



Ominous Omnicell, Inc. (OMCL) Delays the Inevitable

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

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Initiation of Omnicell, Inc., (OMCL) with a Target Price of \$35.50
(59% downside)

Significant declines in revenue and earnings await Omnicell as the company has obfuscated its financials by prematurely recognizing revenue in prior periods and failing to write-off legacy inventory.

- Omnicell possesses one of the worst net AR positions we have seen within a public company. Concealed long-term receivables and declining deferred revenues lead us to believe the company prematurely recognized approximately \$38.3 million in sales over the LTM. The company may need to restate financials based on the magnitude of these inauspicious trends.
- OMCL grossly mismanaged its inventory and now carries a highly bloated inventory balance that needs to be written off as obsolete. We calculate at minimum, management needs to write-off over \$23 million (22.4% of total) of obsolete inventory.
- Anomalous surges in both capitalized expenses and prepaid commissions lead us to believe that the firm has accelerated the capitalization of normal expenses over the LTM. Our analysis points to \$38.0 million in additional capitalized expenses that we believe should have been expensed. This represents a tailwind of \$0.72 to TTM non-GAAP EPS (30% of non-GAAP EPS).
- The lack of accounting experience among the CFO, audit chairman and audit committee present massive red flags to GlassHouse at a time when accounting gimmicks are highly prevalent at Omnicell.



Key Similarities Between Omnicell and Prior Exposed Companies

GlassHouse juxtaposes both Omnicell and the past transgressions of other fraudulent companies. **We believe that many of these accounting gimmicks listed below by prior firms may have been utilized by current Omnicell management.**

Key Characteristic	Omnicell (OMCL)	Similar Accounting Red Flag & Outcome
Recognizing Revenue Prematurely	Based on comments made by management and analysis of receivables and deferred revenues, GHR opines that Omnicell management has subjectively recorded revenue prematurely in the revenue recognition process. We believe the amount is highly material and will reverse in upcoming periods.	A prior company researched by GlassHouse, <u>Electronics for Imaging (EFII)</u> reported similar trends with both AR and deferred revenues. Subsequent to our report, EFII needed to postpone and restate prior earnings as the firm reported issues with “assessments of the timing of recognition of revenue” . The stock dropped over 40% on this news on 08/03/17.
Mismanagement of Inventory Accounting	Management has tried to explain away the bloating of inventory on the balance sheet for the last three years with no reprieve in sight. DSI levels have now reached a 10-year high value of 89 days. We believe management procured excess inventory and will need to write-off millions of inventory in future periods.	Medical device company and peer <u>Natus Medical (BABY)</u> reported similar spikes of inventory metrics with DSIs rising at an alarming pace. We opined that the company needed to write-off millions in excess inventory. A week after our report was released, BABY reported substantial reductions in gross margins due to “inventory reserve” write-offs in Q4 2018 . The stock dropped 11.2% on Q4 2018 earnings. BABY is now down 22% since our report was released on 02/05/19.
Unusual Capitalizing of Expenses	Both the company’s capitalized software and prepaid commission accounts have skyrocketed over the past year. These expenses contain high subjectivity from management as these expenditures could either be classified as an asset or expense. Specifically looking at capitalized expenses, these expenditures circumvent the income statement and represent future heightened expenses that will pressure margins. Also, R&D costs have highly bifurcated from these trends leading us to believe management has decided to capitalize more costs than expense.	Prior disclosed fraud, <u>Winners Internet Network</u> from the early 2000s, reported similar capitalized metrics as OMCL. Here the SEC accused the company of improper capitalization of software costs during a three-year timespan. Specifically, the SEC alleged that Winners improperly capitalized wages, payroll taxes, rent, travel, marketing, and consulting expenses that were purportedly associated with the development of their software. Furthermore, the costs were incurred after a certain date where the software was available for general release to customers. The firm’s stock price lost substantially all of its value after these fraudulent actions were revealed.



Omnicell Financials Are Set to Unravel in H2 2019

The past two years in Omnicell's (OMCL) history have been vital to management's future growth plans as the company has introduced three major product lines; some that have replaced older legacy models. The XT series (decentralized pharmacy), XR2 (centralized pharmacy), and the IVX Workflow and Cloud product lines have been central to the recent run up in OMCL's stock price as customers have been upgrading to the newer systems. However, while management is quick to paint a rosy picture of heightened sales and earnings as customers upgrade, our analysis points to something different happening at Omnicell.

Based on comments made by OMCL management, investors are being led to believe that the company's recent revenue and earnings gains stem primarily from organic sources. This sentiment has been reflected in OMCL's stock price, which has almost doubled since the beginning of 2018. And while GHR does believe there is some merit to OMCL's product lines within the healthcare industry, we opine that the company's current stock price is highly inflated and has been based on faux revenue and earnings over 2018 & 2019.

After going through countless filings, earnings calls and presentations, we believe that OMCL management has been using a variety of accounting gimmicks to turn around a company that previously reported depressed margins and earnings. Based on our extensive experience researching accounting frauds, we take issue with both the quantity and scope of financial engineering used by management over the past two years. Too many accounting anomalies took place on the income statement, balance sheet and within the footnotes for GHR to believe these actions were not purposeful in nature.

When we analyze Omnicell's accounts receivable (AR), inventory, and capitalized expense diagnostics, we find a company that we believe has been manipulating its accounting for significant gains to the income statement. However, in our experience, the manipulation of all these balance sheet accounts points to future share price degradation in upcoming periods as these issues tend to violently reverse.



Management's Comments Regarding Receivables Spike Are Not Plausible

Delving into the crux of our thesis when looking at OMCL's accounts receivable (AR) balances, we believe that management has been recognizing revenue prematurely with respects to their performance obligations. We find this more concerning than a collectability issue, as this type of accounting concern ends up with material revenue shortfalls in future periods. Below, we detail OMCL's unfavorable AR trends and how we believe this will impact revenue and earnings going forward:

- In the latest period, current AR grew by 6.7% YOY to \$203.5 million. As a result, Omnicell's days-sales-outstanding (DSO)¹ levels stood at 90 days and 88 days of 3M DSO and 12M DSO, respectively at Q1 2019. This represented an increase of 7.6% YOY from Q1 2018 (12M DSO). **We view the current levels of 90 days to be extremely heightened from an absolute level as the firm is now waiting approximately three months to get paid on its products.** Furthermore, we point out in the next section that the true DSO value actually lies much higher than 90 days when including long-term AR and factored receivables.
- Looking at the long-term trend of DSO values, we see an inauspicious pattern of longer and longer receivables cycles at OMCL. Dating back to 2013, we see that the company consistently reported DSO values within historical and peer group ranges from 50 to 60 days. However, since this time, DSO values have been on a consistent rise with very limited or inconsistent explanations given by management as discussed in the next section. To put things into perspective, the current DSO value of 88 days now lies 63% above the 2012 ending balance of only 54 days (see Chart 1, Page 8).
- Turning to ending AR balances, we find similar results when analyzing the firm's AR-to-sales metrics. Three-month and 12M balances stand well above their five-year averages at 100.5% and 25.2% respectively. Moreover, OMCL's AR-to-3M sales ratio stands at the fourth highest ratio reported in any period over the past five years.
- Management provides their own calculation of DSO values in every conference call that slightly differs from our calculation; however, the adverse trend still is highly apparent. In the latest period, management discloses a value of 93 days, the second highest value ever reported by OMCL, only to the 97-day value reported in Q1 of last year.

¹ Three-month days sales outstanding (3M DSO) = Average total AR QOQ / 3M Sales * 91.25



- For reference, the last time OMCL reported a DSO near these levels at 95 days in Q2 2015, the firm's stock price drew down by 33% afterwards in H2 2015. Again, we believe OMCL's current predicament lies in a much worse place today than in 2015.

Hidden Long-Term Receivables Metrics Exacerbate OMCL's Dire Situation

Further diving into OMCL's receivable footnotes, GHR finds more concerning metrics that suggest Omnicell will face material sales headwinds over the next year as it deals with billing issues. In addition to OMCL's trade receivables which it stores under current assets, the company also stores both long-term sales-type leases and unbilled receivables in "Other Long-Term Assets" on the balance sheet. Readers familiar with our work know we view these long-term receivables as the worst forms of revenue quality out there as they carry the highest risk.

- Illustrating this, we observe that sales-type leases and long-term unbilled AR currently stand at \$19.5 million and \$11.4 million, respectively, as of 03/31/19. When we add these figures to the current receivables balance, we find that the company is in a much worse position than they are leading on.
- For example, we see that management is patting themselves on the back for reporting a bloated DSO metric of 93 days in the Q1 2019 earnings call. However, when we add these hidden receivables back into our 3M DSO metric, this causes the current value to surge up to 109 days in Q1 2019; this represents the second highest value ever reported by OMCL. Twelve-month DSO also hit an all-time high, increasing by 10% to 106 days in the period (see Chart 1, Page 8).
- GHR finds it to be quite misleading by OMCL management to only report a DSO balance only using trade receivables. In fact, we point out that long-term AR is the riskiest form of receivable balance and it should without-a-doubt be included in their given metric to analysts. For example, if management wanted to conceal a poor DSO metric in any given period, management could subjectively move trade AR into "Other Long-term Assets" on the balance sheet to hide the unwanted receivables.
- Unbilled receivables on a balance sheet specifically mean that the company recognized revenue, but has yet to invoice the client, directly contrasting from CFO Kuipers' explanations detailed in the next section. GHR also wants to point out that ASC 606 adjustments were not to blame for the rise in receivables either, as the pronouncement only impacted Omnicell's AR balance by \$819,000 on 12/31/17.



