BEHIND THE NUMBERS
Quality of Earnings Analysis
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Okta, Inc. (OKTA)
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 OKTA with a 4+ (Acceptable) rating.

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

Summary

We plan to expand our coverage to the software security segment and will begin with OKTA, the leading provider of enterprise identity management solutions. Its products allow companies to provide employees with secure access to applications over the cloud, mobile, and web technologies. OKTA is posting strong bookings and revenue growth with both exceeding 50%.

Overall, we do not have significant concerns regarding the company's earnings quality. It employs the software as a service (SaaS) subscription model under which cash is received upfront and recognized over the contract term, typically one year. This makes tracking trends in deferred revenue and bookings a key and both trends adjusted for minor unusual items look strong in recent quarters.

The main point of concern we see is the heavy dependence on stock options and the distorting impact of adding these expenses back to non-GAAP earnings. The company reported its first non-GAAP profit in the 7/20 quarter which again turned negative in the 4/21 quarter. Without adding back stock options expenses, quarterly profits are negative to the tune of $50-$75 million. The company also has further diluted the share base with convertible debt and utilizing stock to make a recent $5 billion+ acquisition. This all led to 15% share dilution in the most recent quarter.

What is weak

- OKTA is a generous user of stock options, RSUs, and RSAs to compensate employees, directors, and even consultants. Shares issued under these plans typically lead to share base dilution of more than 6% per quarter. While the company just recently began reporting positive non-GAAP earnings in the 7/20 quarter (before reverting back to negative territory in the last two quarters), quarterly GAAP losses which count stock options as real expenses typically run in the $50 million+ range. In addition, free cash flow would also be negative if the company had to pay these amounts in cash.

- We don't propose that OKTA will ever have to pay all its stock option expense in cash. However, we do consider these amounts real expenses- try keeping the employees without them. Plus, the company may have to pay more compensation in the form of cash in the future if the stock price stabilizes (or declines). During the six months ended 7/21, OKTA granted 2.5 million options with an average exercise price of $92 during which time the market price of the stock ranged from $210 to $295. Options typically vest over 4 years. No doubt employees have viewed this as a good deal over the last year, but will they continue to view them as being as valuable in a flat market or if the company raises the exercise price on new options? At that point, the company may have to pay more compensation in cash to keep valuable employees.

- OKTA also utilized stock to fund almost the entire purchase price of its near $6 billion acquisition of Auth0 in May. This led to share dilution jumping to 15% in the 7/21 quarter. The company utilizes convertible debt which has led to the issuance of nearly 5 million new shares with more likely to come.

- Almost the entire purchase price of Auth0 was allocated to goodwill which will not be amortized. We question the logic of this given there is overlap between the companies in both technology and customers which seems to favor a sizeable portion being capitalized as technology and customer relationships with those amounts amortized. If just 25% of the Auth0 purchase price was allocated to identifiable intangibles and amortized over an average of 4 years it would result in approximately $375 million in annual amortization expense. This is unfortunately irrelevant to investors only paying attention to non-GAAP results as the company is adding back amortization to non-GAAP profits as almost all its peers do.

What is strong

- We currently see no red flags associated with the company's revenue recognition. Over 95% of OKTA's revenue comes from subscriptions which it typically bills in advance for one-year periods. Cash is received upfront, and revenue is typically recognized over the subscription period which leads to sizeable deferred revenue balances. While this results in smoother revenue trends and good visibility, it also means that slowdowns in new business signings will be delayed in showing up in the top line. Growth in billings and deferred revenue are key trends to follow to look for early signs of an upcoming revenue slowdown.

- An operational change instituted in the 4/21 quarter resulted in bills going out earlier than in the past. This led to an artificial boost to billings growth and likely deferred revenue as well. Reported billings growth of 83% in the 7/21 quarter falls to 74% after adjustment for the operational change. Adjusted billings growth in the 4/21 quarter falls from 74% to 40%. However, this adjusted growth is still above trend and above reported revenue growth. Likewise, deferred revenue days of sales rose YOY in the last two quarters even if we remove the entire amount of the accelerated billings from deferred revenue. All of this bodes well for continued revenue growth in upcoming quarters.

