BEHIND
THE NUMBERS
Quality of Earnings Analysis

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BTN Thursday Thoughts

Updates and New Developments on Active BTN Ideas

Reports in this issue:

DocuSign, Inc. (DOCU)
Earnings Quality Update

We are maintaining our earnings quality rating of DOCU at 4- (Acceptable).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

DOCU's fiscal 2Q23 non-GAAP EPS of $0.44 beat by 2 cents. That came after reducing guidance with 1Q23 results and the CEO leaving. The company boosted guidance a bit for billings and for subscription revenues. We believe the market was too tough on 1Q results and is giving too much praise for 2Q EPS.

We would not consider the 2 cents a quality beat for a few reasons:

- DOCU's 2Q hit the high point of guidance on non-GAAP operating margin of 18.0%. Non-GAAP margin adds back stock compensation, which rose considerably in 2Q23:

	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21
Sales	$622.2	$588.7	$580.8	$545.5	$511.8	$469.1
Stock Comp	$141.2	$110.7	$118.0	$109.4	$100.0	$81.1
Taxes on Exercise	$3.4	$5.1	$4.2	$10.1	$11.6	$16.3
Total	$144.6	$115.8	$122.2	$119.5	$111.5	$97.4
% of Sales	23.2%	19.7%	21.0%	21.9%	21.8%	20.8%
Stock Comp %	22.7%	18.8%	20.3%	20.1%	19.5%	17.3%

Tax benefits are down as fewer employees exercise stock awards but look at how much gross stock compensation rose. It was up 320bp y/y and 390bp sequentially. 1Q23 was probably too low, but this is commonly about 20%. Every 100bp of additional wages added back as stock compensation adds 2.4 cents to quarterly EPS. DOCU beat by 2 cents and arguably picked up as much as 7 cents in this area.

- On top of that, guidance was for non-GAAP margins of 16%-18% for 2Q, after posting poor results with a 17.4% margin in 1Q and 17.9% in 4Q. 2Q23 came in at 18.0% which was the high end. But consider this, 1Q23 saw gross stock compensation fall by 150bp compared to 4Q22, yet margins only fell by 50bp. Then margins only rose 60bp in 2Q despite being helped by 390bp sequentially.

- Other income (expense) removes marks on strategic investments and rose to $0.9 million in 2Q23 vs. -$1.2 million in 2Q22 and -$5.0 million in 1Q23. The rest of this account benefited from higher interest income with higher rates and lower FX losses that occurred more heavily in 1Q23. This added 0.8 cents y/y and 2.3 cents sequentially.

We still believe DOCU has some solid longer-term potential. But it is still working its way through a tougher post-Covid period. It is rebuilding some of its operating model on the fly, looking for areas to spend more efficiently, enhancing its employee training, and bringing in a new CEO and new senior managers. Our view is still that DOCU's longer-term goals of $5 billion in sales and a non-GAAP operating margin of 20%-25% still look achievable. We say that because it is already doing sales of about half that figure, existing customers continue to expand their usage with DOCU products, and it has already had periods of reaching a 20% non-GAAP margin.

However, the efforts to grow more and focus on expenses and skills will take more than one-quarter to fully put in place.

There Are Some Possible Near-Term Headwinds

- Since June and 1Q23 results, DOCU boosted Billings guidance for fiscal 2023 (ending January 31) from $2.52-$2.54 billion to $2.55-$2.57 billion. It sees a modest increase in subscription revenues from $2.39-$2.41 billion to $2.41-$2.42 billion. It is calling for a non-GAAP operating margin of 16%-18%, the same forecast since 4Q22 results.