- To make matters worse for OMCL, the firm is factoring its receivables, as evident in the footnote below from the 2018 10K. This balance has increased by 39.4% and 16.5% in 2017 and 2018 respectively; far outpacing the recent rise in sales. We believe management may be factoring its receivables at a heightened pace to mask the firm’s already bloated AR balance. The problem with this is that the action is only transitory in nature and cannot stop the eventual rise in AR balance; plus the firm takes a loss on the sale of these receivables, pressuring margins. If we add these values back to AR, we calculate an astonishing DSO balance of 126 days at the end of 2018.²

Sales of Accounts Receivable

The Company records the sale of its accounts receivables as in accordance with accounting guidance for transfers and servicing of financial assets. The Company transferred non-recourse accounts receivable totaling \$46.6 million, \$40.0 million, and \$28.7 million during fiscal years 2018, 2017, and 2016, respectively, which approximated fair value, to leasing companies on a non-recourse basis. Accounts receivable balance included approximately \$10.6 million, \$0.1 million, and \$0.2 million due from third-party leasing companies for transferred non-recourse accounts receivable as of December 31, 2018, December 31, 2017, and December 31, 2016, respectively.

Table 1: OMCL Receivables Metrics

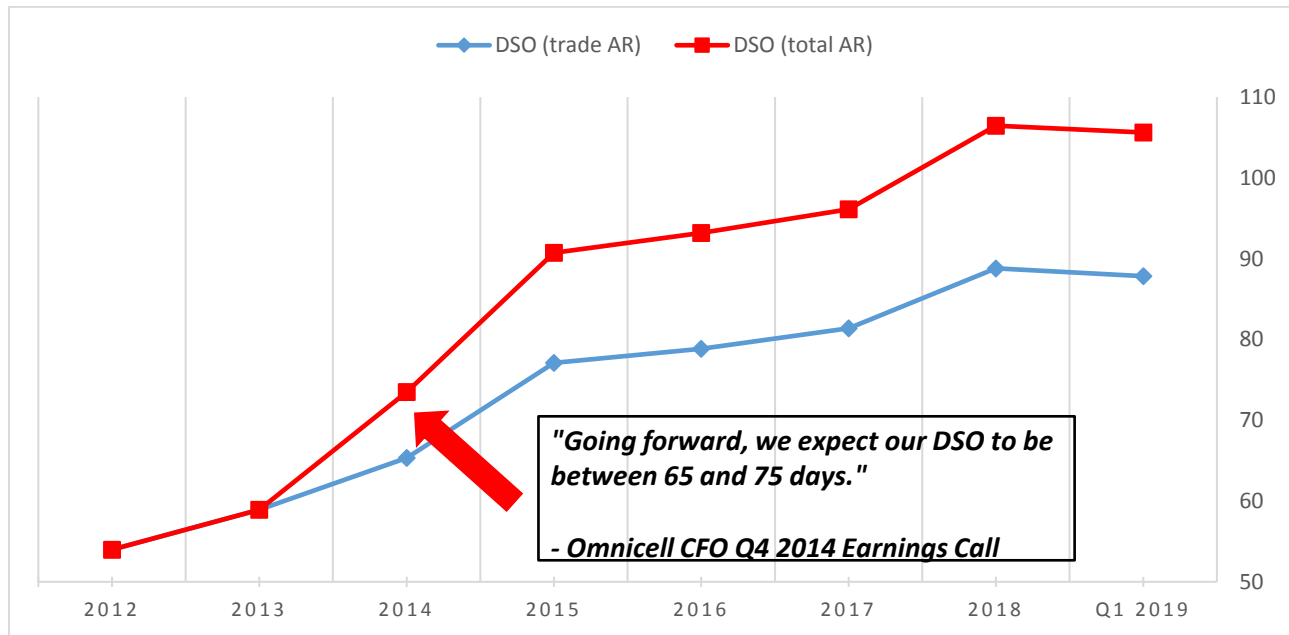
(\$ in millions)

	3M Ended:	Q1 2019	Q4 2018	Q3 2018	Q2 2018	Q1 2018
Trade Receivables		\$203.5	\$196.2	\$206.2	\$174.6	\$190.7
Total Receivables		\$243.4	\$238.5	\$247.7	\$211.9	\$226.3
DSO (trade AR)		90	87	85	88	95
DSO (total AR)		109	105	103	106	112
Management Disclosed DSO		93	85	93	86	97
<u>YOY</u>						
Trade Receivables (%)		6.7%	3.3%	20.0%	15.6%	45.1%
Total Receivables (%)		7.5%	6.6%	26.4%	20.1%	40.4%
DSO (trade AR, %)		-5.3%	3.1%	7.8%	24.1%	9.9%
DSO (total, %)		-3.4%	7.4%	12.8%	24.6%	7.0%
Management Disclosed DSO (%)		-4.1%	-4.5%	8.1%	10.3%	18.3%

² Omnicell does not disclose factored AR balances in the quarterly filings.



Chart 1: OMCL Long-Term DSO Trends



Omnicell Management Continues to Move Goalposts and Gives Elucidations that Do Not Hold Water

Dating back to 2014, then CFO Robin Seim stated that he believed the firm's expected DSO range would lie between 65 and 75 days. Subsequently, when DSOs again began to trend out of line in Q3 2015, the newly appointed CFO Peter Kuipers echoed the same sentiment that OMCL would look to improve on this metric next period.

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.

-CFO Peter Kuipers

Since Q3 2015, management has stayed fairly silent regarding the persistent rise in DSO and AR values. In fact, we find it quite misleading that management dodged questions regarding the heightened levels of DSO values in the latest quarter. Specifically, CFO Kuipers disclosed in the



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Q1 2019 earnings call, “OMCL’s DSO value of 93 days were down four days from the first quarter of 2018. The decrease was mostly driven by strong collections.”

GHR finds this highly disingenuous, as it is all Mr. Kuipers decided to say on the subject. We point out that the firm’s 93 days value is the third highest ever reported by the company, but apparently the company is patting themselves on the back for not being as bad as the disastrous levels of Q1 2018. Let’s not forget that the current value now stands 23 days above the firm’s self-reported target range for DSO values.

So, what is going on with OMCL and their receivables? Management is quick to point out that this rise does not stem from a collectability issue and we at GHR tend to agree with them. However, our analysts at GHR actually believe that something more nefarious may be at play here. Dating back to 2014, GHR found eight instances of OMCL management blaming the firm’s ominous DSO balance on “timing of billing.” However, herein lies the problem for Omnicell and their argument that does not hold water to us or any accountant out there. In Q3 2018 for instance, CFO Kuipers explains that recent DSO value of 93 days at the time was due to the following:

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.

Kuipers, who is not licensed as a CPA in the U.S. and carries more of a FP&A work history, does not appear to give a valid explanation as to why the firm’s receivables balance continues to outpace sales period after period in the long term. Here, he states that billings become revenue in the quarter after installation is completed, but in previous statements he claims that they invoice upon shipment.

These two statements conflict with each other and do not explain the recent rise in DSO values; in fact they would explain the opposite. If this statement from Kuipers was true, we would see AR values plummeting relative to sales. What Mr. Kuipers fails to understand is that when the firm’s AR balance (both billed and unbilled AR) continues to rise at an accelerated rate, it suggests that OMCL is recognizing revenue earlier on in the sales cycle compared to previous periods by jamming in sales at the end of the quarter.



In fact, we point out that OMCL also carries unbilled receivables on its balance sheet. This form of AR is revenue that has been recognized in the period, even before the invoice has been sent out to the client! The transaction Mr. Kuipers is describing is more akin to deferred revenues, which would be stored as a current liability (recent deferred revenue trends do not suggest this is occurring in any way).

Specifically, he is suggesting that the client receive shipment of the product and is invoiced, however NO revenue is recorded until installation is completed in the following quarter. Again, OMCL cannot debit (increase) AR unless revenue is being credited. Therefore, under this bizarre scenario Mr. Kuipers is describing, OMCL's AR balance would actually be going down.

A more likely scenario would be the following at OMCL: the firm has been recognizing revenue at an accelerated rate relative to historical norms at the end of each period (i.e. recognizing revenue prematurely), which would then cause the firm's AR balance to spike to anomalous levels. Because the clients are being invoiced at a later point in time, they still pay within the 60-day normalized timeframe, again not a collectability issue. However, the problem now lies within taking revenue from future periods to meet current estimates, and we all know how that ends up for companies that try this. Time and time again, management explains how the DSO rise is not attributable to collection/credit concerns. If we are to believe them, the only other explanation is that the company is recognizing revenue prematurely, leading to non-recurring gains to the top-line.

