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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 maintain our earnings quality rating at 2- (Weak)

After cutting guidance after 1Q20, RP beat reduced forecasts handily by 8-cents. More importantly, the company pulled up its bottom guidance but did not raise the top forecasts and expects EPS to be lower in both 3Q and 4Q following 2Q's results. We continue to see several areas of poor-quality earnings again at RP. The biggest red flag is the difference between GAAP EPS and adjusted EPS ($0.11 vs $0.49). On the surface this is getting wider:

RealPage EPS	2Q20	2Q19	1Q20	1Q19	4Q19	4Q18	3Q19	3Q18
GAAP EPS	$0.11	$0.16	$0.06	$0.12	$0.21	$0.07	$0.12	$0.09
Adj. EPS	$0.49	$0.43	$0.43	$0.40	$0.48	$0.39	$0.45	$0.38
Adjustments	$0.38	$0.27	$0.37	$0.28	$0.27	$0.32	$0.33	$0.29

- After 1Q20, RP cut 2Q adjusted guidance to 38-42 cents – saying the following:

- "*Adjusted-EBITDA is expected to be $66 million to $70 million, which represents margins of 24% to 25%.* ***Our second quarter adjusted-EBITDA is expected to be impacted by over $3 million*** *of spend that we incurred to ensure not only that we are ready to respond during the COVID-19, but also that we went above and beyond for our customers"*
- "*While we intend to adjust variable costs due to lower revenue and the realization of some productivity improvements,* ***we do not expect to reduce product development or sales and marketing spend*** *given our view that clients will have an increased need for products and services that help them accelerate their transition to more virtual operations."*

- In 2Q20 results, the first thing RP said was that COVID Costs were not as large as expected and for several reasons this was a positive surprise:

  "***Numbers were exceptionally good relative to guidance because the impact of COVID-19 was not as impactful as we had feared*** *and there is surging demand for solutions that facilitate virtual leasing and living offered by RealPage."*

  "Margin performance was driven by continued investments for growth and included incremental expense related to RealPage adapting to the COVID-19 environment. Despite these incremental costs, ***we were able to ramp down some COVID-19 costs faster than anticipated."***
  "we also received some uplift from reduced COVID-19-related costs, such as travel and employee and medical benefits as many procedures were restricted."

- From our reading of this - **$3 million in COVID costs would cut adjusted EPS by 2.3 cents.** RP does not quantify the difference from having these costs vanish more quickly or the unexpected windfall of having less travel expenses or employee medical costs. **If this change was $1 million below guidance, they picked up 0.8 cents in EPS here. It also seems more likely that employee medical** costs will become a headwind in 3Q and 4Q as procedures are likely being done now.

- **Also, after giving guidance that 2Q would not see a reduction in sales and marketing or product development – RP saw both expenses decline:**

RealPage EPS	2Q20	1Q20
Product Development	$31.4	$31.5
Stock Comp.	$1.6	$1.9
Adj. Product Dev.	$29.8	$29.6
Sales & Marketing	$49.4	$54.7
Stock Comp.	$2.3	$5.9
Adj. Sales & Marketing	$47.1	$48.8

In the adjusted EPS, RP adds back stock compensation as though that is a one-time optional expense that occurs every quarter. That is one area where we always point to RP's adjusted EPS being aggressive. However, as RP guided to rising expense and always adds back the stock compensation we will look at from that angle. **Both adjusted costs fell as a percentage of sales. Product Development fell from 10.70% to 10.44% – that added 0.6 cents to adjusted EPS. Sales and Marketing fell from 17.63% to 16.50% - that added 2.4 cents to adjusted EPS.**

- **Our next item to question is what looks like some big-bath charges that appeared with COVID.** The company has made over 45 acquisitions, including some large ones in 2017. While RP either doesn't amortize and/or adds back essentially every cost of a deal – there has not been a much history of taking large legal or restructuring charges:

Last 5 years	2019	2018	2017	2016	2015
Org. Realignment	$1.53	$0.00	$0.00	$0.00	$0.00
Regulatory/Legal	$1.47	$0.08	$11.01	$0.00	$0.00

There were no realignment charges called out until 2019. RP describes these as charges to exit bad contracts, severance pay, closing facilities, and professional fees. Regulatory and Legal costs pop up for Hart Scott Rodino reviews of large acquisitions or settlement of other one-time matters such as in 2017. But, look at the last 8 quarters:

Last 8 Qtrs	2Q20	2Q19	1Q20	1Q19	4Q19	4Q18	3Q19	3Q18
Org. Realignment	**$1.22**	$0.00	**$1.21**	$0.00	$0.83	$0.00	$0.68	$0.00
Regulatory/Legal	**$2.15**	$0.35	$0.36	$0.00	$0.90	$0.00	$0.22	$0.08

We have seen enough restructuring charges to know that they normally involve a big charge upfront and get smaller over time. Here – the first charges are smaller and the quarters with COVID when people are less concerned about every penny, they get larger. Also, RP guided that this charge would be $350,000 in 2Q as the quarter was already a month done and finished at $1.2 million. Given that RP uses this process to clean up poor contracts or assign some third-party fees or management time devoted to restructuring – the growing charges look aggressive to be added back. To the extent these remove future costs like for a low margin contract these help boost future earnings and adding them back boosts current earnings too. If they include items like training or management time – those are recurring expenses in our view. **The alignment charges added 0.9 cents to adjusted EPS**.

There was no discussion or reason given for the surge in legal bills in 2Q20. Guidance was for this to be zero in 2Q. The company does say that it accrues for legal items and we saw accrued expenses rise from $87.3 million to $98.6 million in the quarter. To the extent, this is for legal settlements or bills to pay overtime, this looks a large figure that will reduce future costs and is being added back now to current earnings too. Legal bills are normally about $350,000, **we are going to highlight the additional $1.8 million in 2Q20 as a potentially a lower-quality source of EPS that added 1.4 cents to the results.**

- **Finally, RP also rounded up its Adjusted EPS by 0.4-cents, which brings the total to 6.5-cents with lower COVID, reductions to R&D and marketing, a surge in realignment costs and legal costs. And, the company began the quarter cutting forecasts from likely a range of 45-50 cents to 38-42 cents.**

- **Other red flags appear for future guidance too:**
  - **RP did not raise its top forecasts after the big 2Q beat.** 3Q is expected to be 43-46 cents and 4Q 42-46 cents. Total 2020 guidance went from $1.95-$2.00 down to $1.74-1.84 in 1Q. After beating by 8-cents in 2Q, only the low-end moved and 2020 guidance is now $1.77-$1.84.
  - **Further evidence that the realignment and legal accrual in 2Q may have been big-bath charges that help reduce future expenses is also seen in guidance.** Realignment charges are expected to fall to only $750,000 in 3Q and under $300,000 in 4Q. Legal is expected to come in at zero.

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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