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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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RealPage (RP) EQ Update 9/19 Qtr.

Current EQ Rating*	Previous EQ Rating
2-	2-

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We are maintaining our earnings quality rating of 2- (Weak)

The company just met guidance for 3Q, which has been the case for all 2019 quarters thus far. It did reduce guidance slightly for 2019 from adjusted EPS of $1.73-$1.77 to $1.74-$1.76 with lower revenue of $987-$995 million falling to $983-985 million and adjusted EBITDA forecasts falling slightly also to $280-$282 million from $278-$283 million.

Virtually every issue we had with accounting quality in the initial report is still a potential problem with some already causing problems. We still believe income is inflated with a combination of not amortizing goodwill and writing off acquired assets at a slower speed than internally developed assets. Plus RP's Non-GAAP EPS adds back all amortization of intangibles and stock compensation – even though both activities are consuming cash.

- Is RP really meeting forecasts? Or, is it cutting R&D to make quarterly results? The bad debt reserve as a percentage of sales is also falling this year.

- Is Depreciation and Amortization of software and equipment running too slow for a fast-growth company indicating it is using older equipment? The depreciation/amortization life for PP&E and software is 3-5 years. We believe this

expense should be higher too and this may be another source of unsustainable EPS being tapped.

- Capital Spending may also be too low to sustain PP&E and software given the useful lives. Gross PP&E is $300 million, indicating $60-$100 million in annual capital spending based on 3-5 year useful lives. Capital spending is $38.5 million through 9 months of 2019 instead of $45-75 million. It's also basically flat y/y.

- Deferred revenue growth is running slower than sales and making the company more dependent on current quarter sales to meet revenue targets. Since 4Q17, quarterly revenue is up 36% and deferred revenue is up 5%.

- The adjustments to earnings continue to add back recurring items in non-GAAP EPS. The company guides to this, but when isn't employee pay via stock compensation going to happen? The company's business model relies on making acquisitions, but the cost of these deals is added back too.

- When we adjust reported EPS for simply the reported cash spent to purchase stock used for stock compensation and the amortization of intangibles acquired with cash – the EPS figures fall more than 50%. Cash flow becomes negative quickly when considering cash spent on acquisitions and cash spent buying shares to cover stock-based compensation too.

Cuts to Product Development Are Helping RP Meet EPS Forecasts

RealPage uses its Non-GAAP EPS in setting guidance and judging success. This includes using a 26% tax rate and adding back numerous recurring items such as stock compensation, amortization of its convertible debt, and amortization of intangibles related to acquisitions. In the last three quarters, RP has met forecasts on Non-GAAP EPS. We believe this was largely the result of cutting R&D expense in absolute dollars and as a percentage of sales:

Cuts to R&D	3Q19	3Q18	2Q19	2Q18	1Q19	1Q18
Met Non-GAAP EPS	$0.45		$0.43		$0.40	
Product Dev w/o Stock Comp.	$25,602	$26,422	$26,135	$28,126	$27,417	$26,877
Non-GAAP sales	$255,202	$225,371	$244,018	$216,355	$234,530	$201,614
Prod Dev % Sales	10.03%	11.72%	10.71%	13.00%	11.69%	13.33%
EPS from $ Cut	$0.01		$0.02		$0.00	
EPS from % Cut	$0.03		$0.04		$0.03	

The company is just hitting non-GAAP forecasts, but without cutting R&D investments in both dollar terms and as a percentage of sales – it would be missing. And this is largely a software company! It's also not as though sales growth is leveraging the costs either. Sales growth is only running about 13% and that is padded with acquisitions producing about half that growth.

We also removed the stock compensation from the product development costs above. It is interesting to see that the last two quarters have seen a big drop in stock compensation already, which tempered some of the drop in total R&D:

Cuts to R&D	3Q19	3Q18	2Q19	2Q18	1Q19	1Q18
Product Dev. GAAP	$27,866	$28,942	$28,151	$30,771	$29,891	$29,040
Stock Comp	$1,948	$2,520	$2,016	$2,645	$2,480	$2,163
Non-GAAP Prod Dev.	$25,602	$26,422	$26,135	$28,126	$27,417	$26,877

If the stock compensation had been figured into the mix, (and BTW – try not paying it and see how long the engineers stay) – GAAP EPS benefited another $0.01 in 3Q19 and 2Q19 from lower stock compensation. The company says that the drop in product development expense is due to an effort to reprioritize its R&D toward major new projects. If that is true, we would expect it to rise again in the near future.

