GlassHouse Research

07/15/19

GlassHouse Rebuttal to Omnicell Management Statements Made on 07/15/19

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Overall, we search for evidence of a "culture of fraud" within public companies.

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After dissecting Omnicell's Press Release (07/15/09) "Omnicell Sets the Record Straight on GlassHouse Research Report," we at GHR present the following rebuttal to all of management's bullet points.

As accountants, we use facts and figures with limited sensationalism to reveal our thesis and present it to the market, letting the market decide its credibility. We are short Omnicell's stock and will remain so until we believe our thesis comes to fruition. We point this out numerous times throughout many of our disclaimers on our website and within our research reports.

If our being short OMCL causes investors to disregard our thesis and report because of inherent biases, we respect and understand that. However, we have yet to encounter an actual case where our facts and metrics can be disputed. Even with management's statement today that "A recent report by GlassHouse Research makes numerous false and misleading statements about our company," OMCL instead further corroborates many of our initial concerns laid out in the Press Release.

Below, GHR details and rebuts statements made by management:

- **Omnicell's revenue is properly recognized and accounted for in accordance with U.S. GAAP, including ASC606 and ASC842.** Our revenue recognition policies and controls are carefully and thoughtfully applied and are intended to prevent premature revenue recognition. We recognize revenue upon documented customer acceptance of installation for the majority of our products. Neither the timing of invoice nor customer payment affect the timing of revenue recognition for these products. We invoice products upon shipment and increase both accounts receivable and deferred revenue at that time. Deferred revenue is reduced as installation is accepted and revenue is then recognized. The timing of customer payment after acceptance can vary and accounts receivable is not reduced until payment is received. As our deal sizes have grown, some customers accept product installation in batches over multiple time periods, but do not pay as quickly as installations are completed. Therefore, as order sizes increase, accounts receivable can grow disproportionately to deferred revenue as each are impacted by different activities. In addition, over the last several years the Company's software revenue has significantly increased as Omnicell's business has evolved. Software revenue by nature does not flow through deferred revenue.

- **DSO has increased as a result of the evolution of our business and following the adoption of new accounting standards.** As mentioned earlier, our business has grown and we have expanded our product and service offerings; our average deal size has increased in both dollar amount and complexity. For example, average deal size of our bookings from the top 10 accounts in the fourth quarter of 2018 averaged $10.3 million, compared to $2.7 million in the fourth quarter of 2015. As is typical with the large hospital networks and similar organizations that purchase our products, payment cycles can be elongated. While this increases DSO, the timing of cash collections has no impact on revenue recognition. As GlassHouse acknowledges, our customers are creditworthy and have a long and consistent track record of paying their outstanding balances, underscored by the fact that our write-offs have been less than 0.5% of revenue per year since 2014.

GlassHouse Response: Herein lies the problem with management's explanations-- they differ vastly from what CFO Peter Kuipers has been telling analysts since taking over as CFO four years ago. As stated in our initial report, CFO Kuipers disclosed in the Q2 2015 earnings call that **"This quarter is an anomaly and we will generally expect DSO in the 65-to-75-day range."** Not once in any of the subsequent earnings calls did Mr. Kuipers retract that statement.

Also, management is now quick to point out that the dollar size is impacting the current rise in DSO. However, management did not use this as an explanation for the rise in DSO even once in the last four years of earnings calls. Why the sudden change now? Let's go back and detail every single instance where CFO Kuipers discussed DSO values over the past four years…

> Q1 2015:
> Rounding out the balance sheet, accounts receivable days sales outstanding were 70, up 7 days from last quarter. The quality of our receivables is very high. The increase in DSO is more a reflection of the timing of shipments from our factory. We expect DSO in the 65- to 75-day range.
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> Q2 2015:
> Accounts receivable days sales outstanding were 95, up 25 days from last quarter. Now several factors are driving the DSO this quarter. We had substantially higher shipments than normal at the end of Q2 in preparation for the installations scheduled in Q3, which drove half the increase. We also had receivables added from the acquisitions and a higher mix of international distribution customers who generally have contractual payment terms of 90 days. We review the collectibility of our receivables regularly and we don't feel this increase in DSO indicates any potential increase in the rate of bad debt. This quarter is an anomaly and we will generally expect DSO in the 65 to 75-day range.
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> Q3 2015:
> Accounts receivable days sales outstanding, or DSO, were 85, down 10 days from last quarter. The decrease in DSO this quarter is a result of stronger collections as we completed implementations and increased revenue. As expected, the DSO has started to normalize after the unusually high DSO in the previous quarter. We expect further improvement in the next quarter. We generally expect DSO to be in the 65- to 75-days range. We review the collectability of our own receivables regularly and we do not believe the fluctuation of DSO are indicative of a change in our rate of bad debt.
>
> Q4 2015:
> Accounts receivable days sales outstanding, or DSO, were 76 days, down 9 days from last quarter. The decrease in DSO this quarter is a result of stronger collections as we completed implementations and increased revenue. As expected, the DSO started to normalize after the unusually high DSO in the first half of 2015. We review the collectability of our receivables regularly, and we do not believe that fluctuations in DSO are indicators of any change in our bad debt rate
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> Q1 2016:
> Accounts receivable days sales outstanding for the combined business were 82 days, up 6 days from 4Q '15 when the reported Omnicell stand-alone. The increase in DSO was mix-driven, affected by the addition of the Aesynt business as well as impacted by annual service billings in Europe. We review the collectibility of our receivables regularly, and we do not believe that the fluctuation DSO are indicative of a change in our rate of bad debt. Inventories were $72 million, up $25 million from last quarter as a result of the acquisition

