BEHIND
THE NUMBERS
Quality of Earnings Analysis

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

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Okta, Inc. (OKTA)
Earnings Quality Update- 1/22 Qtr.

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

We are downgrading our earnings quality rating to 3- (Minor Concern) from 4+ (Acceptable)

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

Summary

OKTA reported a non-GAAP loss of 18 cps in the 1/21 quarter which was 6 cps better than the consensus estimate. We discussed in our original review of OKTA that the company's rate of deferring commissions should be monitored for unusual movements and believe it is worth highlighting an unusual jump in the deferral of sales commissions in the 1/22 quarter.

The following table shows the amount of commissions deferred as a percentage of quarterly calculated billings:

	1/31/2022	10/31/2021	7/31/2021	4/30/2021
Calculated Billings	$603.222	$388.679	$362.358	$364.030
Quarterly Commissions Deferred	$80.100	$35.700	$40.000	$14.900
Commissions Deferred % of Billings	13.3%	9.2%	11.0%	4.1%

	1/31/2021	10/31/2020	7/31/2020	4/30/2020
Calculated Billings	$316.047	$252.359	$198.083	$209.505
Quarterly Commissions Deferred	$29.200	$21.500	$18.400	$11.900
Commissions Deferred % of Billings	9.2%	8.5%	9.3%	5.7%

There is understandably a seasonal pattern to billings with a sequential increase occurring in the January quarter every year. This is driven by companies that choose to upgrade at the beginning of the year. Nevertheless, the sharp jump in quarterly commissions deferred to $80.1 million from $35.7 million in the previous quarter and $29.2 million in the year-ago period stands out. Deferred commissions represented 13.3% of billings in the quarter versus 9.2% in both the previous quarter and the year-ago period. Note that the company did initiate process controls in the 4/21 quarter that boosted the pace of billings and after adjusting for that, the commission deferred jumped to almost 15% of billings in the 1/22 quarter. (This may not have had an impact if the company pays commissions when billed rather than at contract signing.)

We pointed out in our original review of OKTA that the quarterly deferrals can be lumpy, noting that the jump in the 7/21 quarter appeared to be a catch-up from the unusually low amounts deferred in the 4/21 quarter. However, the huge jump in the most recent period was out of line historically. We know that the company is investing heavily in its sales force, but that would have driven up billings as well. We estimate that if commissions deferred had been a more normal 10% of billings, it would have shaved almost 7 cps off earnings in the quarter which would have resulted in an earnings miss.

It is also worth noting that the increased pace in deferring commissions is causing a decline in cash from operations:

Year ended:	1/31/2022	1/31/2021	1/31/2020
Operating cash flow	$104.119	$127.962	$55.603
Cash flow impact of deferred commissions	-$170.577	-$81.016	-$61.224
Cash flow net of impact of deferred coms.	$274.696	$208.978	$116.827

Given that the company defers the bulk of its billings and recognizes them over time, we would expect rapid growth to generate positive cash flow growth. We see above that the cash flow

drain from the increase in deferred commissions more than doubled in 2022 causing the decline in operating cash flow.

Billings and deferred revenue trends remain strong. The stock price has been dented following news of a significant security breach at the company and how that resolves will likely be the primary driver of the company's stock price relative to the security software segment in the near future. However, we believe the decline in deferred commissions was unusual and a reversal to a more normal rate of deferral could be a material headwind in upcoming quarters. The trend warrants special attention in the next quarter. This prompts us to downgrade our earning quality rating to 3- (Minor Concern.)

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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