Bad debt reserves have also fallen in 2019. The decline in absolute dollars from $8.85 million to $8.55 million on a 6% increase in receivables. Reserves should be $9.35 million, but they are light $800,000. That added another 1-cent to EPS during the first nine months of 2019.

Depreciation and Amortization of Software May Also Be Helping Non-GAAP EPS

Essentially all assets purchased via capital spending or developed in-house are depreciated over 3-5 years at RealPage: Data processing and communications equipment, furniture and

fixtures, and software. The depreciation and amortization of these items do remain in the reported Non-GAAP EPS.

Here is the current PP&E for Real Page:

PP&E	3Q19	4Q18
Leasehold Improvements	$66,697	$63,391
Data Proc/Communications	$78,549	$68,015
Furniture/Fixtures	$35,057	$33,840
Software	$149,912	$131,437
Gross PP&E	$330,215	$296,683
Accum. Dep/Amt	$170,610	$143,155
Net PP&E	$159,605	$153,528

Over half the gross PP&E has already been depreciated at this point. That would indicate to us that some assets are likely fully depreciated already and the remaining net figures may have 1.5-3.0 years of expensing left. Just taking an average of $155 million net PP&E and dividing by 12 quarters, the depreciation and amortization should be about $13 million per quarter. RealPage is not hitting that figure and in fact, depreciation fell sequentially last quarter:

	3Q19	2Q19	1Q19
Depreciation	$7.5	$7.7	$7.5
Amort. Software	$3.9	$3.8	$3.2
Total	$11.4	$11.5	$10.7

It is very possible that the software is being amortized over 4-years. The unamortized amount was $63 million, which divided by $3.9 million equals 16-quarters. So, 58% of the software has been depreciated, while only 47% of the other equipment has been. Furniture and leasehold improvements are probably largely depreciated at this point. The recent growth has been in computers for PP&E. Yet, the depreciation figure indicates that the remaining PP&E still has 3-years of life. We disagree there. RP is not spending that much on new equipment. Much of the undepreciated equipment may have only 1.5-2.0 years of expense left. Every $1 million additional depreciation is worth about 1-cent in EPS per quarter. We think RP is picking up at least 1-cent here by using older equipment.

Low Capital Spending Also Points to Older Equipment and Reduced Depreciation Expense

Looking at the Gross PP&E figure above with software, it has been essentially $300 million for some time. Replacing those assets over a 3-5 year timeframe would require $60-$100 million in capital spending per year. RealPage is running below that figure and capital spending has been flat for nearly three years now:

	YTD 19	YTD 18	2018	2017	2016
Depreciation	$22.7	$21.3	$28.5	$27.2	$24.5
Amort. Software	$10.9	$8.7	$11.9	$8.0	$5.8
Total	$33.6	$30.0	$40.4	$35.2	$30.3
Capital Spending	$38.5	$37.3	$50.9	$49.8	$75.2

Looking at the Gross PP&E figures also shows a sizeable drop in computer equipment in 2018:

PP&E	3Q19	2018	2017	2016
Leasehold Improvements	$66,697	$63,391	$59,179	$51,242
Data Proc/Communications	$78,549	**$68,015**	**$83,922**	$76,773
Furniture/Fixtures	$35,057	$33,840	$28,752	$26,513
Software	$149,912	$131,437	$107,924	$86,983
Gross PP&E	$330,215	$296,683	$279,777	$241,511
Accum. Dep/Amt	$170,610	$143,155	$131,349	$111,083
Net PP&E	$159,605	$153,528	$148,428	$130,428

Again, this is a software company, so when computer equipment gets old that's a problem for long term competitiveness in our view. In 2018, it appears that RP disposed of a higher percentage of older equipment to lower the gross figure. However, we are concerned about two things. First, the gross amount of computer equipment is still below 2017's levels near the end of 2019. Second, if the company eliminated older equipment that was likely full depreciated and replaced it with newer stuff – then the depreciation should be rising and it's not. Depreciation has been flat for 2019 with a small sequential decline in 3Q19 from $7.7 million to $7.5 million.

