BEHIND THE NUMBERS
Quality of Earnings Analysis
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Q2 Holdings, Inc. (QTWO) Earnings Quality Update 12/21 Qtr.

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

We are maintaining earnings quality coverage of QTWO with a 2- (Weak) rating.

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

Summary

QTWO is still barely earning an “adjusted” profit despite adding back numerous ongoing costs and capitalizing others to limit recognizing some expense in the first place. Its non-GAAP EPS of 2-cents in the 4Q20 missed estimates by 3-cents. This is also a company that trades more on revenue to highlight that there is considerable growth. It beat by $2.8 million on revenue forecasts in 4Q20, but it accelerated $3.3 million in revenue recognition in the quarter from changing the accounting on one deal, which also accelerated the recognition of capitalized costs. It is an either/or situation, if you give them credit for beating on revenue with the accounting change, they missed on EPS. If they didn’t have the faster amortization on costs, EPS beat but then revenue missed. EPS was also helped during the year by saving $9.1 million in travel and trade show expenses with Covid – that was 14-cents for 2020.

Many other signs do not point to strong revenue growth in our view either as capitalized costs are not leveraging and receivable DSOs growing adds to revenue too.

What is strong?

- Deferred revenue is actually rising in dollars and in terms of days. That may make some revenue trends easier to maintain for QTWO:

Def. Rev	4Q	3Q	2Q	1Q
Def Rev 2020	$111.1	$110.0	$101.3	$97.6
DSOs 2020 total	93.0	96.7	94.7	96.4
DSOs Current 2020	68.6	68.5	63.8	63.4
Def Rev 2019	$90.9	$77.4	$71.3	$69.5
DSOs 2019 total	95.5	88.7	83.8	88.9
DSOs Current 2019	60.8	59.6	54.1	57.9

The acquisition of PrecisionLender in 4Q19 added $12 million in deferred revenue, but it was only adding about $1 million per month in sales so that helped boost the total DSO figures. Also, in 4Q20, a change in accounting policy for the Cloud Lending business accelerated $3.3 million of revenue recognition from deferred revenues. That basically knocked 3-days off deferred revenue DSO in 4Q. It also allowed Q2 to beat revenue guidance.

What is weak?

- **Shouldn't Implementation Costs be growing more?** These occur when Q2 installs software and sets up accounts. It capitalizes these costs and amortizes them over 5-7 years, not the length of the contract. Q2 assumes that customers will renew because of the hassle of changing providers, thus the longer amortization period. The capitalized figure had a small jump as Q2 acquired PrecisionLender in 4Q19 and has been essentially flat since:

Cap Implement Costs	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19
Current	$8.3	$10.2	$9.8	$8.4	$5.2	$4.6
Long-term	$15.2	$16.9	$15.7	$14.6	$15.8	$14.9

The change to accelerate revenue recognition from the Cloud Lending deal discussed above in deferred revenues, resulted in the recognition of $4.2 million of capitalized costs. That's why 4Q20 capitalized costs declined sequentially from 3Q20.

From an earnings standpoint, having to recognize so much past expense through the long-term amortization of the capitalized costs requires rapid earnings growth to leverage the rising amortization. Q2 is not getting enough of it:

Cap Implement vs Rev	2020	2019	2018
New Capitalization	$16.9	$14.3	$7.3
Amortization	$14.5	$7.7	$4.7
Amortization % Rev.	3.6%	2.4%	2.0%

The fact that new capitalization was higher than amortization, meant this accounting policy still added 4-cents to EPS for both GAAP and non-GAAP in 2020. The amortization figure for 2020 of $14.5 million is higher due to the accelerated recognition of Cloud Lending revenue. That $4.2 million in additional amortization was a 6-cent headwind. Q2 would have seen 10-cents in EPS from this policy instead of 4-cents in 2020. Also, we think it shows that this policy going forward should be a low-quality source of income as the spread between new capitalization and amortization should widen and look more like 2019. Q2 would still not have leveraged this amortization without the Cloud Lending change. It would have been 2.6% of revenue.

- **The same thing with Deferred Solution and Other Costs**. This includes fees to license third-party software and sales commissions along with some maintenance. Q2 also capitalizes costs like this and again amortizes over 5-7 years rather than the length of the customer contract. We would expect these to be growing and leveraging:

Cap Solutions Costs	4Q20	3Q20	2Q20	1Q20	4Q19	3Q19
Current	$19.0	$18.5	$18.8	$17.3	$15.6	$13.9
Long-term	$32.8	$34.7	$31.3	$32.6	$29.2	$25.4

Cap Solutions vs Rev	2020	2019	2018
New Capitalization	$15.0	$14.2	$6.7
Amortization	$8.5	$6.0	$3.6
Amortization % Rev.	2.1%	1.9%	1.5%

Capitalizing more than amortization in 2020 added 10-cents to EPS for GAAP and non-GAAP results.

