BEHIND THE NUMBERS
Quality of Earnings Analysis
April 9, 2021

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Equinix, Inc. (EQIX)
Earnings Quality Review

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We are initiating earnings quality coverage of EQIX with a 3- (Minor Concern) rating.

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

Summary

We understand the appeal behind EQIX stock. There is strong demand for data centers and numerous portfolios around the world want to own them. So, here's a liquid pure-play on that sector with a $61 billion market cap, and while the dividend is only 1.7%, it's growing the top-line and dividend at 8%. The biggest risk we see is it relies on equity funding to pay for its growth both acquired and built internally. It already has net debt to EBITDA of 3.8x too. We can point to the pipeline companies that have been growing rapidly since 2004, offering good dividends and growth the whole time, but for the last 6-8 years – no one wanted their equity. We can point to new restaurants or retailers with high P/E ratios and growth stats as they open more stores until the law of big numbers hits and growth starts to slow – suddenly no one wants to pay 40x EPS for the stock. We think that could become a risk for EQIX as its growth rate has already slowed from over 20% four years ago to 8% last year and we think organic growth is likely much lower. Also, all the equity funding boosted the share count by 44% in five years diluting results on a per-share basis by 400-600bp annually.

We think the REIT metric of AFFO (Adjusted Funds From Operation) overstates the actual results here on several fronts. It ignores all costs with acquisitions, ignores principal payments on finance leases, ignores stock compensation that could become cash if employees see less upside in the stock, and has a declining maintenance capital spending figure that looks very low to name a few. Using the company's figure – this REIT is already 28x AFFO as it looks to fill shortfalls in capital spending and pay the dividend that is now growing faster than the top line.

What is strong?

- EQIX has refinanced some higher-cost debt lately to the point where interest expense is actually lower on a larger debt balance. Interest expense fell from $522 million in 2018 to $407 million in 2020. Debt is up 8% from $9.9 billion to $10.6 billion over that time and the company pumped up its financing leases by $400 million more.

- EQIX has a deep-pocketed partner for some foreign JVs in Singapore's Sovereign Wealth Fund. EQIX has sold existing assets into the JVs for a 20% interest in these deals that are expected to expand the total footprint with more properties. Recycling some capital has generated cash flow for EQIX, $334 million in 2020 and $359 million in 2019. Given EQIX's continual cash needs, this looks like a reasonable plan on the surface to become a 20% partner in a growth area that is part of its main business.

- As much as we think REIT metrics like AFFO (Adjusted Funds from Operations) can inflate results, EQIX covers its dividend with a 68% payout ratio after we made some adjustments for recurring items. That's tighter than the company's reported 43% payout ratio but there still is cushion.

What is weak?

- EQIX is not self-funding. It routinely runs a free cash flow deficit of $1.3-$2.0 billion after funding all of its growth areas for capital spending and acquisitions. It still has a dividend of $1.0 billion more to pay.

- The company is continually issuing more shares to pay employees, to fund acquisitions, and simply to fund other operations. The dividend yield is only 1.7% so that cost of capital is lower than debt or leases. It has further enticed investors with 8% annual dividend growth – so the total dividend outlay has doubled since 2016. More importantly, EQIX is reporting topline growth of 8%-10% and AFFO growth of 13%-16% - but dilution is cutting 400-600bp off those growth figures. Those growth figures include considerable acquisition-related gains too as well as new building – EQIX does not report organic growth, but we would wager it is lower than the 8%-10% reported top-line figure. We estimate the dividend outlay is growing at 2-3x the organic growth rate of EQIX.

- Heavy use of capital or finance leases inflates the various cash flow figures. The issue is the principal payment shows up as debt payments in the financing section of the cash flow statement. Only the interest portion is going through income into the cash from operations. The principal payment would cut cash from operations by 5%. AFFO would also be 5.3% lower.

- EQIX trades on AFFO at over 28x as the proxy for non-growth REIT free cash flow. We see several areas where AFFO ignores some sizeable expenses. Ignoring principal payments on finance leases is 5.3% of AFFO. Stock compensation is another 14% of AFFO and is being considered a non-cash item. Since AFFO is trying to show what the company's finances look like without growth – we would argue few employees would be clamoring for more stock at a 1.7% yield trading at 28x non-growing AFFO. They would likely want to be paid in cash and without the potential upside of stock appreciation, they may want even higher wages. The recurring maintenance capital spending in AFFO is at 1.1% of net PP&E. We think property renewal is required on a faster basis than 91 years. At 3% or 33-years, it would hurt AFFO by another 13%.