What to watch

- We note that the company's dollar-based retention rate is currently running about 120%. This is due to the company's retention rate being calculated as the annualized contract value at the beginning of the period compared to the annualized contract value for the same customers at the end of the period. Therefore, upsells cause the rate to exceed 100% and demonstrates the degree to which growth is coming from existing customers expanding their contracts and buying more premium services. This trend should be closely monitored going forward for any signs of stagnation from this growth source.

- OKTA defers the cost of commissions related to obtaining both new revenue and incremental revenue from existing customers. These amounts are amortized over 5 years which is a reasonable period when compared to similar software companies. While costs deferred as a percentage of revenue did jump in the 7/21 quarter, it appears to be a rebound from an unusually low 4/21 period. Trends in this number should be tracked looking for signs of any sustained increase which could indicate an expansion of the definition of costs to obtain contracts.

No Profits Without Adding Back Stock Compensation and No FCF if Paid in Cash

OKTA maintains an employee incentive plan under which it pays employees, directors, and even consultants with stock options, restricted stock units, and restricted stock awards. While OKTA is not the first tech company to use its shares as compensation, its aggressive use is leading to significant share dilution that will become even more pronounced when the company posts positive profits. This makes the typical industry practice of adding back stock compensation to non-GAAP profits particularly distortive for OKTA. Below we will look at profits before adjustment for stock compensation expense and look at what free cash flow would be if the company had to pay these amounts in cash.

The company posts substantially negative profits without adjusting out the cost of stock options

Like most tech companies, OKTA adds back its stock compensation expense to non-GAAP results. The following table shows non-GAAP earnings before taxes along with the stock compensation expense that was added back for the last eight quarters:

	7/31/2021	4/30/2021	1/31/2021	10/31/2020
Adjusted Net Income	-$16.289	-$12.982	$7.987	$5.746
Stock-Based Compensation	$187.714	$64.112	$56.407	$53.652

	7/31/2020	4/30/2020	1/31/2020	10/31/2019
Adjusted Earnings Before Taxes	$9.916	-$7.448	-$1.126	-$3,791
Stock-Based Compensation	$48.394	$37.728	$36.930	$35.735

We would note that the large jump in stock compensation in the 7/21 quarter relates to the Auth0 acquisitions. OKTA issued replacement equity awards with a fair value of $655 million with $238 million of that allocated to the purchase price consideration for pre-acquisition services and $417 million allocated to post-combination services which will be amortized over the remaining service periods as stock compensation expense. In addition, the company entered into revesting agreements with Auth0's founders in which 1.2 million additional shares of OKTA stock will be vested to the founders over three years and is accounted for as stock compensation expense with $305 million unvested as of 7/21.

We can see in the above table that non-GAAP profits would be deep in negative territory without the benefit of adding back stock compensation. Employees no doubt value these options in an environment of a rising stock price. During the six months ended 7/21, OKTA granted 2.5 million options with an average exercise price of $92 during which time the stock price ranged from roughly $210 to $295. Options typically vest over 4 years. No doubt employees have viewed this as a good deal over the last year, but will they continue to view them as valuable in a flat market or if the company raises the exercise price on new options? At that point, the company may have to pay more compensation in cash to keep valuable employees.

Free Cash Flow Would Be Negative if Options Paid in Cash

The following table shows that free cash flow would be negative if it paid these amounts in cash. (The 7/21 quarter is higher than usual because of the company adopting Auth0's stock compensation plans in connection with the May 2021 acquisition.)

	7/31/2021	7/31/2020
T12 Free Cash Flow	$123.143	$64.024
T12 Stock Compensation	$361.901	$158.771
Cash Shortfall if Options Were Cash Expenses	-$238.758	-$94.747

As we discussed above, we don't contend that OKTA will ever have to pay all of these stock compensation amounts in cash, but the table simply demonstrates the extent that OKTA is currently utilizing options as a currency.

Share Dilution Will Accelerate When Profits Turn Positive

GAAP accounting rules do not require the company to count potentially dilutive shares in the diluted share count when the company is reporting a net loss as the shares are anti-dilutive (i.e. the reported loss would decline if the shares were counted). OKTA follows this practice in presenting its non-GAAP data and only adds in dilutive shares when non-GAAP results show a profit. The following table shows GAAP and non-GAAP net income, associated GAAP share count adjustments, and the dilution from additional shares for the GAAP and non-GAAP counts count for the last eight quarters.

