BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

July 17, 2020 | www.btnresearch.com

# RealPage (RP) EQ Update- 6/20 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)**

It has been a busy week for RP. The company announced its CFO is leaving next month. The next day it announced that it expects to top the high-end of all its guidance metrics for 2Q20 when results are released on July 30.

We still see many red flags for earnings quality and sustainability at RP. Investors should also remember that RP slashed forecasts after 1Q results, making a "beat" in 2Q much less impressive. This is still largely a software company that collects its fees upfront as deferred revenue – hitting forecasts on revenue and adjusted EBITDA (adding back everything but the kitchen sink including stock compensation and all costs of acquisitions) should not be too difficult, but it appears it is getting tougher at RP.

- **Reduced forecasts call for 2Q20 to come in below 1Q20 and 2Q19 levels.** During 2019 and 2020, RP has made six acquisitions for $763 million. Those companies had over $80 million in revenue and the pro forma figures from RP's 10-Q shows quarterly revenue should be $277 million. RP's 2Q forecast is $276-$280 million with EPS lower than 2019. Organic growth may be zero at this point.

- **Deferred Revenue is a problem for growth also.** If organic growth is low, RP should at least have the benefit of collecting fees in advance and having the quarter largely "baked in." **However, deferred revenues have been falling**.

- **RP has cut R&D spending to help EPS of late by 2-4 cents per quarter. It also reduced its tax rate assumption for 2020 which helps 1Q EPS by 1-cent.**

- **Acquisitions are a way of life for RP, yet it is not self-funding on them. It stretches earnings by not amortizing the bulk of acquired assets at all and where it does amortize – it uses a longer life schedule than largely identical assets built in-house.** RP had 48-cents in non-GAAP EPS in 4Q19 and 43-cents in 1Q20. Goodwill amortization over 40 years would lower those figures by 11-cents. Adding back the amortization of other acquired intangibles was another 16-cents and 20-cents of that quarterly non-GAAP EPS.

- **RP appears to have spent years under-investing in equipment as the company has doubled sales, but still spent the same amount on capital expenditures for 3-years.** The gap between depreciation and amortization vs. capital spending has narrowed and depreciation and amortization have been flat for four quarters now. In 2020, it appears, capital spending is now rising – that could create a headwind for EPS.

## The Forecasts Should Not Be Tough to Beat – But Forecasts Point to Zero Growth

Investors should remember that RP started 2020 with forecasts of for growth of 18%-20% on revenue, 14%-15% growth of adjusted EBITDA, and 11%-14% non-GAAP EPS growth. We think investors should have already been alarmed because much of that growth would have come from acquisitions already made. The proforma revenue figure for 2019 assuming the acquisitions had occurred at the start of the year was $1,059 million. That means RP was only planning for 10%-12% organic top-line growth after cross-selling its existing clients the new services it bought.

After 1Q20, the forecasts were slashed for the year:

| Guidance | 2020b | 2020a | 2019 |
|---|---|---|---|
| Revenues | $1114-1154 | $1163-1183 | $988 |
| Adj. EBITDA | $290-300 | $320-324 | $282 |
| GAAP EPS | $0.22-0.33 | $0.29-0.35 | $0.60 |
| non-GAAP EPS | $1.74-1.84 | $1.95-$2.00 | $1.76 |

Growth is now expected to be only 13%-17%, or organically 5%-9%. EPS growth is expected to be flat and EBITDA only rising 3%-6%. It appears that margins are expected to be squeezed too.

RP spent $763 million making six acquisitions in 2019 and 2020 so far. We cannot find a revenue figure for two of the deals, but the other four had $80 million in annual sales. **According to the 1Q20 10-Q, the proforma sales for these deals was $277 million for 1Q20. That is exactly what RP reported. Organic growth may be zero now with a 2Q forecast of $276-$280 million.** The forecasts for 2Q20, call for all the metrics to decline – not just from 1Q, but from 2Q19 (except revenue) and 2Q19 did not include the recent acquisitions.

| Guidance | 2Q20 | 1Q20 | 2Q19 |
|---|---|---|---|
| Revenues | $276-280 | $277 | $244 |
| Adj. EBITDA | $66-70 | $72 | $68 |
| GAAP EPS | $0.00-0.05 | $0.06 | $0.16 |
| non-GAAP EPS | $0.38-0.42 | $0.43 | $0.43 |
| # of Shares | 94.7 | 93.7 | 94.0 |

Investors should also keep in mind that RP regularly beats forecasts – but they aren't crushing estimates. Their last eight quarters of beats are:

| | 1Q20 | 4Q19 | 3Q19 | 2Q19 | 1Q19 | 4Q18 | 3Q18 | 2Q18 |
|---|---|---|---|---|---|---|---|---|
| EPS Beats | $0.01 | $0.01 | $0.00 | $0.00 | $0.00 | $0.02 | $0.03 | $0.00 |