What to watch

- Depreciation lives look very long to us for a company dealing with tech infrastructure. At the moment, investing in data centers is a hot market so we understand the M&A market gives these assets premium values. But we think the special power and cooling needs of some of this real estate and the fact technology changes often all combine to give these assets shorter effective lives. There are warehouse buildings being amortized over shorter lives as fulfillment methods change with e-commerce. Amortizing core systems over as long as 40 years sounds very long to us and even buildings over 12-58 years seems equally long for this industry. Capitalized software is being amortized over 3-10 years. Most companies we see use 2-5 years. Both EBITDA and AFFO used by EQIX add back depreciation expense so the actual life assumptions do not impact the REIT metrics. But we would watch for potential impairments in this area.

- Acquisitions have been numerous. With some data centers, the PP&E allocation has been basically 25%-60% in recent years, Intangibles 10%-30% with largely a 15-year amortization, and another 30%-40% going to goodwill and not being expensed at all. Again, the EBITDA and AFFO metrics add back the acquired depreciation and amortization as though these deals had no cost. We do not have a problem with a 15-

year amortization of intangibles as that is well within the range of depreciation on PP&E built in-house. However, like depreciation above, we would watch for impairments in this area if technology changes. There have already been some minor impairments on assets sold to the new JVs.

- On basic metrics, EQIX spent $7.8 billion on acquisitions in the last five years, plus $8.75 billion on growth capital spending. The company is not self-funding as it runs a cash flow deficit of $1.3-$4.0 billion per year. So EQIX depends on being able to issue debt and additional stock to cover the shortfalls and also fund its dividend that is now over $1 billion per year as well.
    - With all this spending, growth including the greenfield builds and acquisitions is slowing from 14% to 10% to 8% in the last three years. Organic growth may be much lower than that.
    - Operating income to capital is an ROI of 5%. AFFO to capital is an ROI of 10% and we showed why we think AFFO is inflated above.
    - As a REIT that is growing its dividend at 8%, it still only yields 1.7% today.
    - Unless EQIX can issue stock at high multiples of 28x AFFO, this growth story could unravel in that EQIX cannot afford to make acquisitions and build new facilities at the same pace, which could drop the growth rate and slow dividend growth.
    - We're not calling this a catalyst at the moment– but a sizeable risk factor to watch.

Supporting Detail

Heavy Use of Finance Leases Inflates Reported Metrics and Cash Flow

Finance or Capital leases are accounted for more like debt than leases. In the case of an operating lease – rent expense covers both the actual rent and the implied interest expense and it reduces operating income in full as well as cash from operations. In the case of capital leases, the payment assumes interest expense and depreciation go through operating income. However, the principal payment is not reflected in income. It is also not reflected in cash flow from operations, where in fact the depreciation is added back to cash flow. The principal payment occurs in the financing section of the cash flow statement as a debt payment. With EQIX touting both Adjusted EBITDA and AFFO – the use of capital leases is increasing them along with cash from operations:

	2020	2019	2018	2017	2016
Cap Lease Payments	$115	$127	$104	$94	$114
Cash from Ops	$2,310	$1,993	$1,815	$1,439	$1,019
Leases % Cash Flow	5.0%	6.3%	5.7%	6.5%	11.2%
Adj. EBITDA	$2,853	$2,688	$2,413	$2,052	$1,658
Leases % EBITDA	4.0%	4.7%	4.3%	4.6%	6.9%
AFFO	$2,189	$1,931	$1,659	$1,437	$1,078
Leases % AFFO	5.3%	6.6%	6.3%	6.5%	10.6%

On the surface this is becoming a smaller inflation factor for the various metrics. However, it is still 15% of EQIX's total debt and these payments are not discretionary. Moreover, it is not as though EQIX is self-funding:

	2020	2019	2018	2017	2016
Cash from Ops	$2,310	$1,993	$1,815	$1,439	$1,019
Capital Spending	$2,283	$2,080	$2,096	$1,379	$1,113
Real Estate bought	$200	$169	$182	$95	$28
Acquisitions	$1,180	$34	$830	$3,963	$1,767
Free cash Flow	-$1,353	-$290	-$1,293	-$3,998	-$1,889

This doesn't even include the dividend or scheduled debt maturities like the capital leases.

Shares Are Being Issued Continuously

We always take the approach that paying people in stock has a cost – either through dilution or a cash outflow to repurchase shares (normally at a higher price). In the case of EQIX, they give stock to everyone. They are paying employees with it, issuing shares for deals, settling debt with it, and renewing ATM (At The Market sales of stock) in most years. Dilution has been considerable in recent years. Starting with 62.1 million shares at the start of 2015, EQIX now has 89.4 million, an increase of 44% in five years! This has three basic issues:

- The company has to grow income/AFFO much faster to offset this dilution
- The cash needs are growing as all these shares require a cash dividend

- This is a REIT adding new capacity to report growth to keep the stock high enough to be a currency – which requires more spending and more shares being issued.

