Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

July 30, 2020 | www.btnresearch.com

Twitter (TWTR) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
3+	3+

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 3+ (Minor Concern)

Overall, we believe Twitter has corrected many of the issues we initially had problems with such as its cash flow, cutting R&D and capital spending, and being free cash flow negative if it could not pay for things with stock. We may have raised this rating without COVID hurting recent revenues and causing cash flow to decline.

Our biggest issue is now Twitter's deferred tax asset accounts and valuation reserves that were set up. The company appears to have set itself up to beat forecasts going forward by reversing the reserve back into earnings like it did three times in 2018.

- **Deferred tax assets had a $1 billion reserve against the in 2017 on the notion that Twitter may not be able to realize these deferred tax assets. Twitter reduced the reserve three times in 2018 which helped it beat forecasts.**

- **In 2019, Twitter transferred intangible assets to its foreign subsidiaries which resulted in a $1.2 billion increase in deferred tax assets.** The foreign operations generate lower revenues than US operations and total operating profits were already starting to decline – yet Twitter did not set up an allowance for these new deferred tax assets.

- **In 2Q20, Twitter took a $1.1 billion charge to establish an allowance against the deferred tax assets. It was already missing forecasts for the quarter and COVID provides cover for many things these days. Y/Y operating profits had already declined at an accelerating rate for four quarters without this allowance rising.**

- **Interesting to note, Twitter noted in its press release and its earnings call that it expects to still use these deferred tax assets in the future. It also reported that it may be able to reverse the allowance which would help earnings.**

- **We consider it a positive that R&D spending has grown significantly in recent years and Twitter is paying for more of it in cash over stock.**

- **We also consider it a positive that Twitter is now investing more in the company via higher capital spending.** Capital spending was coming in below depreciation in 2017.

- **We adjust cash flow for capital leases and see that cash flow has improved significantly until recent COVID pressure on revenue.** Most importantly, we believe Twitter was free cash flow positive in most recent years had it paid all expenses in cash and not used stock as a currency.

Did Twitter Set Up Future Earnings with Deferred Tax Assets?

Watching Twitter's deferred taxes may be the largest changes unrelated to the 2017 tax cuts that we have seen. The company has a large amount of deferred tax assets – largely from tax credits and prior operating losses. Historically, there was a large allowance against these deferred tax assets indicating that management believed it would be unable to realize the full benefits:

	2019	2018	2017
Income tax Exp.	-$1,075.5	-$782.1	$12.6
Net Op Losses	$390.0	$513.4	$720.4
Tax Credits	$425.0	$375.7	$327.8
Fixed Assets/Intangibles	$1,214.1	$24.8	$10.8
Total Deferred Tax Assets	$2,290.0	$1,023.9	$1,152.6
Allowance	-$223.8	-$210.9	-$1,021.3
Net Deferred Tax Assets	$2,066.2	$813.1	$131.3

In 2018, Twitter started to reverse the allowance back into income and allowed income tax expense to become hugely negative:

- 2Q18 the allowance was cut by $42 million reflecting changes in Brazil.
- 3Q18 the allowance was cut by $683 million reflecting higher profitability in the US making it more likely the deferred tax assets would be realized.
- 4Q18 the allowance fell by $120 million based on forward estimates changing and reducing the allowance.

This helped Twitter meet some of its forecasts on EPS, but adjusted for the tax allowance changes – EPS started to miss in 4Q18:

- 2Q18 EPS of $0.17 beat by 1-cent, the adjusted EPS was $0.17
- 3Q18 EPS of $0.21 beat by 7-cents, the adjusted EPS was $0.21
- 4Q18 EPS of $0.31 beat by 7-cents, but the adjusted EPS was only $0.17

In the 2Q19 – Twitter boosted deferred tax assets by transferring many intangible assets to its foreign subsidiaries. Notice that it did not boost the allowance by much after more than doubling the amount of deferred tax assets. In the 2Q19, Twitter earned $1.58 per share which beat by $1.39. However, the adjusted EPS was only $0.05, indicating a sizeable miss.

In 2Q20 – Twitter built a huge allowance against deferred tax assets again. It added $1.1 billion to the allowance based COVID driving losses. The company was expected to post $0.00 for EPS and had a huge loss largely related to this allowance of -$1.56. The adjusted EPS of -$0.16 was in fact a large miss.

There are many signs in our view that this allowance is simply taking advantage of COVID to set up future earnings growth by reversing the allowance going forward.

