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Twitter (TWTR) EQ Review- 9/18 Quarter

We are setting the Twitter EQ Review rating at 3+ (Minor Concern) as the situation is improving. We still believe expenses will start to rise at the same rate if not exceed revenue growth and offset some of the earnings gains. We also believe capital spending will reach higher levels. We cannot check advertising expense trends without the annual results but expect those to increase too. However, compared to periods when over half of R&D was not paid with cash, free cash flow adjusted for capital leases, non-cash compensation, and acquisitions was essentially negative or considerably below reported figures – many areas of Twitter's reported results have improved in quality. We would urge readers to review our February 2018 note to see more discussion of these concerns:

- Capital spending is exceeding depreciation again, which reduces some of our concerns that TWTR is using older equipment
- The use of capital leases has fallen and is improving reported cash flow
- R&D is starting to rise, and the amount paid with stock is falling
- Reported cash flow looks better as well and dilution is not as rampant as in the past

Capital Spending

Twitter went two years in 2016 and 2017 when depreciation exceeded capital spending. That is a sizeable issue for a tech company and one that claims to be a growing organization. This has been helping earnings because depreciation has been growing very slowly and we speculated that Twitter was likely using fully depreciated equipment.

	2015	2016	2017
Depreciation	$257	$333	$349
Cap Ex + Cap Leases	$379	$319	$284

We expected this to be a short-lived issue and capital spending would bounce back. Guidance early in the year was for $375-$450 million in capital spending in 2018. So far through 3Q18, capital spending is $410 million plus another $16 million of equipment acquired via capital leases. Guidance for 4Q18 is $60-$85 million in capital spending which would put the company at about $500 million and handily beat the high-end of guidance. With depreciation at $315 million through 3Q18, the trend of picking up cash flow from underinvesting has reversed.

We will note that Twitter has no equipment that is depreciated longer than 5-years. Net PP&E was actually falling! We believe Twitter's capital spending will need to continue rising and may exceed $500 million going forward to deal with growth, normal replacement, plus two years of under-investment.

Twitter Is Using Fewer Capital Leases to Buy Equipment

Capital leases inflate income because the payment is split into interest expense and principal payments. Only the interest expense impacts income, the remaining payment does not reduce income like an operating lease payment.

Capital leases also inflate free cash flow because the principal payment is recorded in the financing section of the cash flow statement. Also, equipment bought with a lease is not listed as capital spending. Free Cash Flow is defined as cash from operations less capital spending. The cash from operations is inflated because income does not have the principal payment. The capital spending is understated because new equipment purchased with a capital lease isn't listed.

Thus, capital leases boost income and free cash flow, but sets up the company for heavy cash repayments in the future.

Twitter was a huge user of capital leases to acquire equipment but that has seen a big improvement in 2018:

	2015	2016	2017	3Q 18
Purchases with Leases	$31	$100	$123	$16
Payments on Leases	$118	$101	$103	$70

In 2013 and 2014 – capital leases were used to buy $156 and $141 million in equipment. Total capital spending was heavily driven with leases:

	2015	2016	2017	3Q 18
Purchases with Leases	$31	$100	$123	$16
Capital Spending	$347	$219	$161	$410
Total Cap Ex.	$378	$319	$284	$426

We think this improves the quality of Twitter's reporting. We'll give them kudos for this change. As leases payments wane, it could allow Twitter to boost capital spending further.

R&D Expenses Are Rising Again and TWTR Is Paying with Cash

This area still needs to rise considerably in our view, but at least it is moving in the right direction now. When a growing tech company cuts R&D to improve cash flow, that's a red flag in our view:

	2015	2016	2017
R&D Expense	$807	$714	$542
R&D paid in stock	$402	$336	$241
Cash Wage %	50%	53%	56%

	1Q17	2Q17	3Q17
R&D Expense	$129	$143	$136
R&D paid in stock	$64	$64	$57
Cash Wage %	50%	56%	58%

	1Q18	2Q18	3Q18
R&D Expense	$123	$139	$151
R&D paid in stock	$47	$45	$53
Cash Wage %	62%	67%	65%

Twitter used to only pay for R&D in cash at about 36% of the total. With the company now being in the mid-60% area – that's a big improvement for earnings quality.

The company used to spend over $800 million on R&D and likely won't hit $600 million in both 2017 and 2018. In our view, there may still be a $100 million headwind on earnings annually going forward to get R&D back to at least $650 million and it will then grow from there. That would be about a 10-cent per share headwind.

One quarter doesn't make a trend, but at least R&D has started to grow y/y again in 3Q18.

Cash Flow Statement Looks Better

By the standard definition of free cash flow, here is what Twitter has reported:

	2014	2015	2016	2017	3Q18
Cash from Ops	$82	$383	$763	$831	$1,008
Capital Spending	$202	$347	$219	$161	$410
Free Cash Flow	-$120	$36	$544	$670	$598

We have discussed many items left out of this view and adjusting for them, Twitter was a cash eating machine. Just looking at the cash figures, the actual cash flow fell considerably:

	2014	2015	2016	2017	3Q18
Cash from Ops	$82	$383	$763	$831	$1,008
Capital Spending	$202	$347	$219	$161	$410
Less Lease Payments	$103	$118	$101	$103	$70
Less Cap Lease buys	$141	$31	$100	$123	$16
Cash Acquisitions	$164	$62	$167	$1	$34
Adj. FCF	-$528	-$175	$176	$443	$478

Slowing the capital spending via capital leases is helping adjusted free cash flow to rise and more closely match the standard definition. We should note that this is penalized to the extent equipment bought in the current year shows up as both a purchase and part of the lease payments.

We have talked about acquisitions too. Twitter considers this to be a key area for its future growth as it may need a new technology or access to a new platform and buying it may be the only way to make it happen. Given that was part of the operating model, we thought the lack of acquisitions in 2017 was a red flag. So, a minor boost to acquisitions in 2018 is a small plus here.

The stock-based compensation and paying for acquisitions via stock remains a concern. People don't want to be paid in a weak stock. The options are worth less if they are less likely to hit strike prices. As noted above, the R&D people are getting paid more in cash than stock than in the past. Heavy use of stock-based payments remains a risk here for cash flow because Twitter may still need to use more cash than stock going forward:

	2014	2015	2016	2017	3Q18
Adj. FCF	-$528	-$175	-$176	$443	$478
Wages in Stock	$632	$682	$615	$434	$244
Acq. with Stock	$148	$517	$1	$0	$19
Total Stock Payments	$780	$1,199	$616	$434	$263

Comparing the Adjusted Free Cash Flow to the total Twitter paid for with stock shows that 2018 is the first time the actual cash flow could withstand going to 100% cash payment model.

Explanation of EQ Rating Scale

Rating	Description
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 recent 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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