BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Verisk Analytics (VRSK) EQ Update- 6/20 Qtr.

Current EQ Rating*	Previous EQ Rating
4-	4+

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 reducing our earnings quality rating to 4- (Acceptable) from 4+ (Acceptable) indicating a minor deterioration in quality

We continue to view VRSK's earnings quality as relatively high quality. The reduction in our rating reflects a mild deterioration from the increase in deferred commissions and a sizeable boost from lower stock-based compensation.

- We noted in our original review of VRSK that it regularly acquires a half dozen or more smaller companies a year. In some years, the company's cash flow does not cover buyback, dividend, and acquisitions. We are usually critical of growth-through-acquisition strategies, but in the case of VRSK, the company is still generating meaningful organic growth without the acquired operations. Understandably, core revenue growth fell to 0.6% in the 6/20 quarter due to the impact of COVID on gaining new business. Acquisitions driving the bulk o the 4% growth in total revenue. Investors should be concerned if core revenue growth does not return to the mid-single-digit range as conditions normalize.

- Deferred commissions rose sequentially in the 6/20 quarter despite a sequential decline in revenue. Over 80% of the company's revenue is locked up under subscriptions and long-term contracts so it did not see a drop in revenue, but it also was clearly not signing up new business in the quarter either. This makes the sequential increase in deferred costs to obtain new contracts look unusual and it a potential indicator of increased aggressiveness in capitalizing costs. If deferred commissions had remained consistent, the balance would have been about $3.5 million (1.7 cps) lower. Given the relatively small amount and the sequential decline in sales from the COVID disruption, we are not assigning a high degree of concern to this, but the development of deferred commissions warrants attention in future quarters.

- Lower stock-based compensation added over 4 cps to earnings in the quarter.

- Core revenue growth in the Energy and Specialized Markets segment was -4.1%. We noted in the original review that this segment accounts for the bulk of intangibles and goodwill and underperformance in that segment increases the possibility of an impairment charge.

A Quick Glance at Core Revenue Growth

We noted in our original review of VRSK that it regularly acquires a half dozen or more smaller companies a year. In some years, the company's cash flow does not cover buyback, dividend, and acquisitions. We are usually critical of growth-through-acquisition strategies, but in the case of VRSK, the company is still generating meaningful organic growth without the acquired operations. However, organic growth has fallen off in the last two quarters which is not unexpected given the impact of COVID:

	6/30/2020	3/31/2020	12/31/2019	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Total Revenue Growth	4.0%	10.4%	10.3%	9.0%	8.5%	7.5%	7.7%
Growth ex-acq./divest.	0.6%	4.8%	5.4%	7.0%	6.4%	5.9%	5.0%

VRSK stated in the 6/20 10-Q that it is not seeing its business fall apart in the current environment as such a large part is already locked in under long-term contracts:

> *"We have analyzed our solutions and services to assess the impact of COVID-19 on our revenue streams. We have not identified any material impact of COVID-19 on*

approximately 85% of our revenues at this point, as much of these revenues are subscription in nature and subject to long-term contracts. These revenues grew approximately 5% for the three months ended June 30, 2020.

Of the remaining 15%, we have identified specific solutions and services, largely transactional in nature, that are being impacted by COVID-19. The primary causal factors are lower auto and travel insurance activity, the inability to enter commercial buildings to perform engineering analyses, decreased capital expenditure in the energy sector, and reduced levels of advertising by financial institutions and marketers. The portion of our revenue that is attributable to these solutions has been negatively impacted by COVID-19, and declined approximately 20% for the three months ended June 30, 2020. The deepest impacts were in the categories of travel insurance analytics, auto underwriting and claims analytics in the insurance industry, consulting services in the energy industry, and spend informed analytic solutions in financial services. Although we have experienced a decline in revenue attributable to these specific solutions during the last two weeks of March 2020 and for the three months ended June 30, 2020, currently we do not anticipate lasting impacts of a material nature to our long-term growth profile. As the global outbreak of COVID-19 is still rapidly evolving, management continues to closely monitor its impact on our business."

The 0.6% organic growth in the 6/20 quarter has a reasonable explanation- for now. We will be watching in upcoming quarters to see if organic growth recovers. In our minds, the biggest risk for VRSK is it evolving into the typical growth-though-acquisition story where it is dependent on acquisitions to drive all the growth.

Increase in Deferred Commissions

VRSK capitalizes the costs to obtain certain contracts if it expects the benefit to last longer than one year. The following table shows the balance of these deferred commissions for the last several quarters:

	6/30/2020	3/31/2020	12/31/2019	9/28/2019	6/29/2019	3/30/2019	12/29/2018
Deferred Commissions	$69.2	$66.7	$63.7	$58.5	not disc	not disc	$49.5
Revenue	$678.8	$689.8	$676.8	$652.7	$652.6	$625.0	$613.9
Deferred Commissions Days	9.3	8.8	8.8	8.2	na	na	7.3

The company did not begin disclosing deferred commission balances until the 9/19 quarter so the 6/19 and 3/19 quarters are not available. Note that the deferred commission balance has risen steadily on a sequential basis over the last few quarters assuming the two unavailable quarters were in line with the trend. The company essentially saw no growth in its core business in the quarter, implying there was little in the way of signing up new business. Regardless, the deferred commission balance continued to rise in the 6/20 quarter. If deferred commissions had remained a constant percentage of quarterly sales, they would have been about $3.5 million lower (1.7 cps). If this amount represented the company becoming more aggressive in the capitalization of costs, it could have been a material one-time boost to earnings. Given the relatively small size of the move and the fact that the slowdown in revenue growth in the quarter could have had an impact on the timing of the components, we do not view this as a significant item at this point. Still, this is an area to keep an eye on in upcoming quarters.

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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