Our thesis is further corroborated by statements made by CEO Randall Lipps when discussing the delayed rollouts of the XT series pharmacy in Q4 2017:

Analyst

First question, maybe you could give us an update on the implementations. It sounds like there have been a couple sticking points here the last couple of quarters. Obviously, when you've got a new platform rollout, such as XT, that's the software as well as the hardware, you would expect maybe a couple hiccups. But it seems to be these are dragging on a little bit. Maybe if you could provide an update on that front.

Randall A. Lipps, CEO

Well, I think there are a couple of dynamics that are changing, but one of them is the orders are getting very large. And therefore, the implementation pieces are getting very large. And so it's a little blockier, which is -- it's not a bad thing. But when somebody slows it down, it slows down a larger block of implementations. And the team has gotten better and better every quarter at setting up the installations and moving those forward. And I think that, certainly, for 2018, we have built in a plan that allows for more of these last-minute changes if we get them, just because backlog has backed up even a little more.



So there's no individual reason why some of these accounts get pushed off. They're always for different reasons. But it's just that the size of some of these single installations are at the size that it does impact the revenue.

Analyst

One question, just in terms of the outlook and then a couple of housekeeping items. So first, we've seen 2 quarters in a row where you've had this issue with implementations. Understanding that it's difficult to sort of get the customer to move in the larger implementations, but do you think relative to your guidance for 2018, you've factored in some of these issues -- do you think you adequately reflected some of these implementation, if you want call them, challenges that you've had the last couple of quarters?

Randall A. Lipps, CEO

Definitely. We've shifted both our strategy with our customers, the way we've positioned particular Q1 to make sure that -- to be conservative in case something happens. I just think - - I'm like you. The last 2 quarters, I said, "That's enough of this." And so this year's plan is built on not doing that anymore.

While these delayed implementations fully corroborate our thesis, Mr. Lipps has stated that these implementation concerns have been fixed in later periods. However, in the latest earnings call we continue to see issues pop up:

Randall A. Lipps, CEO

The implementations are always a little bit longer in that sense in that we usually have to do some preparatory work and redesign maybe in a pharmacy to get some of those installs done.

Based on these comments made by management that suggest that installation and implementation of Omnicell's new products are taking longer than expected, we believe that management may have possessed high motivation to recognize revenue prematurely in order to meet revenue targets. As the evidence suggests, OMCL is not facing a collectability issue from its customers, therefore the only other explanation for the unfavorable receivable trends is management recognizing revenue in advance of meeting its performance obligations. This directly conflicts with CFO Kuipers comments about "timing" and "deferring" revenue on the income statement until the next period.



Deferred Revenues Suggest Lower Quality of Revenues

When analyzing companies that have a spiking AR balance, we also need to make sure that the firm's deferred revenue (DR) balance does not offset this rise with a rise of its own. If the firm is pulling in more cash in the form of deferred revenue, this usually alleviates most our concern for the AR increase. However, this is not the case for Omnicell. When we dive into the deferred revenue footnotes, we find a scenario similar to what management explained for their DSO increase above:

Note 9. Deferred Revenues

Short-term deferred revenues of \$81.8 million and \$78.8 million include deferred revenues from product sales and service contracts, net of deferred cost of sales of \$11.1 million and \$16.9 million as of December 31, 2018 and December 31, 2017, respectively.

The short-term deferred revenues from product sales relate to delivered and invoiced products, pending installation and acceptance, expected to occur within the next twelve months.

A contract liability is an obligation to transfer goods or services for which we have received consideration, or for which an amount of consideration is due from the customer. Contract liabilities include customer deposits under non-cancelable contracts, and current and non-current deferred revenue balances. Our contract balances are reported in a net contract asset or liability position on a contract-by-contract basis at the end of each reporting period.

However, none of what Mr. Kuipers stated still makes any sense, as deferred revenues have been on a consistent downtrend relative to sales in the last five years. On top of that, we would expect a CFO of a company to know the difference between accounts receivable and deferred revenue, but based on his flawed explanations, we are not so sure at the moment. Below, we detail OMCL's recent negative deferred revenue trends:

- When analyzing both current and non-current DR balances, we find that DR actually *decreased* by 3.9% YOY to \$100.4 million in Q1 2019. Again, from a quality of revenue standpoint, our analysts would like to see deferred revenues increasing, especially when relative to sales. When unearned revenues increase on the balance sheet, this added cash acts as a "down payment" by the client and virtually guarantees future revenues on the income statement.
- Here we find the opposite impact has been plaguing OMCL. Relative to 3M sales, DR has decreased by 765 bps YOY to 49.6%, representing a five-year seasonal low for the company. This compares unfavorably with the five-year seasonal average of 60.2%. Longer-term



metrics report similar discouraging trends with DR falling by 156 bps YOY to 12.4% relative to 12M sales.

- Days-of-deferred revenues (DDR)³ also reported material degradation by falling 10.3% (9.1%) YOY to 43 days (44 days) as referenced on Table 2, Page 14. Both figures represented a new five-year low for the firm. Ouch.
- As stated above, our analysts like to judge net receivables and deferred revenues trends to get a full picture of the firm's quality of revenues. In most cases, we expect to see companies with a net balance near \$0 or negative, as the firm's deferred balance is above AR. This was the case for Omnicell in the years preceding 2013, suggesting strong quality of revenues.
- In Omnicell's case, net AR reached its third highest absolute level (only to Q3 & Q4 2018), increasing by 17.4% YOY to \$143.0 million. This absolute value stands at an extremely high level for the company, especially when we see that this balance stood at a *negative* \$1.3 million only four years ago.
- As one would expect, relative to quarterly sales, net AR jumped by 391 bps to 70.6%, representing the second highest ratio recorded in any period. Twelve-month net AR-to-sales reported a similar increase of 140 bps to 17.7%. **Make no mistake about it, these are absolutely terrible net figures reported by OMCL and very rarely seen to this extent in our experience.**
- Overall, the continued increase of receivables coupled with the deterioration of unearned revenue metrics lead us to believe that the quality of OMCL's recent sales is at extremely low levels. Based on our experience, we expect to see a material drop off of revenues in future periods as a result. This is corroborated by the excerpt above detailing contract liabilities as being "customer deposits under non-cancelable contracts".
- To quantify the impact that recognizing this revenue earlier relative to historical standards has had on performance, we can reverse engineer OMCL's net AR balance using the firm's net DSO value reported in Q1 2018 (47 days). As a result, we calculate that OMCL recognized an astonishing \$38.3 million more in revenue (also pure margin gains) over the TTM. This considerable figure also translates to a tailwind of 72-cents in EPS over the last year, or 30.2% of non-GAAP EPS!

³ Three-month days of deferred revenue (3M DDR) = Average total deferred revenues QOQ / 3M Sales * 91.25



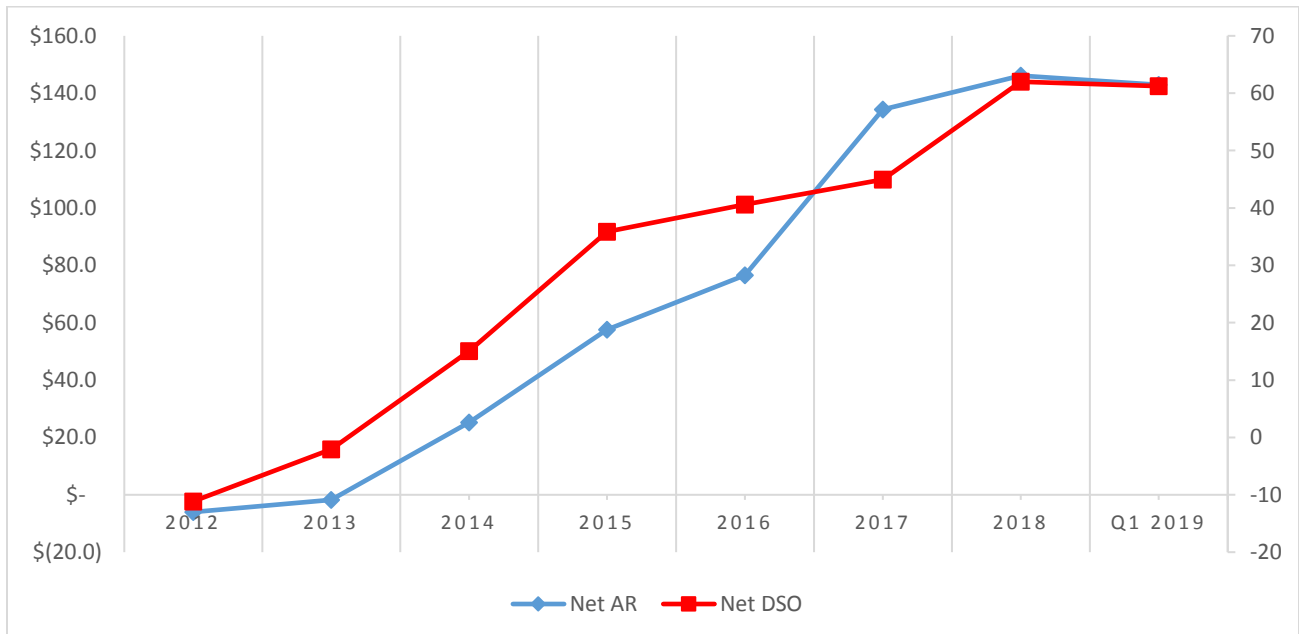
Table 2: Deferred Revenue and Net AR Metrics