of Aesynt as well as the built-in inventory from Med Adherence products for delivery in the second quarter. Our headcount is 2,275, up 824 from last quarter, driven by acquisition of Aesynt that was completed in January this year.

Q2 2016:
Accounts receivable days sales outstanding for the combined business were 85 days, up 2 days from the first quarter in 2016. The increase in DSO was mostly billing timing driven. We review the collectibility of our receivables regularly, and we do not believe the fluctuation in DSO are indicative of the change in our rate of bad debt.

Q3 2016:
Accounts receivable days sales outstanding for the combined business were 91 days, up 6 days from the second quarter. The increase in DSO, however, was entirely billing timing-driven as we exceeded cash collection goals.

Compared to the second quarter, we had an additional $20 million in invoicing related to shipments of equipment. Our customer agreements specify that for equipment sales, the company invoices 100% of the contract value at shipment date. We review the collectability of our receivables regularly and we do not believe that the fluctuation in DSO are indicative of a change in our rate of bad debt.

Q4 2016:
Accounts receivable days outstanding were 82 for the fourth quarter, down 9 days from the third quarter. The decrease in DSO was driven by record cash collections in the quarter. For context, our customer agreements specified that for equipment sales the company typically invoices 100% of the contract value at shipment date. We review the collectability of our receivables regularly and we do not believe the fluctuation in DSO are indicative of change in our rate of bad debt.

Q1 2017:
Accounts receivable, days sales outstanding were 82 for the first quarter, up 1 day from the fourth quarter despite the lower sequential sales. For context, our standard customer agreement specified that for equipment sales, the company [invoices] 100% of the [context value and] shipment days. We review the collectability of our receivables regularly and we do not believe that the fluctuation of DSO are indicative of a change in our rate of bad debt.

Q2 2017:
Accounts receivable days sales outstanding were 78, down 4 days from the first quarter driven by strong collections.

Q3 2017:
Accounts receivable days sales outstanding were 86 days, up 8 days from the second quarter, and down 5 days on the third quarter of last year. The increase in accounts receivable days sales outstanding from prior quarter was mostly driven by invoiced shipments towards the end of the third quarter for fourth quarter revenue. Based on our customer agreements, we largely invoiced upon shipment.

Q4 2017:
Accounts receivable days sales outstanding for the fourth quarter were 89 days, up 3 days from the third quarter. The increase in accounts receivable days sales outstanding from prior quarter was mostly driven by invoiced shipments towards the end of the fourth quarter. Based on our customer agreements, we largely invoice upon shipment.

Q1 2018:
Accounts receivable days sales outstanding for the first quarter were 97 days, up 7 days from the fourth quarter of 2017. The increase in accounts receivable days sales outstanding was mostly driven by lower sequential sales. It's good to remember that based on our customer agreements, we largely invoice upon shipments.

Q2 2018:
The second quarter 2018 cash flow from operations was $22 million, mostly driven by cash flow from accounts receivables and prepaid expenses.

Accounts receivable days sales outstanding for the second quarter were 86 days, down 11 days from the first quarter in 2018. The decrease in accounts receivable days sales outstanding was mostly driven by more linear timing of billing during the quarter. Based on our customer agreements, we largely invoice upon shipments.

Q3 2018:
Accounts receivable days sales outstanding for the third quarter were 93 days, up 7 days from the second quarter in 2018. The increase is mostly driven by timing of billing during the quarter. Based on our customer agreements, we largely invoice upon shipments. Generally, shipments and related billings in the last month of the quarter become revenue in the following quarter after installation is completed. The month of September 2018 was a record billing month.

Q4 2018:
Accounts receivable days sales outstanding for the fourth quarter were 85 days, down 8 days from the third quarter of 2018. The decrease is mostly driven by increased collections during the quarter.

Q1 2019:
Accounts receivable days sales outstanding for the first quarter were 93 days, down 4 days from the first quarter of 2018. The decrease was mostly driven by strong collections.