- In the 2Q20 press release, Twitter said, *"In Q2 2020, we recognized a deferred tax asset valuation allowance of $1.1 billion and a non-cash income tax expense based primarily on cumulative taxable losses driven primarily by COVID-19. **This valuation allowance would be reversed in the event, and to the extent, that it is more likely than not that there will be sufficient taxable income to realize the tax benefit**."*

- On the 2Q20 call, Twitter was even clearer, *"Let me also cover a couple of modeling things where you may have questions. You may have also noted a large non-cash loss related to a valuation allowance for a deferred tax asset. This reverses a gain that we took last year. It's related to our ability to use some of our international deferred tax assets in the near future. **We're confident that when the current operating environment turns around, we'll eventually be able to use these deferred tax assets.**"*

- The nature of the international business has not changed with COVID if our view. If the reason for a huge allowance against the deferred tax assets is lower profitability – they could have made that same argument in 2Q19 when they transferred these intangible assets to the foreign subsidiaries and established the allowance then.

International usage consistently grows faster than the US. It's not as profitable, but International was 81% of total monetized daily average usage in 2Q20 and the growth is accelerating.

Monetized DAU	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Y/Y US Operations	24%	18%	15%	15%	12%	4%
Y/Y Intl Operations	36%	27%	22%	17%	15%	6%

Twitter has seen operating profits in decline for a year before COVID, and yet did not increase the allowance:

	2Q20	1Q20	4Q19	3Q19	2Q19	1Q19
Y/Y Op Inc. change	-$199.6	-$101.1	-$54.0	-$47.7	-$3.9	$18.7

R&D Has Increased and Twitter Is Paying for More of It with Cash – Positive

When we first started following Twitter it was cutting R&D spending in absolute dollars and it was boosting the amount paid in stock compensation over cash wages. There has been a solid turn-around in this area to improve reinvesting in the company and earnings quality:

	YTD20	YTD19	2019	2018	2017	2016
R&D Spending	$416	$306	$683	$554	$542	$714
R&D paid in stock	$139	$97	$209	$184	$241	$336
Cash Wage %	67%	68%	69%	67%	56%	53%

Twitter has still not topped 2015's rate of R&D spending of $807 million. At least, it is moving in the right direction for a tech company. Also, Twitter boosted spending in 2020 even as revenues declined as customers pulled back on advertising spending. That is crimping EPS, but Twitter is catching up on underinvestment in our view.

Twitter Has Invested in New PP&E and Is Not Using Capital Leases - Positive

We said in late 2018: "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."

The company has now seen capital spending rise to levels that exceed depreciation again:

	YTD20	YTD19	2019	2018	2017	2016
Depreciation	n/a	n/a	$449	$407	$349	$333
Capital Spending + Cap Leases	$287	$219	$541	$484	$284	$319
Cap Leases	$0	$0	$0	$16	$123	$100

Capital leases inflate free cash flow because only the interest expense lowers net income, which inflated cash from operations with the principal payment in the financing section of cash flow. Also, new equipment on capital lease is not listed as capital spending so the free cash flow figure is inflated via a lower capital spending number. In 2016 and 2017, the amount of equipment acquired this way was a significant amount of the total, and Twitter was still spending less than actual deprecation. We consider it a positive that capital spending has now topped depreciation for 2.5 years and there are no new capital lease issues.

The Cash Flow Statement Looks Much Better Too – Positive

In prior years, Twitter was a cash eating machine. That was even before adjusting for the capital lease accounting. It was extremely dependent on using stock to pay for normally cash items such as wages and acquisitions. Until 2018, if Twitter had to pay cash – it would have reported negative free cash flow or basically zero free cash flow. COVID has resulted in 2020 seeing this reverse due to declining revenue. This could reverse as advertising recovers. As noted earlier, the monetized daily average usage trends have accelerated its growth during COVID.

BTN Adj Cash Flow	YTD20	YTD19	2019	2018	2017	2016	2015
Cash from Ops	$448	$691	$1,303	$1,340	$831	$763	$383
Less Principal on Cap. Leases	$17	$38	$67	$90	$103	$101	$118
Adj. Cash from Ops	$431	$653	$1,237	$1,250	$728	$663	$266
Less Capital Spending	$287	$219	$541	$484	$161	$219	$347
Plus Sales of Equipment	$4	$3	$6	$13	$3	$0	$0
Less Cap. Lease Purchases	$0	$0	$0	$16	$123	$100	$31
Less Cash Acquisitions	$34	$20	$30	$34	$1	$167	$62
BTN Adj. Free Cash Flow	**$114**	**$417**	**$671**	**$729**	**$446**	**$177**	**-$175**
Wages paid in Stock	$231	$178	$378	$326	$434	$615	$682
Acquisitions paid in Stock	$1	$0	$0	$19	$0	$1	$517
Total Stock Payments	**$232**	**$178**	**$378**	**$345**	**$434**	**$617**	**$1,199**

Looking at cash flow, the legacy of capital leases is having a smaller impact. Comparing the adjusted free cash flow figures to the total spent via stock, the free cash flow exceeds the stock total. So, Twitter could go to 100% cash payments and not result in negative free cash flow anymore. The exception is 2020, where there is a legitimate excuse.

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.

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.