The declining deferred revenue as days of quarterly sales also makes RP more dependent on writing new business in the current quarter than it needed in the past.

| Def. Rev Days | 1Q | 4Q | 3Q | 2Q |
|---|---|---|---|---|
| 2020/2019 | 48.4 | 51.5 | 47.5 | 49.9 |
| 2019/2018 | 50.6 | 52.6 | 49.0 | 51.3 |
| 2018/2017 | 54.5 | 61.9 | 61.5 | 63.1 |

## Other Areas Where EPS Has Already Been Stretched

We discussed much of this after the 1Q20 results, but we will reiterate them here to remind readers about other earnings quality issues for RP.

- RP has been cutting R&D to make earnings and adding 2-4 cents per quarter of late.

In 1Q20, R&D rose in dollar terms, but still declined as a percentage of sales.

| Cuts to R&D | 1Q20 | 4Q19 | 3Q19 | 2Q19 | 1Q19 |
|---|---|---|---|---|---|
| Cuts in $ terms | -$2.0 | $2.7 | $0.8 | $2.0 | -$0.5 |
| EPS help | -$0.02 | $0.02 | $0.01 | $0.02 | $0.00 |
| Cuts in % of non-GAAP sales | $3.0 | $5.9 | $4.3 | $5.6 | $3.8 |
| EPS help | $0.02 | $0.05 | $0.03 | $0.04 | $0.03 |

- **RP relies on acquisitions for some of its R&D and it has now made 46 deals.**
    - The first problem is **RP is not self-funding for these deals**, yet if it doesn't do them, organic growth is not as impressive as reported growth. Being free cash flow negative is a problem in our view. That is why RP just issued more stock – to repay revolver debt and deal with dilution on convertible notes used to fund deals.

| | 1Q20 | 2019 | 2018 | 2017 |
|---|---|---|---|---|
| Cash from Ops | $61.6 | $317.0 | $244.8 | $140.3 |
| Capital Exp. | $13.3 | $51.5 | $50.9 | $49.8 |
| Acquisitions | $59.5 | $665.8 | $278.6 | $649.9 |
| Free Cash Flow | -$11.2 | -$400.3 | -$84.7 | -$559.4 |

    - The next problem is that **had RP built these assets in house, the wages would have been expensed as incurred and the equipment amortized over 3-5 years. Instead, the bulk of the acquired assets are goodwill of $1.66 billion and are not amortized at all.** Even over 40 years, it would be costing RP 11-cents in EPS per quarter.

- **The intangibles that are amortized are largely developed technology over 3-7 years and client relationships over 3-10 years. Internally-developed software is amortized over 3-5 years and sales commissions for signing up a new client are amortized over 3 years.** That stretching is boosting GAAP results, and the fact that RP adds back the amortization of acquired assets as "non-recurring" items boosts non-GAAP results. In 4Q19, adding this cost back was 16-cents of the reported 48-cents of non-GAAP EPS. In 1Q20, it was 20-cents of the reported 43-cents.

- **RP picked up 1-cent in 1Q20 by assuming a 24% tax rate** down from 26% in 2019 for its non-GAAP EPS. That alone is the 1-cent beat in 1Q.

- **We also continue to believe that RP is underinvesting in equipment and the lower depreciation is helping EPS.** Capital spending was $75 million in 2016 and has now been $50 million for three straight years. During that time, RP made $1.7 billion in deals, assets are up four-fold, and sales have more than doubled. Yet, capital spending is down to flat. Capital spending has not risen even though depreciation and software amortization has increased:

| | 2019 | 2018 | 2017 |
|---|---|---|---|
| Depreciation | $30.2 | $28.5 | $27.2 |
| Amortz. Software | $14.8 | $11.9 | $8.0 |
| Dep/Amortz. | $45.0 | $40.4 | $35.2 |
| Capital Spending | $51.5 | $50.9 | $49.8 |

| | 1Q20 | 4Q19 | 3Q19 | 2Q19 | 1Q19 |
|---|---|---|---|---|---|
| Depreciation | $7.4 | $7.5 | $7.5 | $7.7 | $7.5 |
| Amortiz. Software | $4.1 | $3.9 | $3.9 | $3.8 | $3.2 |

Depreciation and amortization have been basically flat for four quarters at this point as sales have risen 18%. This looks like an area where investors should expect more headwind on costs. In 1Q20, capital spending did increase by over $2 million and RP guided to 2Q spending for $2-$3 million more so employees could work remotely. They amortize this over 3-5 years. If the equipment upgrade is finally beginning – every $1.25 million increase in depreciation expense is worth 1-cent in EPS.

# 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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