	7/31/2021	4/30/2021	1/31/2021	10/31/2020
GAAP Net Income	-$276.682	-$109.232	-$75.806	-$72.764
Non-GAAP Net Income	-$16.289	-$12.982	$7.987	$5.746
GAAP Diluted Share Count	151.357	131.777	130.138	128,813
Diluted Shares Added Back due to Non-GAAP Profit	0	0	13.541	14.579
Non-GAAP Diluted Share Count	151.357	131.777	143.679	143.392
GAAP Dilution	-15.4%	-6.3%	-6.6%	-8.1%
Non-GAAP Dilution	NM	NM	-15.4%	-17.4%

	7/31/2020	4/30/2020	1/31/2020	10/31/2019
GAAP Net Income	-$60.100	-$57.662	-$50.472	-$63.495
Non-GAAP Net Income	$9.916	-$7.448	-$1.126	-$3,791
GAAP Diluted Share Count	126.319	123.494	121.562	118.976
Diluted Shares Added Back due to Non-GAAP Profit	15.936	0	0	0
Non-GAAP Diluted Share Count	142.255	123.494	121.562	118.976
GAAP Dilution	-10.2%	-8.8%	-11.6%	-8.6%
Non-GAAP Dilution	-20.1%	NM	NM	NM

Here we see that the company adding in potentially dilutive shares in its calculation of non-GAAP EPS only in quarters with positive non-GAAP profits. The first thing to note is the regular GAAP dilution of 6-10% every quarter which spikes to over 15% in the 7/21 quarter due to the Auth0 deal.

Second, we see that when the company reports positive non-GAAP profits, the potentially dilutive shares are added back which roughly doubles the rate of dilution in the period.

Convertible Debt

In addition to stock compensation, OKTA has diluted its share base through the utilization of convertible debt to finance operations. This allows the company to enjoy much lower interest rates but exposes it to sizeable liabilities if the convertible go “in the money”. For example, the company realized proceeds of $325 million from its 2023 notes issues in 2019. While the interest rate was a mere 0.25%, the stock price quickly exceeded the exercise price on the convertibles resulting in the company having to pay over $800 million to redeem the shares in the form of $224 million in cash (partly raised by the issuance of the 2025 notes) in addition to issuing 4.5 million additional shares over the subsequent 2 years. Carrying value on the 2025 notes was $903 million at the end of the 7/21 quarter but the fair value was estimated at $1.6 billion with the difference being the implied equity value of the stock. Likewise, the carrying value of the 2026 notes is $890 million with a fair value of $1.5 billion. The company will either have to pay cash when these shares are likely redeemed or further dilute the share base by issuing new shares.

The following table shows cash flow information related to the convertible notes for the last three fiscal years.

	2021	2020	2019
Proceeds from Issuance of Convertible Senior Notes	$1,134.841	$1,040.660	$334.980
Payments for Repurchases of Convertible Senior Notes	-$446.000	-$224.414	
Purchases of Hedges Related to Convertible Senior Notes			-$80.040
Proceeds of Hedges Related to Convertible Senior Notes	$195.046	$405.851	
Proceeds from Issuance of Warrants Related to Convertible Senior Notes			$52.440
Payments for Warrants Related to Convertible Senior Notes	-$175.399	-$358.622	
Purchases of Capped Calls Related to Convertible Senior Notes	-$133.975	-$74.094	

The company did utilize calls to hedge exposure to the conversion liability of the 2023 notes. Similar arrangements are in place for the 2025 and 2026 notes although the company did not utilize warrants with those as it did with the 2023 notes.

AUTH0 Acquisition Almost Entirely Allocated to Goodwill So No Amortization

OKTA acquired Auth0 on May 3, 2021 for a purchase price of $5.67 billion by issuing $5.18 billion in stock (19.2 million shares), $257 million in cash, and assuming equity awards with an initial fair value of $238.4 million. The company also issued unvested restricted stock with a value of $332.1 million which is being recognized over the service period since it contains a post-combination service requirement. Likewise, the company issue replacement equity awards with a value of $430.2 million that will be recognized over an estimated service period as they also contain a post-combination service requirement. As we noted above, the share count was diluted by more than 15% in the 7/21 quarter with roughly half that due to the newly minted OKTA shares used in the deal.