- **Receivable DSOs are up a few days in 2020 vs. 2019.** Some of that could be Covid delays and then easing after 2Q, but it's not as though sequential growth is materially different than 2019 either:

	4Q	3Q	2Q	1Q
DSOs 2020	30.5	37.0	31.4	26,3
Seq Growth 2020	5%	6%	6%	6%
DSOs 2019	23.5	27.9	31.3	25.0
Seq Growth 2019	7%	3%	9%	6%

This is a company where people watch sales and sales growth. Three days of receivables is equal to about $3.5 million in sales in any quarter or about 3% growth. It is also worth noting that receivables are already lower by almost $1 million due to higher bad debt reserves. Thus, the higher DSO may be adding more than 3% to sales growth. **Also for revenue trends, it is worth noting that unbilled receivables fell in half from $4.3 million in 4Q19 to $2.1 million in 4Q20.** These are tied to transaction volume and reflect revenue booked before the end of the quarter but billed early in the next quarter. If revenue growth is smoking hot – then transactions should be growing and so should unbilled receivables.

- **Q2 is also adding back previously written off deferred revenue to its revenue figures.** This comes from having marked the deferred revenue at PrecisionLender to fair market value under purchase accounting rules. That would have assessed the likelihood of it being realized and timing. This is getting smaller as more time has elapsed since the purchase. Since Q2 adds this to revenue, that figure rises. It also adds it as 100% profit to adjusted gross profit and boosts its reported margin. This has been a big driver of gross profit and adjusted EPS:

Non GAAP rev	4Q20	3Q20	2Q20	1Q20	4Q19
Add back Prec Lend Def Rev	$0.7	$1.0	$1.3	$1.4	$1.8
Boost to gross margin	30bp	40bp	30bp	70bp	90bp
Boost to Adj EPS	1c	1c	2c	2c	3c

- In 4Q, Q2 also had to restructure a client's contract who needed relief. The result was it reversed out $2.8 million from revenue. This is probably a one-time item, but a little lucky that it occurred in the same quarter the company changed its revenue recognition of another business to accelerate deferred revenue recognition.

What to watch

- The spread between GAAP and non-GAAP figures remains absurdly huge in our view. Keep in mind, both sets of figures benefit from the capitalized implementation, solutions, and commission policies. Both GAAP and non-GAAP benefit from using asset lives that exceed industry norms like up to 5 years on amortizing software or amortizing capitalized costs over periods longer than customer contracts, plus adding back amortization as a non-cash cost. Both have the lower travel expense figures for 2020 too.

	2020	2019
Cash from Operations	-$2.9	$0.6
Cap Exp	$23.7	$13.9
Free cash flow	-$26.6	-$13.3
GAAP Loss	-$137.6	-$70.9
Int/Taxes/Dep/Amort	$80.4	$32.6
Stock Comp	$49.2	$39.4
Purchase Acctg Def Ref	$4.4	$1.8
acquisition related	$3.6	$16.7
Exting of debt chg	$8.9	$0.0
Termination chg	$13.2	$0.0
Adjusted EBITDA	$22.2	$19.6

Notice that EBITDA is not positive as normally defined. It requires adding back the stock compensation to get Q2 to an almost $0 level of EBITDA.

	2020	2019
GAAP Income	-$137.6	-$70.9
Purchase Acctg Def Ref	$4.4	$1.8
Termination chg	$13.2	$0.0
Exting of debt chg	$8.9	$0.0
Stock Comp	$49.2	$39.4
Amortiz Acq Tech	$21.3	$9.9
Acquisition related	$3.6	$16.7
Amort. Debt Discount	$23.3	$16.7
Amortiz Acq Intang	$17.9	$6.3
non GAAP Income	$4.3	$19.9
GAAP EPS	-$2.65	-$1.53
non GAAP EPS	$0.08	$0.41

We don’t mind adding back truly one-time items like a termination charge. But, acquisitions consumed cash and that expense should be recognized. Even adding those ongoing items back, there still is no non-GAAP income!! It takes adding back stock compensation to make Q2 profitable on a non-GAAP basis.

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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