(\$ in millions)

Period Ended:	Q1 2019	Q4 2018	Q3 2018	Q2 2018	Q1 2018
Deferred Revenue	\$100.4	\$92.4	\$98.4	\$94.7	\$104.5
3M DDR	43	41	43	48	48
12M DDR	44	44	46	47	49
Net AR	\$143.0	\$146.1	\$149.3	\$117.1	\$121.8
Net 3M DSO	65	64	60	58	64
Net 12M DSO	61	62	59	53	47
YOY					
Deferred Revenue (%)	-3.9%	3.4%	1.2%	-6.9%	-1.9%
3M DDR (%)	-10.3%	-5.2%	-11.2%	-8.2%	-25.3%
12M DDR (%)	-9.1%	-13.1%	-17.0%	-16.6%	-16.0%
Net AR (%)	17.4%	8.8%	51.1%	56.9%	122.9%
Net 3M DSO (%)	1.8%	17.5%	40.4%	77.3%	58.8%
Net 12M DSO (%)	29.4%	37.9%	39.2%	28.0%	13.6%

Chart 2: Long-Term Net AR & DSO Trends

(\$ in millions)





GHR Believes that Omnicell Mismanaged Inventory Levels and Needs to Write Off Approximately \$23.3 million of Excess Inventory

In our extensive history researching frauds and earnings management within public companies, one of the strongest indicators lies within concurrent spikes within both receivables and subsequently inventories as we see here with Omnicell. What this suggests is that delays or implementation issues leads to management recognizing revenue prematurely (i.e. rise in DSOs), and thus causing a spike in days-sales-of-inventory (DSI).

When screening all public companies for significant rises within both DSO and DSI metrics, **we find Omnicell's extended rise (both DSO and DSI) from 50 to 90 days to be one of the worst within all public companies.** Management has been regurgitating the same old reasoning of building up inventory for future sales dating back to 2016. However, GHR believes something more nefarious is at play here as we think management has quietly been writing-off inventory in recent periods. Similar to our last short, Natus Medical (BABY), it appears that analysts are completely blind to the highly growing balance of inventory on the company's balance sheet, as inventories have been rarely discussed in recent conference calls. In this regard, we understand that Omnicell has come out with three new significant product lines. However, we find the material rise in inventory to be a gross mismanagement of inventory levels dating back to 2014.

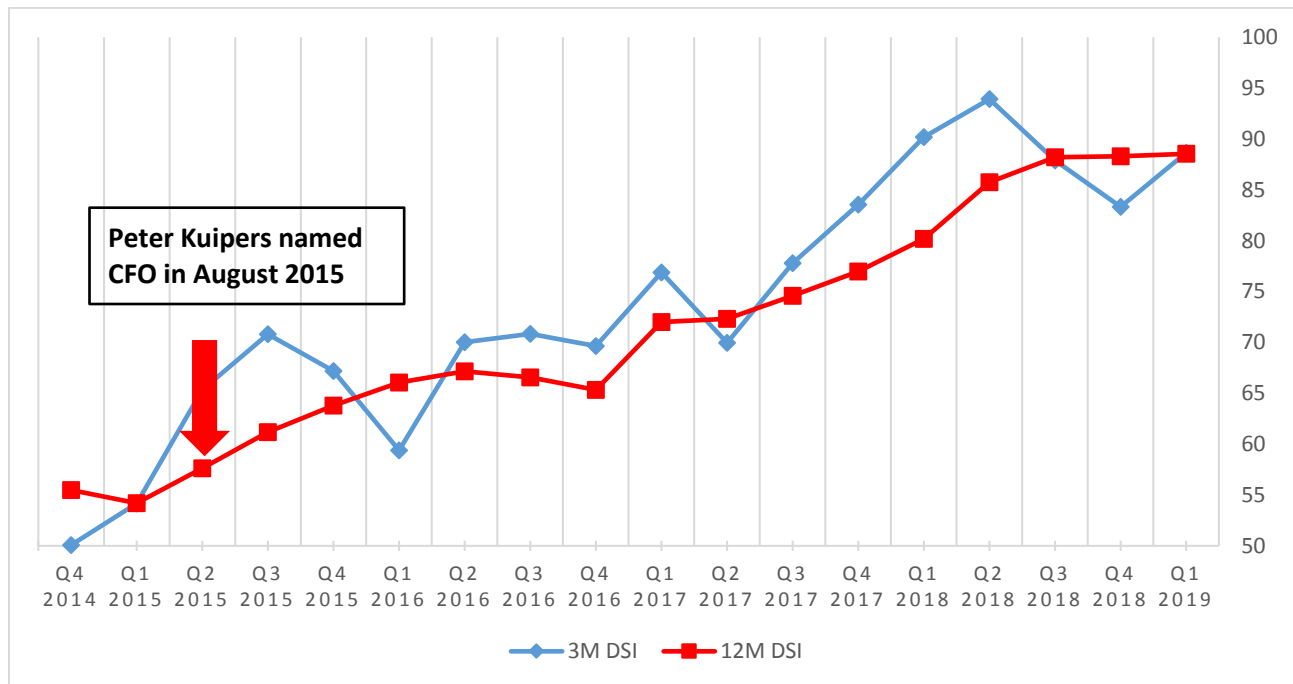
Diving into Omnicell's inventory diagnostics, GHR finds an excess of accounting concerns which all point to the fact that OMCL has: 1) grossly mismanaged its inventory procurement in recent years and/or 2) refusing to write-down their obsolete inventory in order to keep margins artificially healthy. With prior revenue and earnings metrics waning in 2016 and new product lines coming out in 2017 and 2018, we believe that CEO Randall Lipps and CFO Peter Kuipers were highly motivated to increase sales/margins and may have resorted to these accounting gimmicks in order achieve this. Overall, our research has pointed to OMCL's new product lines previously being pushed onto hospitals, GPOs, and customers to the point where they are stuffed with products and hesitant to procure any more inventory; especially when dealing with implementation issues. **To make matters worse, it appears that management's visibility into future buying trends of its customers were highly inaccurate based on comments from management and inventory trends dating back to 2016.**

Thus, with only unfavorable options on the table for OMCL, we believe our inventory analysis puts a time catalyst of OMCL's share price decline (within one-to-three quarters). Below we detail OMCL's unfavorable recent inventory metrics:



- Similar to OMCL’s prior receivable balances, the company actually carried normalized levels of inventory dating back to five years ago. And similar to the spike in AR, we find a concurrent rise in inventory with the never-ending explanation of more sales coming in future periods. Illustrating this trend, we report that Omnicell reported a typical days-sales-of-inventory (DSI)⁴ balance between 50 and 60 days dating back to 2014. However, since that time, DSIs have risen in a stair-step fashion all the way to near 90 days level (see Chart 3, below).
- While the current 3M DSI balance is slightly down on a YOY basis, the 89-day value is the third-highest value ever reported in any quarter by the company going back over 10 years. For reference, the five-year seasonal average for Omnicell’s DSIs stand at 74 days. Twelve-month DSIs actually increased by 10.4% YOY to 89 days at 03/31/19, representing a new five-year high and dwarfing the average of only 70 days.
- OMCL’s inventory-to-quarterly-sales metric also portrays a harbinger for future margin compression as this metric currently stands at 51.3% at the end of Q1 2019; the third-highest value ever reported. Inventory-to-12M-sales follow a similar pattern standing at 12.9%, well above the five-year average of 11.1%.

Chart 3: OMCL Long-Term DSI Trends



⁴ Three-month days of inventory (3M DSI) = Average total inventory QOQ / 3M COGS * 91.25



Distinct Inventory Metrics Show that Omnicell's Needs to Impair Excess Inventory

- As explained in the next section, GHR wondered if OMCL was procuring more of its XT and CBM series on top of XR2 and IVX units to build for future sales. When analyzing OMCL's future sales figures and their history, the numbers do not point to this being the case. Using consensus sales estimates for future periods, we can analyze inventory relative to future sales to see if these figures are historically within norms for Omnicell.
- After interpreting our analysis, we actually found that metrics were hazardously high for the firm. Even as analysts predict low-double-digit growth for Omnicell over the next year, there appears to be an excess of current inventory built on the balance sheet that will not subside in future periods. Relative to forward 3M and 6M sales, we find that inventory stands at 48.5% and 22.2%, respectively, as of 03/31/19. Both values stand well above historical norms for the firm, thus deflating any future demand for OMCL's current inventory levels. For example, just four years ago in Q1 2015, these metrics stood at only 29.4% and 11.0%, respectively, much lower values that indicate future demand may not be there.
- Even when judging OMCL's current inventory versus bookings (i.e. expected future sales), the company's metrics still appear to be highly outsized relative to history. Illustrating this, we see that this ratio now stands at 14.1% at the end of 2018. While this amount is off the five-year high of 16.9% reached in the prior year, it is still well above historical values of 8.8%, 11.9%, and 12.7% reached in 2014, 2015, and 2016, respectively.
- Based on our expertise, GHR believes that there are only two possible outcomes in this scenario: 1) Omnicell will attempt to maintain its price points on its products, resulting in decreased sales and future impairment risk of its inventory and/or 2) the company will need to discount its products significantly in order to move inventory and avoid warehousing & transporting costs. **Our overall thesis based on these figures suggests that the launch of the XT series and other new product lines have not produced the sales expected by management when they obtained their current inventory levels. Furthermore, based on the significant inventory rise, OMCL management has yet to write these obsolete models off the balance sheet.**
- Further corroborating our thesis, we turn to the firm's accounts payable-to-inventory ratio. As of 03/31/19, this ratio currently stands at its lowest value ever recorded, at 37.0%. This ratio has declined substantially over the past two years, as it is down from a recent high of 65.4% reached in Q2 2017. This divulges to us that management has actually been



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decreasing its inventory purchases over the last five years. **As management constantly touts building inventory for future sales, this metric tells us the opposite is occurring.**

- Exacerbating OMCL's inventory problems, management also resorted to transferring some of its inventory into property, plant, and equipment, according to the 2018 10K. This is the first instance GHR can find where management chose to transfer some of its inventory into PP&E (see below). While from an absolute standpoint, the balance is not highly significant at \$2.03 million, it does reveal to us other avenues management is willing to go down to conceal inventory problems on the balance sheet. We will continue to monitor this account, as we expect management may continue to transfer inventory into PP&E at heightened levels in the future.