- Billings are calculated by adding GAAP revenues + the quarterly change in deferred revenues + the quarterly change in unbilled revenues. The potential headwind may be that the deferred revenue change has been smaller with only the exception of 4Q21:

	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21	1/31/21	10/31/20
Sales	$622.2	$588.7	$580.8	$545.5	$511.8	$469.1	$430.9	$382.9
Change Def. Rev	$20.4	$25.4	$87.9	$21.4	$80.8	$57.1	$98.3	$63.9
Change Unbilled	$5.1	-$0.5	$1.4	-$1.6	$1.6	$1.3	$5.8	-$6.4
Billings	$647.7	$613.6	$670.1	$565.3	$594.2	$527.5	$534.9	$440.4
Billings/Rev	104.1%	104.2%	115.4%	103.6%	116.1%	112.4%	124.1%	115.0%

The change in deferred revenue used to consistently be $60-$80 million per quarter, but now it's down to $20 million. Billings are not growing much faster than revenues and don't forget 2Q23 beat revenue forecasts by $20 million.

- Also, deferred revenues expressed as Days of Sales have declined y/y for each of the last four quarters:

	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21	1/31/21	10/31/20
Sales	$622.2	$588.7	$580.8	$545.5	$511.8	$469.1	$430.9	$382.9
Deferred Rev	$1,094.9	$1,074.5	$1,049.1	$961.2	$939.8	$857.9	$800.9	$702.7
DSO	161.9	162.4	166.2	162.1	169.0	162.8	171.0	168.8

Deferred revenues remain at high levels, but this bears watching for evidence that growth is picking up again.

- Slowing deferred revenue growth can translate to slower future revenue growth. Also, look at retention rates. Retention records the growth in dollars paid by existing customers. A customer that renews at the same rate would post a 100% figure. One that adds extra users or adds new features and pays more than last year would see a retention rate of more than 100%. Slowing retention rates should also mean some revenue pressure:

	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21	1/31/21	10/31/20
Retention	110%	114%	119%	121%	124%	125%	123%	122%

Over 100% still represents some good growth potential. DOCU believes its training and new sales focus and additional services will improve retention going forward. Right now, this is still moving in the wrong direction.

- Headcount is rising. This is a positive in our view. Remember that DOCU was seeing considerable turnover after Covid as the stock price declined and completing sales (and earning a commission) was not as easy as simply taking an order by answering the phone. However, these new employees and existing employees are getting new bosses, they are getting new training programs, and they are getting more education on the products and new releases. That all costs money and they may be earning salaries upfront until they start to close sales:

	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21	1/31/21	10/31/20
Headcount	8,061	7,642	7,461	7,056	6,551	6,080	5,630	5,364

DOCU laid out a good plan for all this investment being a way to boost long-term results. But remember, guidance is for the same 16%-18% non-GAAP margin. It’s unlikely many new people will be paid heavily with stock early on. There is also likely to be some churn among these new hires and DOCU will start over with another set of new employees. We agree with the company on the positives here. However, remember 2Q23 results were helped by a surge in stock compensation that seems unlikely to be as high again in the near future. Even with that, DOCU hit the high-end of guidance at 18.0% on margin. If they come in at a 17% margin or a 16% margin – which could easily happen if higher wages see 1%-2% more cash payments rather than stock – will they get a pass? The decline in the stock price makes a shift to cash wages a real possibility. We like the long-term situation here – but this looks like a risk to near-term results.

- Watch Cash Flow as well:

	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21	1/31/21	10/31/20
Cash Ops	$120.9	$196.3	$62.2	$105.4	$177.7	$135.6	$45.5	$57.4
Cap. Exp.	$15.4	$21.7	$18.3	$15.4	$15.9	$12.6	$30.0	$19.4
Free Cash Flow	$105.5	$174.6	$43.9	$90.0	$161.8	$123.0	$15.5	$38.0
Stock Comp	$141.2	$110.7	$83.6	$109.4	$99.5	$81.1	$55.6	$80.9
Net Commissions	-$12.2	-$6.5	-$35.3	-$15.3	-$16.6	-$15.2	-$17.5	-$26.6
A/R change	-$38.7	$140.1	-$62.5	-$20.9	-$34.4	$73.2	-$78.4	-$36.6
Def. Rev. change	$23.1	$18.7	$89.4	$24.4	$85.0	$51.6	$95.2	$65.0

  - If 2Q's stock compensation level is not sustainable in the near term – then more expenses should be incurred in cash, which would lower cash flow as well as non-GAAP operating margins. Notice the size of the free cash flow vs. the amount of stock compensation being added back to it.