In our view, RP may be picking up 1-2 cents in EPS per quarter from using older equipment that is fully depreciated, seeing lower depreciation, having flat capital spending against 30%

sales growth in 2018 and 14% in 2019 YTD. The company may need to ramp up capital spending considerably going forward or risk losing competitiveness.

Deferred Revenue Growth Is Not Keeping Pace with Sales

We talked about this in the initial EQ report and it has continued to worsen. Days Sales for Deferred Revenue was well above 60 days in 2017. Now it's well below 50 days in 2019. It has also fallen sequentially for 3-straight quarters:

	3Q19	2Q19	1Q19	4Q18
On Demand Rev	$245.6	$235.2	$226.5	$218.1
Def. Rev	$127.9	$128.7	$125.7	$125.6
Days Sales	47.5	49.9	50.6	52.6

	3Q18	2Q18	1Q18	4Q17
On Demand Rev	$215.4	$206.9	$193.3	$180.1
Def. Rev	$115.6	$116.4	$115.4	$122.2
Days Sales	49.0	51.3	54.5	61.9

This will make the company more dependent on signing up new business in the current quarter to make forecasts. It also has a negative impact on cash flow because rising deferred revenues brings in cash. The ASC 606 rule adoption lowered deferred revenues in 2018 by $3.7 million that is only about 1.5 days. Compare that to the drop from 61.5 days from 3Q17 to 47.5 days in 3Q19.

The Adjustments to Earnings and Cash Flow Are Inflating Results in Our View

We are going to highlight three major areas where the non-GAAP results may be overstating the results here.

Acquisitions are a key part of RP's growth model. It has made several in prior years and has added two more in 2019 with a third announced this month. RP wants to view this as discretionary spending and therefore it is free cash flow positive without acquisitions. We would argue that the company is addicted to doing more deals to jumpstart growth. Organic growth is about half the rate of reported growth with acquisitions.

Even though the bulk of the acquisitions' purchase price is being allocated to goodwill and therefore is not amortized at all, remaining assets such as developed technology is being amortized over 5-7 years and client relationships are being amortized over 10 years. If these assets were built in house, sales commissions are paid as they occur or are amortized over 3-years. That's much faster than 10-year amortization. The acquired technology would be amortized over 3-5 years if built in house. Plus, that amortization would not be added back to reported Non-GAAP earnings. These are some sizeable figures looking at the two most recent deals in 2019:

	Goodwill	Client Rel.	Dev. Tech	Total paid
Simple Bills	$9.5	$5.2	$4.0	$18.1
Hipercept	$23.1	$3.0	$1.7	$28.2

The goodwill isn't being amortized at all – even if it only half what they paid for goodwill would have been necessary to build it in-house, that figure would be depreciated over 3-5 years into income or expensed immediately into income. The other assets are being amortized – but RP adds it back to both non-GAAP earnings and to cash flow. The most recent deal that was announced was Buildum for $580 million. The company has negative EBITDA and revenues of $50 million so they paid over 11x revenue for it. Per *Zoom Info*, Simple Bills had revenue of under $6 million so they paid more than 3x sales for that. *Owler* showed revenue for Hipercept of about $10 million, so RP paid nearly 3x sales for that deal.

Total assets at RP are $2.3 billion and 48%, or $1.1 billion, is goodwill. Another $261 million are acquired intangibles or 11% of the total. The size of acquisitions dwarfs capital spending, R&D, and even sales and marketing combined. To us, that makes this an on-going activity not a one-time event:

	2019YTD	2018	2017	2016
Cash Acq.	$38.5	$278.6	$649.9	$66.4
Other Acq Payments	$26.3	$28.4	$8.5	$5.7
Capital Spending	$49.0	$50.9	$49.8	$75.2
Prod. Dev.	$85.9	$118.5	$89.5	$73.6
Sales & Marketing	$145.9	$166.6	$140.5	$122.5
C+P+S&M	$280.8	$336.0	$279.7	$271.3

This assumes all of product development costs and sales & marketing are cash. **Also, in 2019, RP has already announced another $580 million deal for Buildum. That alone will**

outdo everything spent on internal business building items. In 2018, acquisitions were basically equal to spending on internal items. In 2017, acquisitions were more than twice the level of internal spending.