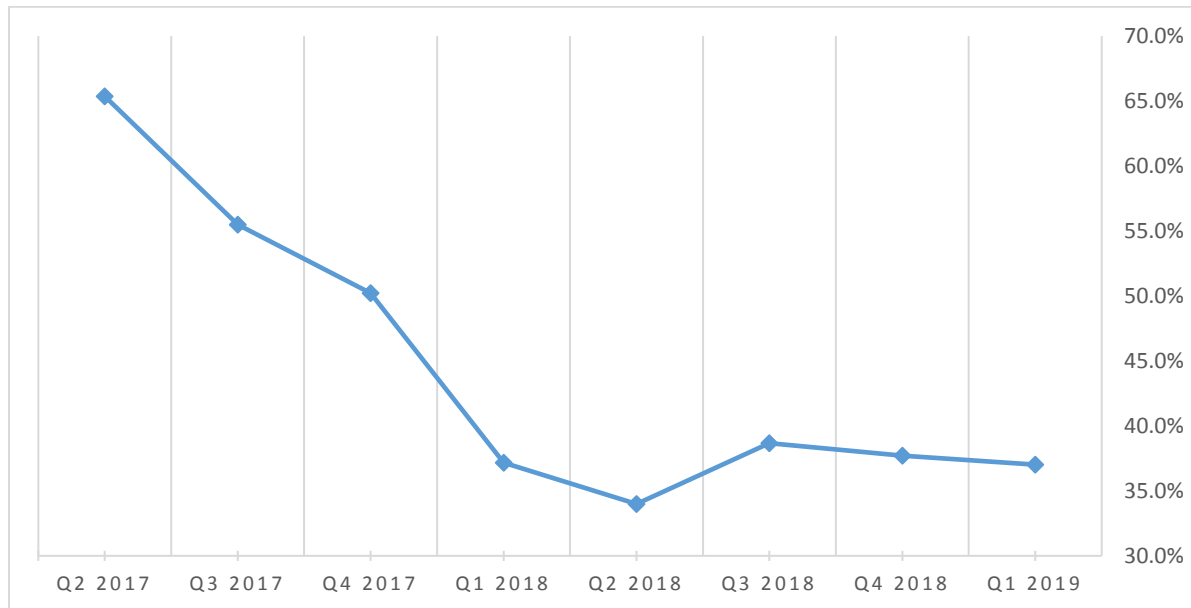
Net increase (decrease) in cash and cash equivalents	34,768	(22,064)	(27,729)
Cash and cash equivalents at beginning of period	32,424	54,488	82,217
Cash and cash equivalents at end of period	<u>\$ 67,192</u>	<u>\$ 32,424</u>	<u>\$ 54,488</u>
Supplemental cash flow information			
Cash paid for interest	\$ 7,487	\$ 6,550	\$ 5,344
Cash paid for taxes, net of refunds	\$ 3,489	\$ 7,780	\$ 11,091
Supplemental disclosure of non-cash investing activities			
Non-cash activity business acquisition	\$ —	\$ 3,400	\$ —
Unpaid property and equipment purchases	\$ 1,123	\$ 1,691	\$ 246
Transfers between inventory and property and equipment, net	\$ 2,032	\$ —	\$ —

The accompanying notes are an integral part of these consolidated financial statements.

- To quantify the impact that declining to impair these inventories has had on earnings, we can reverse engineer Omnicell's inventory balance using the firm's five-year DSI average of 70 days. As a result, we estimate that OMCL should have written-off \$23.3 million of their inventory in the latest year to match a historical balance for the firm. **This impact would result in a \$18.2 million after-tax loss over the TTM, or \$0.44 of EPS.**



Chart 4: Omnicell Accounts Payable-to-Inventory Ratio



Failing to Write-Off Obsolete Inventory Will Be a Significant Headwind for Omnicell

With Omnicell rolling out a collection of new product lines to its customers in recent years, our analysis has led us to believe that two outcomes are occurring: 1) OMCL’s new product lines have not been selling at the rate management initially thought they would and 2) OMCL’s legacy products have not been written-off to reach normalized levels. Judging from excerpts from prior earnings calls and OMCL’s current inventory levels, we believe both outcomes have concurrently taken place with Omnicell now facing an ominous future, as it will need to unwind the slow moving and/or obsolete inventory on its balance sheet.

Furthermore, GHR will refute the point that due to OMCL currently being in an upgrade cycle, this would explain the recent rise in DSI balance. In fact, we would expect the opposite to be true. For example, the last time Omnicell reported a significant upgrade cycle was with the G4 automated pharmacy in 2013 and 2014. Throughout this period, DSIs reported a tight range of only 55 to 59 days throughout those quarters. These values were well within historical and peer group standards in the midst of a major product line upgrade.

Viewing data on Chart 3 on Page 16, we can see how DSIs have been growing in a stair-step fashion dating back to 2015. With the appointment of CFO Peter Kuipers within the same timeframe, we do not believe it is a coincidence that DSI levels have risen so sharply. As a



result, margins may have been artificially protected, as Mr. Lipps and Mr. Kuipers obstinately refused to write-off obsolete inventory.

Our first acknowledgement by management that inventory metrics started to come out of line was in the Q2 2016 earnings call with CFO Kuipers stating:

Inventories were \$74 million, up around \$2 million from last quarter, mostly for our built-in inventory for installs and deliveries in the third quarter.

However, after this statement, we found that inventory metrics never normalized to historical values when the “future sales” occurred over the next year. While, yes, sales did increase over the next year (with the help of the Aesynt acquisition’s sales), we would have expected OMCL’s DSI values to normalize into the 50-to-60-day range. This did not occur. In fact, starting in Q1 2017, management exclaimed in nine consecutive earnings calls that the recent inventory bloat was “primarily driven by an inventory build for future quarter installs.”

Based on our analysis above, we believe this explanation is a road to nowhere and that heightened write-offs are inevitable. Estimated future sales and bookings estimates still show a very bloated inventory balance that will need to be written off unless a miracle causes sales to rise significantly above estimates. With our receivables’ analysis showing that management cannot even understand simple AR/sales journal entries, why should we believe them in this instance? Management has had 10 periods in order to get their inventory metrics under control and it just continues to spiral higher.

In the Q4 2018 earnings call, management discloses the specific new product lines that have driven the inventory increase:

Inventories at December 31, 2018, were approximately \$100 million and relatively flat from the prior quarter and up 5% from last year, **as we are ramping up production of the XT Series, XR2 and IVX Workflow**

According to the firm’s 2018 annual report, however, we find an excerpt relating to obsolete inventory that may be a harbinger of more unfavorable inventory trends to come:

Medication Adherence. Cost of revenues increased by \$10.1 million for the year ended December 31, 2018 as compared to the year ended December 31, 2017. 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.**



Here, we believe the crux of our inventory thesis lies with legacy inventory gathering dust in warehouses of OMCL (G4 pharmacy, RobotRx, etc.). The continued drop off of accounts payable-to-inventory ratio suggests that a decline in inventory procurement has not mitigated any inauspicious DSI trends as it continues to rise. On top of that, with management disclosing that it has started to write-off inventory, GHR believes it is only the tip of the iceberg until we see DSIs normalize into the 50-to-60-day range. Curiously, management does not disclose the firm's excess obsolescence reserve in the firm's annual report. Being in the highly transformative medical device industry, we find it bizarre that a company this size would not disclose any metrics regarding their obsolescence reserve.

To conclude, let us leave the reader with a major statistic that details Mr. Kuipers' tenure as CFO. **During his tenure as CFO, Omnicell's DSI metric has increased by 31 days (or 53.4%), from 58 days to 89 days.** Given management's somewhat broken record of "building for future sales," we find it highly peculiar that no analysts want to ask the tough questions relating to the never-ending build of inventory on the balance sheet.

Management's aforementioned statements of "timing issues" and "building for future sales" speak to both a mismanagement of inventory levels and revenue that has been pulled forward to meet sales/earnings estimates. Again, while management may cosmetically enhance sales and earnings through these accounting gimmicks for a short period of time, these actions are not sustainable in the long-term and point to a decreased demand for their products. GHR believes that over the next year, most investors can expect a large drop off in revenues as the previous non-recurring revenue gains disappear.