  - Sales commissions are paid but are also capitalized and amortized over time. This has been a net outflow of cash for DOCU, but the figures have been smaller than normal this year. This may be the result of the employee turnover. If DOCU is successful with its new growth plans and sales process changes, the commissions could become a larger cash drain.

  - Receivables have a big seasonal drop in fiscal 1Q in April. The rest of the year, this saps cash flow. In looking at DSOs for receivables, we did not see a reason for concern.

  - Deferred revenues produce cash flow too. Growth in this area has dropped off this year, which is hurting cash flow. This is another place to watch for improvement if DOCU is successful in reorganizing its sales programs.

Lancaster Colony Corporation (LANC)
Earnings Quality Update

We are maintaining our earnings quality rating of LANC at 4+ (Acceptable)

LANC reported EPS of $1.06 in the 6/22 quarter. To its credit, LANC does not report official non-GAAP numbers. To compare to Street estimates we need to add back $0.29 in restructuring and impairment charges largely consisting of a write-down to the tradename of Angelic Bakehouse. There were also $0.31 in Project Ascent costs. The resulting adjusted EPS of $1.66 was 86 cps ahead of the consensus expectation of $0.80. A lower tax rate from a nonrecurring state tax adjustment added about 10 cps so the earnings beat is still well intact.

We believe LANC's earnings quality is one of the highest in the food group. However, we wanted to point out a 4-day YOY jump in accounts receivable DSOs in the quarter given that its receivables typically trend in-line:

	6/30/2022	3/31/2022	12/31/2021	9/30/2021
Receivables	$135.496	$110.131	$104.769	$108.365
Receivables Days of Sales	27.3	24.6	22.5	25.4
	6/30/2021	3/31/2021	12/31/2020	9/30/2020
Receivables	$97.897	$97.877	$87.530	$96.993
Receivables Days of Sales	23.1	24.7	21.5	25.6
	6/30/2020	3/31/2020	12/31/2019	9/30/2019
Receivables	$86.604	$87.649	$77.061	$91.554
Receivables Days of Sales	24.6	24.8	20.0	25.0

The jump was related to the company activating its new ERP systems during the quarter which prompted many customers to move their orders forward to avoid the risk of interruptions. To the company's credit, it prominently identified these incremental sales and quantified them at $25 million in sales and $5 million in operating profit. This represents over 14 cps which still leaves a huge earnings beat. Reported revenue was $37 million above targets so revenue also outperformed even after adjustment for the extra revenue. Given this and the strength of the company’s disclosure on the matter, we are not downgrading our earnings quality rating at this time.

Patterson Companies, Inc. (PDCO)
Earnings Quality Update

We are raising our earnings quality rating of PDCO to 2+ from 2- (Weak).

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

PDCO's non-GAAP EPS of $0.32 missed forecasts by 6 cents for 1Q23 (ending in July). It held guidance for the year flat at $2.25-$2.35 after the quarter. After following this company for several years, this may be the cleanest quarter ever from PDCO in terms of earnings quality:

- There was ONLY ONE adjustment to EPS – they added back amortization of acquired intangibles for 7 cents – flat y/y. No inventory write-offs, no big changes in reserves. That's a big improvement for PDCO.

- Bad debt reserves rose 31bp from 4Q which cost PDCO 0.9 cents in EPS

- Gains/Losses on the sale of receivables and equipment contracts was almost flat from a year ago – only about 0.2 cents in tailwind.

- Interest rate contracts produced a higher loss this year which was 0.6 cents in headwind.

- Stock compensation declined, but looks explainable by the extra week from the year before.

- The tax rate was basically flat at 22.4% vs. 22.2%.

What to Watch

We are still concerned about a few items going forward. Given numerous issues we have seen with PDCO in the past, one clean quarter can not fully change our opinion. Here are some areas of concern:

- Despite fairly clean results and price increases boosting gross margin by 25bp – PDCO still reported adjusted operating income margin declined by 70bp. They are blaming this on the timing of certain expenses being pulled forward.