The OKTA deal resulted in the creation of an enormous amount of goodwill. Of the $5.6 billion purchase price, the company initially booked only $334.3 million in identifiable intangible assets with $5.3 billion being booked as goodwill. The value of the goodwill is based on expected synergies in sales "opportunities across complementary products, customers and geographies, cross-selling opportunities, and improvements in the selling process." Intangible assets consist largely of developed technology which is being amortized over 5 years and customer relationships being amortized over 2-6 years. We don't consider these to be excessively long amortization periods for such assets when compared to other SaaS companies. The entire value of the acquisition is tied up in goodwill that will not be amortized under GAAP so the cost of the deal will essentially be ignored on the income statement.

The bulk of Auth0s business is in customer identity solutions while OKTA's focus is on workforce identity. Management disclosed on the conference call that Auth0 had $38 million in standalone revenue during the two months that OKTA owned the company implying roughly $200 million in annual revenue compared to $900 million for OKTA. Standalone Auth0 revenue appears to be growing more than 60%. The rationale behind the deal appears to be that not only is OKTA getting a growing business, but also rich opportunities to cross-sell OKTA products to Auth0 customers and vice-versa. However, we have several thoughts regarding the decision to assign the whole value to goodwill:

- At $200 million in sales, Auth0s entire operating budget likely approximates its current revenue level of $200 million. As far as synergies go, even eliminating all of Auth0's costs doesn't go far in justifying almost $6 billion in goodwill.

- While OKTA specializes in workforce identity, customer identity does account for roughly 20% of revenue so it does have some presence in that segment. This adds weight to the argument that the acquisition represents the purchase of another company's technology and a meaningful part of the excess purchase price should be capitalized and amortized.

- There is already some overlap between Auth0 and OKTA customers. Similar to the technology argument, the acquisition can be viewed as OKTA adding customers to its existing business which favors a material portion of the excess purchase price being capitalized as customer relationships and amortized.

- If we just assigned 25% of the purchase price to identifiable intangibles being amortized over an average of 4 years, it would mean $375 million in annual amortization expense.

Unfortunately, none of this is especially relevant to investors only tracking non-GAAP earnings as OKTA is adding back amortization of acquired intangibles back to non-GAAP profits.

Revenue Recognition

OKTA operates under the software as a service model (SaaS). Over 95% of OKTA's revenue comes from subscriptions which it typically bills in advance for one-year periods. Cash is received upfront, and revenue is typically recognized over the subscription period which leads to sizeable deferred revenue balances. While this results in smoother revenue trends and good visibility, it also means that slowdowns in new business signings will be delayed in showing up in the top line. This makes following trends in deferred revenue balances and bookings very important for companies like OKTA.

Billings Growth Looks Solid Even After Adjustment for Operational Change

The following table shows revenue, billings, and their growth rates for the last six quarters:

	7/31/2021	04/30/2021	01/31/2021	10/31/2020	07/31/2020	04/30/2020
Revenue	$315.500	$251.006	$234.740	$217.379	$200.446	$182.859
Calculated Billings	$362.358	$364.030	$316.047	$252.359	$198.083	$209.505
Revenue Growth	57.4%	37.3%	40.3%	42.0%	42.7%	46.0%
Reported Billings Growth	82.9%	73.8%	40.5%	43.7%	27.2%	42.3%

Billings growth should be adjusted for an operational change that the company noted in the 4/21 and 7/21 quarters. Consider the disclosure from the 7/21 Q:

> *"Calculated billings increased 83% in the three months ended July 31, 2021 over the three months ended July 31, 2020, and increased 78% in the six months ended July 31, 2021 over the six months ended July 31, 2020. We implemented operational changes to our billings process in the six months ended July 31, 2021 pursuant to which we billed customers earlier than we would have under our historical billing practices. These changes had a favorable effect on billings in the three and six months ended July 31,*

> *2021. Absent the impact of the billings process changes, Calculated billings would have grown 74% year-over-year in the three months ended July 31, 2021 and 57% year-over-year in the six months ended July 31, 2021, respectively."*

The company noted in the conference call that billings growth adjusted for both the operational change and the Auth0 acquisition was 47% which was in line with the last few quarters. While the change in the timing of sending out bills was a meaningful artificial boost to billings in the last two periods, the adjusted growth rates compare favorably to both the trend in billings and reported revenue.

