BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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RealPage (RP) EQ Update- 9/20 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 an 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)

Results for 3Q were much cleaner than in the recent past. RP beat forecasts of adjusted 45-cents by 7-cents. And it didn't do it by guiding to higher product development and marketing costs and then actually cutting them like in 2Q. The company did guide to $4 million of COVID related savings and came in at $7 million but that $3 million is only 2-cents of EPS. Guidance did not look very strong calling for sequential revenue to be lower by $2-$6 million and adjusted EPS of 46-50 cents for 4Q.

What Improved?

- RP said on the call that expects to be much less active in making acquisitions in 2021 and thereafter. We are stunned as it has been a serial acquirer and makes several deals per year.
- Their acquisition accounting is our biggest problem with RP's earnings quality because it doesn't run any of it through adjusted earnings.

What deteriorated

- Customer deposits fell in 3Q by just over $30 million. This is from customers who pay rent online and RP sends the cash to the apartment owner.
- Residential services like this have been the fastest-growing part of revenue and it accelerated under COVID. We don't have the 10-Q yet to see what 3Q's residential services revenue growth was. A decline could indicate that this area of revenue growth may slow going forward.

- If RP spends less on acquisitions, will it need to ramp up internal product development spending? That would improve earnings quality – but product development spending was $34 million last quarter compared to $1.6 billion deals where RP adds back every nickel of cost and amortization to adjusted earnings.

Hyper Residential Services Growth May Not Be Sustainable

With COVID, more people went to online bill-paying. RP has software and web-portals that allow residents at apartments to pay their rent online, their utility bills online, buy renters insurance, and send in maintenance requests online.

This had been an area growing in the high-teens for RP in recent years that accelerated in 1Q to 23% and to 28% in 2Q20. We think that may have been part of the reason for the revenue beat in 3Q too. We're familiar with online rent payment and it requires residents to pay a fee to use it, thus it's cheaper to pay with a check or use online banking to do it for free. Hearing the conference call, RP was very focused that the future will be one of more people continuing to work from home forever and this will be a growth area.

Customer deposits are basically the rent payments that RP collects and then transmits to the apartment owner. In looking at their results, customer deposits dropped noticeably in 3Q20. They fell $30.6 million in the period from 2Q and stand at $232.6 million. That's a 12% drop from 2Q for what has become the fastest-growing revenue item. This was a huge cash flow headwind for 3Q:

	3Q20	3Q19
Cash From Ops	$50.4	$112.8
Chg in Deposits	-$30.6	$45.5
CFO w/o Deposits	$81.0	$67.3

This bears watching if to see if it continues and it may have played a role in the guidance for lower sequential revenue growth.

Acquisitions Continue and an Interesting Comment on the Call

RP has always been a serial acquirer in our view. It adds new tech features and software products through its many acquisitions. We have always viewed this as a way for RP to keep R&D and many of the programming costs off the income statement. Instead, you just buy the tech you need on the cash flow statement.

RP then assigns a great deal of the purchase price to goodwill which is not amortized and it doesn't penalize earnings. The rest of the intangibles are amortized but added back as non-cash expense for adjusted earnings. And any transaction costs or integration costs are added back too in adjusted earnings. Magically RP gets new product and higher revenue and it cost absolutely nothing to create according to adjusted earnings. This is one of our biggest issues with RP's accounting as the deals clearly consume cash and RP has few years with free cash flow, but adjusted earnings keep rising expense-free:

	3Q20	2019	2018	2017	2016
Cash from Oper.	$50.4	$317.0	$244.8	$140.3	$129.4
Capital Spend.	$18.6	$51.9	$50.9	$49.8	$75.2
Acquisitions	$70.2	$665.8	$307.0	$658.4	$72.1
Free Cash Flow	-$38.4	-$400.7	-$113.1	-$567.9	-$18.0

Adjusted Earnings show that ignoring this large cash cost of acquisitions is a major part of boosting GAAP earnings. Again, without goodwill amortization, this still doesn't show the full extent of the problem. Goodwill is $1.7 billion. The intangibles being amortized and added back are only $350 million.

	3Q20	2019	2018	2017
GAAP Pretax	$20.4	$60.6	$34.3	$15.2
Amortization	$25.4	$80.8	$71.7	$39.9
Acq. Expense	$1.7	$4.8	$2.4	$16.6
Stock Comp	$15.8	$62.6	$50.6	$45.8
Adj. Pretax	$68.7	$223.4	$183.7	$127.1

There are more adjustments going on, but it is obvious that adjusted income is several multiples higher than reported earnings and a big part of that is ignoring all cash costs of acquisitions.

On the conference call, it was noted that investors can expect M&A activity to decline in 2021 and thereafter too.

That was an astonishing statement to us as RP has made several dozen deals in the last few years. When we look at what they have been spending on acquisitions, it makes us think "all that could have been going through the income statement as Product Development costs and wages." We'll have to see what happens, but if RP brings more development in house rather than buying it, it could see operating expenses increase. Plus, it would tough to claim that should be added back because they would be cash expenses. By comparison to the $1.6 billion spent on deals in recent years – RP's own product development expenses were only $34 million last quarter. The adjustments to EPS would get smaller and earnings quality would improve if this becomes the new future. It could also mean lower earnings overall.

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 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.

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