Each time DSOs increased in a period, the same “timing of billing during the period” was used as an explanation for the increase. Why is management now changing their tune, stating that “average deal size” is the reason for the increase? We detailed in our report management’s divulging of implementation issues of the XT series back in 2018. This would be far more plausible as reasoning for the recent rises as opposed to deal size, which was not mentioned until today.

However, we do agree with management that "payment cycles can be elongated," which can be a nicer way of saying "implementation issues are causing customers to extend the acceptance process." We believe management is putting a more agreeable spin on our assessment of prematurely recognizing revenue. For example, if customers are now accepting product installation in batches over multiple time periods (an extended cycle), revenue recognition should be extended out further to reflect that (recognize revenue later on). When management does not do that, they in essence recognize sales prematurely and cause DSO values to spike.

As detailed in our report, what happens next is usually a material drop off in sales as management has pulled in revenue from future periods. We also need to consider that these customers will not be purchasing future products at the same frequency, as they still have extended payments to make on prior purchases. This will all impact Omnicell negatively in future periods.

- **Inventory levels have increased as a result of the requirements to service our increasingly diverse product lines and growing installed base.** Omnicell regularly reviews its inventory levels and considers its value in accordance with U.S. GAAP. We have a large installed base of equipment and maintain sufficient inventory levels required to meet customers' expectations of continued support of prior-generation automation. In addition, multiple new products that we have launched or added to our offering through strategic acquisitions over the past several years have materially increased our inventory, as our products now have less commonality of manufacturing and service parts compared to our prior offerings.

GlassHouse Response: Again, nowhere in any of the last four years' worth of earnings calls does management point to a "diverse product line and installed base" as the reasoning for the inventory increase. In fact, they just use the same response over and over again, "the increase is driven by inventory builds for sales in future periods." This dates back to Q2 2016!

We documented in our report how Omnicell rolled out its new G4 product line back in 2013/2014 with no notable reported increase in DSI levels, so why have DSI levels increased now?

Furthermore, OMCL attributes acquisitions for the reasoning behind the DSI increase. We can prove this to be totally false with numbers. For example, the major acquisitions in which inventory transfers were disclosed were in 2016 with the Aesynt and Ateb acquisitions. This brought over $19.2 million worth of inventory on the balance sheet. However, from Q4 2015 to Q4 2016, 12M DSI values only rose from 64 to 65 days. Only afterward did DSI values begin to rise on a consistent basis up to 89 days currently, thus debunking this explanation.

We understand that management will never come clean and say that they mismanaged their inventory procurement and that they now have too much inventory on hand, which must be written-off. But what we have higher conviction in are statements made in filings such as their 10K:

> The increase in cost of revenues is primarily due to the increase in revenues for the year ended December 31, 2018 compared to the year ended December 31, 2017, and $2.1 million of excess and obsolete reserve for slower moving inventory.

OMCL did not once cite slow moving inventory as a factor in the DSI rise during their conference call or rebuttal. However, their audited 2018 10K tells a different story.

- **Capitalized software development costs have increased as we have invested in more platform features and software-based services.** We have made these investments to enhance products and increase the value of our platform for our customers, and we continue to invest in the platform and solution set to support the growth of our business. Capitalized software development costs are documented and accounted for in accordance with U.S. GAAP.

GlassHouse Response: As stated in our report, the surge in capitalized software costs may be in complete accordance with U.S. GAAP, however the end result remains the same. Heightened expenses now capitalized on the balance sheet *will* need to amortize through the income statement in future periods. Thus, whether or not the actions were nefarious in nature, the company will need to take accelerated amortization expenses in future periods as a result.

As our report stated, we calculate that OMCL now holds an additional $20.2 million of capitalized software on the balance sheet than it normally would. This amount will need to amortize in future periods, acting as a significant headwind to margins.

- **We account for our sales commissions in accordance with U.S. GAAP.** In 2018, we adopted ASC340-40, which requires the Company to capitalize prepaid commissions as long-term assets and amortize them over a period that covers the maintenance portion of the contract, including expected renewal periods. Prior to the adoption of ASC340-40, all prepaid commissions were recorded as current and expensed at the time automation products were installed. As a result of adopting the new standard, the amortization of commissions better matches the corresponding revenue. The impact of this change was disclosed in our Form 10-K filed with the U.S. Securities and Exchange Commission on February 27, 2019.

GlassHouse Response: Nothing above refutes any part of our report. The company has now elected to defer commission expenses which were once expensed up-front. These material expenses will now be deferred to future periods, pressuring margins. As our report stated, we calculate that OMCL holds an added $17.8 million in prepaid commissions on the balance sheet than it typically would. Investors and analysts should brace themselves when these heightened expenses come off the balance sheet.

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