- Inventory levels jumped to 65.7 days vs. 53.0 days a year ago and 54.8 days in April. DSI's have been about 70 days in the past so this by itself is not a huge red flag at the moment. On the call, they hinted there was some strategic buying. If that is true, it should further help margins going forward and the DSIs could decline.

- We will be watching to see if rising interest rates have greater negative impacts for gains/losses on selling receivables and equipment contracts. This has often been a source of low-quality earnings for PDCO in the past when interest rates were basically 0%.

- How much longer will PDCO blame Covid-related inventory for its woes? Management took one quarter of panic in May and June of 2020 when there was a shortage of sanitizer, face masks, and gloves to proclaim it had invented a new growth market. Within about four months, this new growth market was glutted and demand was falling. It is now two years later, multiple sizeable inventory write-offs later, and PDCO is still calling out pricing weakness for Covid-related products. In this quarter, management called out a -2.7% sales figure for consumables due to pricing declines in infection control products. It further said it expects deflationary pressure for the rest of this fiscal year in that area to continue as a headwind.

- In the recent past, declining stock compensation has been a tailwind for PDCO's earnings. The stock has been weaker. Does this translate into higher cash wages with inflation? Will stock compensation snap back to historic levels and become a headwind too? It was flat y/y in 4Q22 and it looked to be almost flat y/y in 1Q23 adjusting for the extra week in 1Q22.

- We have noted in the past that volume rebates and other sales incentives have helped PDCO's results. It continues to tout efforts to become more involved in its own private label products. That could have a higher profit margin for PDCO but at a lower price point. Will that still leverage other fixed costs as much to help operating margin overall? And, will PDCO lose more sales incentives from selling suppliers' branded products and that source of revenue should come with little incremental costs?

Zscaler (ZS) Earnings Quality Update

This should be read along with our September 8, 2022, report updating our comparison of the earnings quality of the major security software companies.

Summary

ZS reported after we published the other five companies of this group. Its non-GAAP EPS of $0.25 beat by 4 cents. Guidance was also strong for 37% sales growth and 70% EPS growth for fiscal 2023.

- We saw that share compensation continues to increase in terms of EPS. One doesn't have to look too far back to find when it wasn't growing this rapidly. This is helping drive non-GAAP EPS higher. EPS is up 11 cents y/y with stock comp up 22 cents:

	7/31/22	4/30/22	1/31/22	10/31/21	7/31/21	4/30/21	1/31/21	10/31/20
Stk Comp/share	$0.810	$0.760	$0.700	$0.650	$0.590	$0.450	$0.460	$0.420
non-GAAP EPS	$0.250	$0.170	$0.130	$0.140	$0.140	$0.150	$0.100	$0.140

- Sales growth has been strong and ZS is getting some operating leverage from this area. We doubt they expected cash R&D to actually decline in dollar terms from the prior quarter, but it fell from $45.2 million to $44.7 million sequentially. However, this only accounts for 0.4 cents of non-GAAP EPS. This may be more of a headwind going forward.

- ZS stuck to its normal internal growth model and made a small acquisition in the fiscal 4Q22 and added $18.8 million to goodwill. That did not change the minor impact of not amortizing goodwill on non-GAAP EPS. It remains about 0.3 cents for ZS and it is still adding back intangible amortization of 2 cents.

- ZS has one of the stronger Deferred Revenues of the group as well at 295 days. That makes it tough to miss revenue forecasts and ZS is guiding for fiscal 2023 to $1.49-$1.50 billion so a very tight range.

- Even with all that Deferred Revenue helping cash from operations, ZS would not be free cash flow positive without the hefty and growing stock compensation. In the last 12 months, Free Cash Flow was $231.3 million, which was helped by a $391.2 million increase in Deferred Revenue plus $409.6 million in stock compensation.

- The earnings beat appears real to us, with some concern about the rising dependence on share compensation. We did not see an issue with DSOs for receivables falling about 4-days y/y the last two quarters. Payables and accruals are up – but remain small dollar items 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 Concern)- 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 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 upcoming quarters. 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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