Thus, we are not going to treat the acquisitions are one-time in nature for cash flow, nor are we going to view the amortization of acquired assets as non-ongoing costs. If they didn't buy this stuff, it would have been required that they built it and expensed it.

Share compensation is another item that continually recurs and often increases. Employees consider it pay. Try not paying it and see what employees demand in cash wages. We talked about some of this in the section on cutting product development costs. RP tries to minimize the dilution of shares issued in this manner by repurchasing shares and that consumes cash too.

	2019YTD	2018	2017	2016
Share Compensation	$47.3	$50.6	$45.8	$36.9
Share Repos for comp.	-$16.8	-$29.0	-$30.9	-$6.0

At a minimum, we believe the cash spent buying back shares should be expensed.

Reported Earnings and Adjustments

	2019YTD	2018	2017	2016
Non-GAAP EPS	$1.28	$1.51	$0.93	$0.76
Non-GAAP pretax inc.	$162.4	$183.1	$127.1	$98.8
Less Cash spent on Stk Comp.	$16.8	$29.0	$30.9	$6.0
Less Amort of Intangibles	$60.4	$71.7	$39.9	$30.3
Adj. Non-GAAP pretax inc.	$85.2	$82.3	$56.3	$62.5
26%/40% tax rate	$22.1	$21.4	$22.5	$25.0
Net Adj. Non-GAAP	$63.0	$60.9	$33.8	$37.5
Adj. Non-GAAP EPS	$0.67	$0.68	$0.43	$0.48

If we only deduct the cash spent on share repurchases related to stock compensation and do not accelerate the amortization of acquisition intangibles to conform with RP's actual depreciation schedule of 3-5 years, that is already enough of a change to cut reported EPS in half.

Remember, the acquisitions consumed cash too, we are simply putting some of that cost into the income statement. Also, the other areas of EPS that may have inflated recent results such as cuts to product development for 3-4 cents per quarter in 2019, the cuts to bad debt expense and the reduced depreciation would still be inflating these adjusted figures.

Reported Cash Flow and Adjustments

	2019YTD	2018	2017	2016
CFO Reported	$186.1	$244.8	$140.3	$129.4
Cap-Ex	$38.5	$50.9	$49.8	$75.2
FCF Reported	$147.6	$193.9	$90.5	$54.2

Here is what RP is reporting for cash flow. It looks like solid results. We are going to adjust this for three things:

- We believe capital spending is too low and are going to boost it to $60 million annualized where necessary
- We are moving the cash spent buying stock to offset stock compensation from the financing section to the operating section
- While we will let the amortization of intangibles be added back, we are going to consider acquisitions an ongoing cash outflow as well as move additional consideration paid on prior acquisitions listed in the financing section to the investing section

	2019YTD	2018	2017	2016
CFO Reported	$186.1	$244.8	$140.3	$129.4
less cash Stock Comp	-$16.8	-$29.0	-$30.9	-$6.0
Adj CFO	$169.3	$215.8	$109.4	$123.4
Cap-Ex	$38.5	$50.9	$49.8	$75.2
Additional Cap-Ex	$6.5	$9.1	$10.2	$0.0
FCF before Acq	$124.3	$155.8	$49.4	$48.2
Acquisitions	$50.1	$278.6	$649.9	$66.4
Add Acq consideration	$26.3	$28.4	$8.5	$5.7
Adj. FCF	$47.9	-$151.2	-$609.0	-$23.9

Again, remember that there is another $580 million acquisition coming in 2019. The company's cash flow drops noticeably when low capital spending, cash spent on stock for compensation, and the acquisition payments are taken into account.

Explanation of EQ Rating Scale

Rating	Explanation
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 Concerns"	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 may 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 the next quarter. 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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