Capitalized Software Deviates Considerably from R&D Trends

In addition to our revenue recognition and inventory concerns, we find that management pulled yet another accounting lever over the past two years to *greatly* increase operating margins. As stated above, we believe management was facing the pressure of three consecutive years of declining margins (2014-2017), and therefore chose to use accounting gimmicks to turn it around.

Miraculously in 2018, both non-GAAP gross and operating margins increased by 210 and 370 bps, respectively. While management was quick to boast about their non-GAAP operating margin being above 15% (a long-term goal for OMCL), we believe it was disingenuous of management to not explain the primary reasons for it on the same Q4 earnings call. However, buried in the firm's 2018 10K, we see why the company reported decreased R&D costs:

Research and Development

Research and development expenses decreased \$1.2 million for the year ended December 31, 2018 as compared to year ended December 31, 2017, primarily driven by a decrease in research and development expenses of \$3.9 million in our Automation and Analytics segment, offset by an increase in research and development expenses of \$0.7 million in our Medication Adherence segment and an increase of \$2.0 million in corporate-related research and development expenses.

The decrease in the Automation and Analytics segment was primarily attributed to several research and development projects reaching capitalization stage during the period ended December 31, 2018 as we are allocating additional resources to software projects, resulting in lower research and development expenses.

While this excerpt may appear to be fairly innocuous in nature, we believe that the accelerated capitalization of software costs over the past two years provided a material boost to EPS. Again, these are nothing more than subjective calls by management (as to when a project reaches certain production stages) to reduce expenses at their discretion.

This action is eerily similar to the accounting case study on the Winners Internet Network fraud in the early 2000s. Here the SEC accused the company of improper capitalization of software costs during a three-year timespan.⁵ Specifically, the SEC alleged that Winners improperly capitalized wages, payroll taxes, rent, travel, marketing, and consulting expenses that were

⁵ <https://www.sec.gov/litigation/complaints/comp18652.htm>



purportedly associated with the development of their software. Furthermore, the costs were incurred after a certain date where the software was available for general release to customers.

In laymen's terms, Winners' management capitalized its costs on the balance sheet, therefore circumventing the income statement and making margins look better than they actually were. But this game cannot be played forever and will violently reverse when these capitalized expenses come off the balance sheet at a heightened rate.

Without diving too much into the accounting minutiae, we will contextualize how OMCL management is able to use ASC 985-20 to its advantage to cosmetically enhance earnings. Under this pronouncement, management needs to make subjective calls in order to determine whether expenditures are to be classified as normal expenses (R&D costs) or capitalized expenses (capitalized software). The key aspect of this pronouncement is that management needs to make a call regarding whether internal generated software has reached "technological feasibility." Technological feasibility is established upon completion of a detailed program design or, in absence, completion of a working model.

So why do we at GHR believe that Omnicell is engaged in similar acts as Winners? Based on the highly anomalous figures disclosed by the company and research of the firm's software product offerings, we believe their recent reported earnings figures are too good to be true.

- Omnicell's capitalized software balance (stored in "Other Long-term Assets" on the balance sheet) has skyrocketed over the past year. This is concurrent with R&D expenses stalling on the income statement for no apparent reason. In the last four periods, capitalized software (CS) has spiked by 30.1%, 41.9%, 47.2%, and 57.2% YOY, respectively. In contrast, R&D costs have reported YOY decreases in three of the last four periods (see Chart 5, Page 25).
- The contrast is even more apparent when judging CS versus revenue trends. Prior to 2018, this ratio of CS-to-3M sales ranged between approximately 15% to 20%. However, in 2018, something changed drastically, causing the ratio spike to a recent high of 31.9% as of Q1 2019, or 1,233 bps above the trailing five-year seasonal average of 19.6% (see Table 3, Page 25).
- Looking at longer-term trends for Omnicell, the company's CS-to-12M sales ratio rose by 250 bps YOY to 8.0% as of Q1 2019. This ratio also reached a new recent high and stood 260 bps above the five-year average of only 5.4%.



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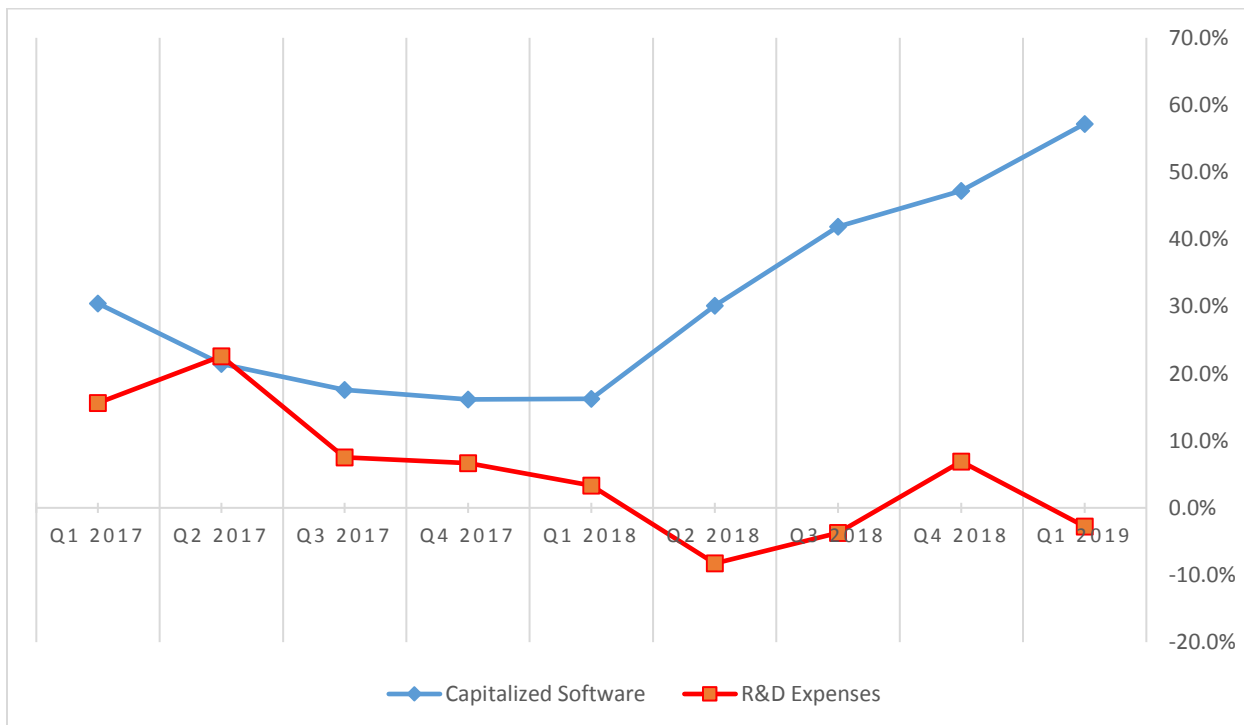
- To quantify this impact, if GHR uses the 5.5% prior year's CS-to-12M sales ratio as a baseline, GHR calculates that a standard capitalized software balance should stand at \$44.5 million on the balance sheet. Therefore, ceteris paribus, OMCL would have reported \$20.2 million more in R&D expenses over the TTM. **Flowing through to earnings, this translates a highly material 38-cent benefit to the bottom line for OMCL over the TTM. In other words, 16% of non-GAAP EPS over the TTM was based on this unsustainable benefit alone.**
- Even if OMCL management had grounds to capitalize these significant amounts of expenses for valid reasons based on product life cycles, this 38-cent gain to EPS is *highly* transitory and will not reoccur in 2019. In fact, this prior one-time gain will now act as a material headwind as OMCL will have to make up this gain in future periods.
- At worst, management needed to turn around margins after three dismal years of declines and turned to financial engineering in order to mislead investors/analysts. At best, however, even if the increase in these balance sheet accounts were 100% organic, the total increase in margins and EPS (\$0.38, 16% of non-GAAP EPS), *will not* reoccur in 2019. Thus, the previous gains will now act as substantial headwinds for 2019 earnings.



Table 3: Capitalized Software Relative to Sales

Period Ended:	Q1 2019	Q4 2019	Q3 2018	Q2 2018	Q1 2018
Capitalized Software (CS)	\$64.7	\$56.8	\$52.1	\$46.1	\$41.1
R&D Expenses	\$16.1	\$17.0	\$15.8	\$15.5	\$16.5
CS / 3M Sales	31.9%	26.8%	25.5%	24.5%	22.5%
CS / 12M Sales	8.0%	7.2%	6.7%	6.1%	5.5%
CS / Total Assets	5.5%	5.3%	4.9%	4.5%	4.0%
YOY					
Capitalized Software (%)	57.2%	47.2%	41.9%	30.1%	16.3%
R&D Expenses (%)	-2.8%	6.9%	-3.7%	-8.3%	3.3%
CS / 3M Sales (bps)	941	718	584	487	-129
CS / 12M Sales (bps)	250	180	141	89	23
CS / Total Assets (bps)	154	146	98	60	6

Chart 5: Capitalized Software Versus R&D YOY Growth Trends





Change in Expense Recognition Policy Drives 14.1% of TTM Earnings

Continuing with the theme of heightened expense deferrals and capitalized expenses, GHR found another interesting balance sheet item swelling over the past year in “Prepaid Commissions.” With the full retrospective adoption of ASC 606 as of 01/01/18, we find that Omnicell reclassified prepaid commissions as a non-current asset and adjusted its amount by \$25.8 million on that date. The company now carries two balances of prepaid expenses, one as a current asset and one as non-current prepaid commissions.