Management has warned that as billings grow in absolute size, the growth rate will slow. This is reasonable to expect. However, going forward, a sharp and sustained deterioration in billings growth should be considered a red flag.

Deferred Revenue Trends Look Reasonable

The following table shows deferred revenue days of subscription sales for the last eight quarters:

	7/31/2021	4/30/2021	1/31/2021	10/31/2020
Subscription Revenue	$303.121	$240.058	$225.400	$206.743
Total Deferred Revenue	$737.297	$624.912	$513.598	$432.114
Total Deferred Revenue Days of Subscription Sales	223.8	231.7	209.6	192.3

	7/31/2020	4/30/2020	1/31/2020	10/31/2019
Subscription Revenue	$190.689	$173.781	$158.514	$144.517
Total Deferred Revenue	$396.820	$398.191	$371.450	$313.756
Total Deferred Revenue Days of Subscription Sales	191.5	206.2	215.6	199.7

Deferred revenue days have trended up year-over-year for the last two quarters. While the company does not adjust deferred revenue for the change in billings noted above, we think it is reasonable to expect that some clients who received bills earlier than usual also paid their bills earlier than usual which would have also lifted deferred revenue. Reported billings growth in the 7/21 quarter was 83%, about 900 bps above the billings growth adjusted for the operational change. Even if we assume all of those early billings wound up in deferred revenue, that only amounts to about $18 million, and deferred revenue days adjusted for that amount fall to 218 which is still well above last year's 191.5. Therefore, we do not see red flags with the company's deferred revenue trends at this point.

Deferral of Contract Costs

OKTA capitalizes commissions related to both new revenue and incremental revenue generated from existing customers. These are amortized on a straight-line basis over the estimated period of benefit which the company estimates at 5 years. The following table shows the calculation of deferred commissions days of sales, the amount of commission deferred by quarter as a percentage of quarterly revenue, and the amortization of deferred commissions as a percentage of the outstanding deferred balance:

	7/31/2021	4/30/2021	1/31/2021	10/31/2020
Total Deferred Commissions	$184.197	$157.920	$154.504	$135.213
Deferred Commissions Days of Sales	53.7	56.0	60.6	57.2
Quarterly Commissions Deferred	$40.000	$14.900	$29.200	$21.500
Commissions Deferred % of Sales	12.7%	5.9%	12.4%	9.9%
Amortization of Deferred Commissions % of Average Balance	7.8%	7.6%	7.8%	8.0%

	7/31/2020	4/30/2020	1/31/2020	10/31/2019
Total Deferred Commissions	$124.364	$114.065	$111.510	$95.010
Deferred Commissions Days of Sales	57.1	56.1	61.3	57.1
Quarterly Commissions Deferred	$18.400	$11.900	$24.600	$15.300
Commissions Deferred % of Sales	9.2%	6.5%	14.7%	10.0%
Amortization of Deferred Commissions % of Average Balance	7.9%	7.7%	7.8%	8.1%

While deferred commissions days of sales have been trending down, we note that the amount of commissions deferred in the fourth quarter jumped to 12.7% of revenue from 9.2% in the year ago quarter. The deferral amounts are relatively volatile and some of the 7/21 quarter amount appears to be a rebound from the unusually low deferral in the 4/21 quarter. As a result, we are not concerned by the deferral rate in the 7/21 quarter, but this should be monitored for signs of a sustained increase relative to revenue which could indicate the company expanding the definition of costs to obtain contracts. Likewise, the amortization period of 5 years seems very reasonable when compared to similar software companies and the amortization percentage of average deferred balances has trended very steadily around 8% so we see no problems there. This figure should also be monitored and any increase could be an early sign that the company has extended the estimated amortization time.

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

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