricted to employees of S2
- 2021 39,000 shares largely Restricted to employees of Zaraz
- 2022 71,000 shares to largely Restricted employees of Vectrix

Stock options have been declining in use at NET. No stock options were awarded in 1Q22. Only 100,000 shares were awarded as stock options in 2021 with an average exercise price of $137.17. That is down considerably from 1.7 million options awarded in 2020 with an average exercise price of $18.05. We do not see a major issue with stock options as the exercise prices for most options remain far below the current share price.

Acquisitions Rely Heavily on Stock Payments Too and the Accounting Recognizes Zero Cost for Acquisitions

We have seen acquisitions start to increase for NET. There are pluses and minuses to this. NET can add new technology and product lines more quickly for existing customers. At the same time, it is expensive and NET doesn't consider any of it to be actual expenses.

There are three recently completed deals and a fourth that just closed for which there are not full details. In each case:

- NET used its stock as currency to pay for a large part of the deal. What happens if new companies don't want NET's stock? We know NET is free cash flow negative.

- NET also is looking at large future stock compensation expense to pay new employees. This is a negative for earnings quality as those expenses will be added back to non-GAAP income.

- NET acquired mostly Goodwill – which will not be expensed and inflate both GAAP and non-GAAP income

- NET also allocated purchase price to Developed Technology and BIG POSITIVE here – it amortizes that over a rapid two years. However, this is a negative in that amortization is added back to non-GAAP income.

S2 Systems was purchased in January 2020 for $13.7 million in cash + $1.8 million in NET stock + $2.2 million in cash holdback to cover S2 contingent obligations for $17.7 million. It also issued cash and equity awards to S2 employees that it sees as $20.3 million in stock compensation expense.

S2's purchase price was allocated to $5.6 million in developed tech and $13.1 million in Goodwill. Adding in the $20.3 million in stock compensation expense – NET spent $38 billion and a large part of that was cash and its Non-GAAP income is not showing a nickel of expense for this deal.

Zaraz was acquired in October 2021 for $5.6 million in cash + $1.6 million in NET stock. It also paid $1.1 million in stock to settle equity deals with Zaraz employees + $6.5 million in additional stock compensation for new NET awards for those employees.

That purchase price was allocated to $1.4 million in developed tech and $6.35 million for Goodwill. Just like S2, none of this mostly cash deal will ever be expensed.

Vectrix was purchased in January 2022 for $4.3 million in cash + $2.0 million of NET shares + $1.3 million in cash holdback to cover Vectrix contingencies. NET also sees $8.0 million of stock compensation going to Vectrix employees.

Interesting, Vectrix only had 10 employees so how big was this place? NET allocated $3.1 million to developed tech and $4.95 million to Goodwill.

Area 1 Security was acquired on April 1, 2022 for $162 million. We do not have a full breakdown for this deal yet, but some disclosure says that 40% of the purchase price was in NET shares. Also, NET is looking at potentially $300 million of stock compensation for Area 1 employees.

Our overall conclusions for growth-through-acquisition for NET are negative:

- Since 2019, NET has recorded $202 million in stock compensation – It now says that it will record $300 million in stock compensation just for the Area 1 deal. We think this adds weight to our theory that NET's non-GAAP margin expansion plans depend on moving more ongoing costs to stock compensation that it can add back to non-GAAP results.

- The stock compensation component in each of these four deals exceeds the purchase price for the actual company.

- What is the plan if no one else wants NET's stock? Do they just throw greater volumes of stock to complete deals? Pick your poison: slower growth and lower margins, or dilution.

- We also think that an investor in NET vs. some of its competitors may need to view NET as a company that gets acquired in the future. However, what is it going to cost a potential acquirer to unwind/resolve all these stock comp deals NET has been giving out? Area 1 has a stock comp deal that is almost twice what they are paying for the company.

Stock Prices Also Impact the Debt Level because of Convertible Bonds

NET has two convertible bonds outstanding. The first is convertible at $37.43 per share and the second at $191.34. It changed its accounting policy at the start of 2022 whereby it no longer separates the bonds into debt and equity components with the equity component reducing the amount of net debt. Now the net debt figure is the face amount of debt outstanding less only the unamortized debt issuance costs:

	1Q22	1Q22	4Q21	4Q21
	2026 Notes	2025 Notes	2026 Notes	2025 Notes
Face Amount	$1,293.8	$158.4	$1,293.8	$175.0
Unamort Discount	$0.0	$0.0	-$248.2	-$45.4
Unamort Issue Cost	-$17.3	$2.2	-$14.5	-$1.7
Net Debt	$1,276.4	$160.6	$1,031.0	$128.0

The unamortized discount represented the equity component of the bonds and the company assumed an effective rate of interest that was higher than the bonds stated rate, which is 0.75% for the 2025 issue and 0% for the 2026 issue. That is lowering interest expense which is boosting GAAP earnings. Non-GAAP already added back the amortization of debt discounts from the equity components. NET should see declining interest expense y/y for all of 2022.

	1Q22	1Q22	2021	2021
	2026 Notes	2025 Notes	2026 Notes	2025 Notes
Coupon Interest	$0.0	$0.3	$0.0	$1.1
Amort of discount	$0.0	$0.0	$0.0	$8.6
Amort of issue cost	$1.0	$0.2	$0.0	$0.4
Net Interest	$1.0	$0.5	$0.0	$10.0

With both bond issues being convertible, NET hedged the conversion with capped calls on both bonds. This is designed to limit dilution if the debt is settled with shares instead of cash. Investors should note that the cost of these capped calls was not expensed through the income statement. Instead, they are treated as reductions to paid-in capital on the balance sheet and appear as a cash drain in the financing section of the cash flow statement. For the 2025 notes, this cost $67.3 million and for the 2026 notes another $86.3 million. If they had to expense this, it would have cost NET 28 cents of EPS in 2021 and 22 cents in 2020.

We would also point out that the lower stock price makes it more likely that NET will settle more of these notes in cash when the time comes. So far it retired $400 million of the $575 million face amount of the 2025 notes with $400 million in cash plus accrued interest and 7.6 million shares of stock worth at the time $921 million. The cash component came from issuing the 2026 notes. We would argue that is effectively far more expensive than just issuing straight debt with even an 8% coupon.

Also of note, the 2026 notes with a conversion price of $191.34 may be less likely to see a stock conversion at all. If NET has to settle those in cash, it is $1.3 billion in face amount. The company has cash and securities to more than cover the bonds, but it is posting negative free cash flow.

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.

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.