Prior to the adoption, we can see below how OMCL classified both assets in the footnotes (2017 10K):

	December 31,	
	2017	2016
	(In thousands)	
Inventories:		
Raw materials	\$ 22,750	\$ 14,322
Work in process	9,818	7,800
Finished goods	63,569	47,175
Total inventories	<u>\$ 96,137</u>	<u>\$ 69,297</u>
Prepaid expenses		
Prepaid commissions	\$ 15,671	\$ 13,176
Other prepaid expenses	20,389	15,470
Total prepaid expense	<u>\$ 36,060</u>	<u>\$ 28,646</u>

In addition, the footnotes discussed its prepaid commissions in the following excerpt from the same filing:

Commissions

Sales commissions are incremental and directly related to customer sales contracts in which revenue is deferred. These commission costs are accrued and recorded in prepaid expenses upon execution of a non-cancelable customer contract and subsequently expensed in the period of revenue recognition. Commission expense was \$19.4 million, \$22.0 million and \$13.7 million for the years ended December 31, 2017, December 31, 2016 and December 31, 2015, respectively.

However, accompanying the adoption of ASC 606, Omnicell seems to have changed their commission expense recognition policy that appears to defer costs to future periods. OMCL



provides the following excerpt below detailing their new expense recognition policy with respects to prepaid commissions (Q1 2018 10Q):

Contract Costs

The Company has determined that the incentive portions of its sales commission plans require capitalization since these payments are directly related to sales achieved during a time period. These commissions are earned on the basis of the total purchase order value of new product bookings. Since there are not commensurate commissions earned on renewal of the service bookings, the Company concluded that the capitalized asset is related to services provided under both the initial contract and renewal periods.

The commission expenses paid as of the consolidated balance sheet date to be recognized in future periods are recorded in long-term prepaid commissions on the Consolidated Balance Sheets.

As trained CPAs, we take issue with OMCL's expense deferrals in this new policy and believe the previous policy is more in-line with GAAP, even when accounting for ASC 606 and the new five-factor performance obligation model. However, putting that issue aside, the end result will remain the same... heightened capitalized expenses on the balance sheet will unwind violently in future periods, crushing margins.

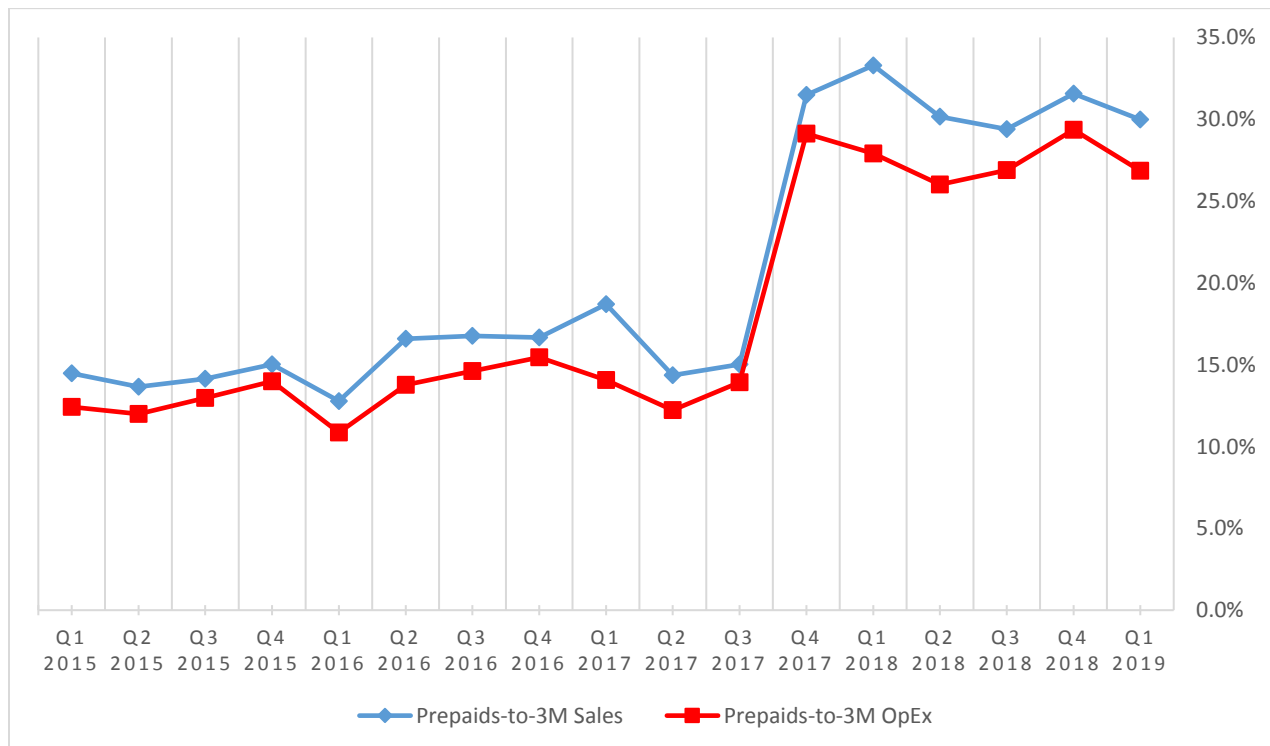
- At the end of 2018, prepaid expenses and commissions (AKA "prepaids") jumped by 85.4% to \$66.8 million as the firm changed their expenses recognition policy (\$20.7 million of prepaid expenses and \$46.1 million in prepaid commissions). Relative to 3M and 12M sales, the increase pushed these ratios up to 31.6% and 8.5%, respectively, as of 12/31/18, both near their five-year high.
- In Q1 2019, these ratios declined slightly, however still remained near their respective maximums at 30.0% and 7.5%. To put this in perspective, we see that the average 3M ratio only stood at 16.2% in the five years before this expense policy was changed.
- We find similar results when the level of prepaids is measured against total operating expenses. For instance, OMCL's prepaids balance stood at 26.8% relative to 3M OpEx in the Q1 period, which is almost double the value that was reported before the policy change. Again, analyzing longer-term patterns, prepaids standing at 6.8% of 12M OpEx also doubled their pre-policy value of only 3.5%.
- To quantify the rise in prepaid expenses and commissions relative to earnings, we calculate that if Omnicell would have kept the prepaid-to-12M sales ratio constant at its five-year average of 5.3%, **the company would have to reduce its EPS by \$0.34 over the**



TTM. This EPS value also equates to 14.1% of TTM non-GAAP EPS. Thus, if Omnicell would have expensed commissions at the normalized rate of the past, over 14% of earnings would have vanished.

- Again, we want to point out that regardless of whether the change in expense recognition policy has merit or not, the end result will be the same. Absent similar growth in revenues, margins will decline as these costs must ultimately be amortized against earnings in future periods.
- Our final note on these capitalized expenses (both prepaid commissions and software costs) is that these expenses remain extremely subjective under management’s discretion to either expense or capitalize these balances. Based on numbers alone, these metrics appear to be highly anomalous and are not normally seen in most public companies to this extent. We find it to be very disingenuous that management did not divulge the benefit of these two items in any conference calls when discussing the recent turnaround in margins, when they obviously played such a large part.

Chart 6: Omnicell Prepaid Expense Trends





Management Gets Rich Off Manipulated Earnings Numbers

Both CEO Randall Lipps and CFO Peter Kuipers received generous compensation packages over the past two years as the firm’s stock price surged in value. Mr. Lipps’ total compensation grew by 25% and 24% (to \$6.3 million) in 2017 and 2018, respectively. The CFO, Peter Kuipers grew his compensation by an astonishing 72% and 57% (to \$2.5 million) in 2017 and 2018, respectively. The salaries of both these C-Suite executives stayed fairly constant while stock grants and non-equity incentive plans drove most of the gains.

Named Executive Officer	Year	Salary (\$)	Bonus	Stock Awards (\$) ⁽¹⁾	Option Awards (\$) ⁽¹⁾	Non-Equity Incentive Plan Compensation (\$) ⁽²⁾	All Other Compensation (\$)	Total (\$)
Randall A. Lipps	2018	690,000	—	2,094,997	2,291,430	1,219,154 ⁽³⁾	40,000 ⁽⁴⁾	6,335,581
<i>Chairman,</i>	2017	669,231	—	2,364,210	1,457,876	558,404	40,000 ⁽⁴⁾	5,089,721
<i>President and Chief Executive Officer</i>	2016	640,000	—	1,725,841	1,070,171	546,923	82,252 ⁽⁵⁾	4,065,187
Peter J. Kuipers	2018	407,500	—	888,464	639,477	529,875 ⁽³⁾	—	2,465,316
<i>Executive Vice President,</i>	2017	381,923	—	605,658	373,706	212,250	—	1,573,537
<i>Chief Financial Officer</i>	2016	372,500	—	238,154	147,662	155,923	—	914,239

Diving into the firm’s proxy reports we find that the “non-equity plan compensation” aspect for both these executives stem from performance targets relating to bookings and, you guessed it, “non-GAAP earnings.” For both Mr. Lipps and Mr. Kuipers, their respective non-equity compensation more than doubled in 2018 to the highest amount ever received by each executive (\$1.22 million for Mr. Lipps and \$530,000 for Mr. Kuipers).



Below we disclose the excerpt regarding performance goals for 2018 listed in OMCL’s 2018 proxy:

2018 Targets and Bonus Determination

Corporate Threshold Targets. The Committee established the Corporate Threshold Targets on a quarterly basis, and such targets were intended to incent the executive officers to achieve results that were consistent with the Company’s board-approved financial plan. The actual amount of each target was set by the Committee based on a combination of the input of management, historical quarterly results, the Company’s desired growth, financial forecasts and analyst expectations. The following table sets forth the quarterly Corporate Threshold Targets applicable to the NEOs for 2018:

Corporate Threshold Targets	YTD Quarter 1	YTD Quarter 2	YTD Quarter 3	YTD Quarter 4
Quarterly Profit Target ⁽¹⁾	\$14,037,000	\$35,356,000	\$63,831,000	—
Annual Profit Threshold Target ⁽¹⁾	—	—	—	\$ 98,862,000
Bookings Threshold	—	—	—	\$625,000,000

(1) The Profit Target and the Annual Profit Threshold Target represented the minimum profit required to meet the cash equivalent of that quarter’s desired earnings per share target based on non-GAAP net income excluding share-based compensation expenses pursuant to Accounting Standards Codification ("ASC") Topic 718 "Stock Compensation" ("ASC Topic 718"), amortization of intangible assets as determined pursuant to ASC 805 "Business Combinations" and other items that the Committee determined were unusual, non-recurring or not reflective of normal operations. The Profit Target for the second, third and fourth quarters of 2018 represented the year-to-date target through the end of the second, third and fourth quarters of 2018, respectively.

Specifically, looking at the quarterly profit targets, it was disclosed that OMCL management was able “to meet or exceed the applicable profit target set by the committee” in every period of 2018. GHR is quick to point out that OMCL did not reach any of the quarterly or annual profit thresholds, even based on non-GAAP earnings figures. Although, we believe the Board excluded certain undisclosed expenses in order for management to reach their profit goals and ensuing a bonus for each period (OMCL reported non-GAAP earnings of \$84.6 million versus the target of \$98.9 million).

Sustainable Earnings Vastly Differs from Manipulated Earnings

On top of missing profit goals in 2018, but still receiving their full bonus, we believe earnings figures would have been in a much worse position (and that the Board would have declined to provide management with a bonus) if accounting gimmicks were not used to enhance earnings in 2018.



We at GHR believe the company's sustainable economic earnings can be better estimated using the accounting adjustments made in the previous sections. Adjustments made for OMCL's anomalous net receivables, inventory, capitalized software, and prepaid commissions need to be made in order to strip out any financial engineering gains. Thus, we believe management possessed high motivation to enhance earnings after depressed results reported by OMCL in prior years.

Below are the adjustments made to come to our sustainable EPS figure:

Table 4: Sustainable EPS Calculation

	TTM Ended:	Q1 2019
Stated non-GAAP EPS		\$2.40
Net Receivables Adjustment		-0.72
Inventory Adjustment		-0.44
Capitalized Software Adjustment		-0.38
Prepaid Commissions Adjustment		-0.34
<u>Sustainable EPS</u>		<u>\$0.51</u>

OMCL Audit Committee Along with CFO Kuipers Have Limited Accounting Experience

When diving into the backgrounds of OMCL's audit committee, comprised of James Judson (64), Joanne Bauer (63), and Gary Petersmeyer (72), we are shocked to find out that no one within this group has received any type of accounting training throughout their college or work history. We would expect the Audit Chairman, James Judson, to possess some accounting training, however we find that he only served in a few CFO roles for very short timeframes. His background stems from a BS in industrial management from Purdue and an MBA from Indiana University. Although the Omnicell Corporate Governance Committee believes differently stating:

The Corporate Governance Committee believes that Mr. Judson's financial and operational expertise in executive level financial positions at a rapidly growing, global, publicly-traded company provides the Board with valuable insights into the financial operations of the Company and financial matters generally. The Corporate Governance Committee believes that Mr. Judson's knowledge of the Company and its accounting practices as Omnicell's former Interim Chief Financial Officer is especially valuable as Chairman of the Audit Committee.



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While we would always hope for the audit committee chairperson to come from public accounting as a CPA due to the complexity and dynamic environment that is GAAP accounting, even an accounting degree would somewhat suffice in this position.

Ms. Bauer's and Mr. Petersmeyer's backgrounds are also not up to par to effectively serve on this important committee at Omnicell. Specifically, Ms. Bauer appears to have come from a Marketing and Management background with no listed accounting experience. Also, Mr. Petersmeyer received his BA in Political Science and a MAT (for teaching) and MBA from Harvard—again, no relevant accounting experience.

We find it peculiar that OMCL failed to choose one CPA with any accounting experience for its Audit Committee and selected a CFO with limited accounting experience. While the Board may believe that these members and Mr. Kuipers are performing well with the recent uptick in earnings, we beg to differ. We find a company that has manipulated earnings by 79% over the last year, on top of a CFO that has incorrectly disclosed or maybe misled how the firm's receivables balance has spiked in recent years. We believe a more seasoned Auditing Committee with relation to accounting experience would have asked OMCL management the tough questions over the past year, such as:

- 1) Why have the total DSO balance crossed above the 100-day mark to 109 days without any end in sight for the continued rises? You disclosed that you expected DSOs to have a target of 65-to-75-days, what has changed?
- 2) If revenue is being deferred into future quarters as you say in the Q3 2018 earnings call, how can receivables & DSOs be spiking upwards from an accounting standpoint? A receivable increasing suggests that revenue has been recognized at that time, which conflicts with your statement.
- 3) You first brought up inventory being built for future sales back in Q2 2016, why haven't DSI levels normalized since that timeframe? With the recent uptick in inventory obsolescence write-downs, what is the materiality of writing off more obsolete inventory in future periods?
- 4) Why have capitalized expenses spiked on the balance sheet concurrent with declines in R&D expenses?
- 5) Why did you change the expense recognition policy regarding commissions? With prepaid commissions rising drastically because of it, how will this impact margins going forward?



Red Flags Are Set to Violently Reverse for Omnicell in 2019

The bull case regarding Omnicell's stock price revolves around the following tenants that we believe the sell-side community has misunderstood:

- 1) Analysts believe that recent gross and operating margin increases are sustainable and will be able to maintain the long-term targets of 50% and 15%, respectively.
- 2) Analysts believe the recent uptick in sales growth is fully attributable to the success of XT pharmacy and that the new product lines XR2 and IVX solutions will provide future increases of bookings/sales.
- 3) Analysts believe that a stated organic growth target of 8% to 12% annually is attainable for the long-term.

Regarding the above items, we have gone step-by-step to debunk many of these flawed reasonings for investors and analysts. Based on our analysis, we believe that much of the recent sales growth was attributable to prematurely recognizing revenue. With respects to expanded margins, we believe this was achieved by consciously deciding not to write-off what we believe to be legacy and impaired inventories on the balance sheet.

Furthermore, we believe that margins were greatly enhanced by the heightened capitalization of normal expenses in recent periods. This is apparent from the recent surges in both the company's "capitalized software" and "prepaids commission" balances. Basically, the only way that Omnicell has been able to keep non-GAAP operating margins near their stated goal of 15% is through Mr. Lipps' and Mr. Kuipers orchestrated accounting games with inventories, receivables, capitalized software, and their prepaid expenses. As such, we believe Omnicell's stock price will decline precipitously over the next twelve months as these accounting gimmicks reverse. Furthermore, we highly doubt that the sell-side community fully comprehends the magnitude of accounting headwinds that OMCL will face over the next year.

For our valuation, we decided to use a hybrid approach using all EV-to-sales, EV-to-EBITDA and FWD P/E metrics to arrive at our fair value. When analyzing the firm's sustainable values, we made adjustments to revenue, EBITDA and earnings figures that have been detailed throughout this report. Furthermore, we applied peer group multiples among all the valuation metrics to arrive at our calculated stock price.⁶ We then used an amalgamation of all these three figures to arrive at our estimated fair value for Omnicell. Basing our valuation on adjusted TTM sales of \$769.0 million, adjusted TTM EBITDA of \$57.7 million, and our sustainable EPS value of \$0.51, we believe a

⁶ Peer group consists of Cerner (CERN), NuVasive (NUVA), Natus Medical (BABY), Allscripts Healthcare (MDRX), AngioDynamics (ANGO), Blackbaud (BLKB), Genomic Health (GHDX), and ICU Medical (ICUI).



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fair share-price for the firm stands currently at \$35.50, which represents a 59% downside to the share-price.

In light of our concerns regarding the myriad of accounting red flags laid out herein, GlassHouse finds the current stock price to be highly egregious. Accordingly, we are initiating coverage on Omnicell, Inc., with a target price of \$35.50.



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