	2020	2019	2018	2017	2016
Dilution from Stk Comp	0.9%	0.9%	1.2%	1.1%	1.4%
Dilution from ATM	0.5%	1.1%	0.9%	1.1%	0.0%
Dilution from Issues	3.0%	3.7%	0.0%	8.5%	14.2%
Total Dilution	4.4%	5.7%	2.1%	10.7%	15.6%
AFFO	$2,189	$1,931	$1,659	$1,437	$1,078
AFFO Growth	13.4%	16.4%	15.5%	33.3%	29.6%
AFFO per Share	$24.76	$22.80	$20.69	$18.53	$15.23
AFFO per Share Growth	8.6%	10.2%	11.6%	21.7%	7.1%
Dividends Paid	948	836	739	622	500
Dividend Growth	13.4%	13.2%	18.8%	24.4%	-4.2%
Dividends per Share	$10.64	$9.84	$9.12	$8.00	$7.00
Div. per share growth	8.1%	7.9%	14.0%	14.3%	-60.5%
Stock Compensation	$311	$237	$181	$176	$156

We do not think EQIX should add back stock compensation as a non-cash expense. The growth in total dividend outlay has been spectacular. In 2015, EQIX paid special dividends too and spent $521 million to pay shareholders $17.71 per share. The current dividend will cost $1.015 billion and amount to $11.48 per share.

14% of AFFO is adding back stock compensation and 11% of adjusted EBITDA is adding back stock compensation. EQIX reports constant currency growth with acquisitions of 7%-8%. Without acquisitions, organic growth may be 4%-6%. The total dividend outlay is growing 2-3x that rate. When the stock is strong, everyone wants it. If it falls, people may want cash wages and cash for deals instead. It’s easy to make a case that hiccups in EQIX’s growth mechanism could derail the heavy issuance of stock plan.

Several Reasons We Consider AFFO Overstated

AFFO is a REIT metric that is supposed to approximate free cash flow for the current company without growth. It excludes growth capital spending but estimates a recurring maintenance capital spending figure. Unlike EBITDA, it does take into account interest expense and taxes. We see several other items that should likely be adjusted for that would lower AFFO:

- Principal payments on finance leases noted above are over 5% of AFFO and had they been viewed as operating leases would have seen the full payment lower net income.

- Stock compensation is 14% of AFFO. EQIX adds it back as a non-cash item. However, we note that EQIX is paying ever-higher dividend outlays due to the higher share count and diluting all shareholders, which impacts even employees. We believe that stock compensation represents pay to employees who would likely demand even larger amounts in actual cash wages if they were not giddy to participate in stock appreciation.

- The recurring capital spending is actually going down! This is a company that has seen its PP&E jump over 50% since 2017 and it is tech-oriented. Yet, recurring capital spending is down:

	2020	2019	2018	2017	2016
recurring Cap Ex	$161	$186	$203	$168	$142
Net PP&E	$14,503	$12,153	$11,026	$9,394	$7,199
% of PP&E	1.1%	1.5%	1.8%	1.8%	2.0%

We'd argue that 2% may be too low indicating a 50-year life for assets, but it's now 1% only a few years later. 3% would be a 33-year life and we will adjust for that below.

- It's one thing for a company to make an occasional acquisition and argue that it's a one-time event. It's another when making deals is a key part of the business model. EQIX spent nearly $8 billion on purchases in the last five years. Yet, AFFO ignores the depreciation and amortization of these deals. It further adds back all the transaction costs and integration expenses. It ignores impairments too. Literally, these deals add to revenue and income but cost nothing more than interest expense for the financing. And to the extent EQIX paid with stock, which it has, the cost of that capital even as the dividend is ignored. At a minimum, we think transaction costs, integration, and impairments are recurring and should not be added back to AFFO.

- On interest expense, EQIX capitalizes part of it and doesn't even record all of the cash interest being paid. We adjusted for that:

	2020	2019	2018	2017	2016
AFFO per EQIX	$2,189	$1,931	$1,659	$1,437	$1,078
Less Cap Lease payment	$115	$127	$104	$94	$114
Less Stock Comp	$311	$237	$181	$176	$156
extra CapX to 3% of PPE	$275	$179	$128	$114	$74
Less Acq. Costs	$56	$25	$34	$39	$64

Less impairments	$7	$16	$0	$0	$8
Less Cap. Interest	$27	$32	$20	$23	$13
BTN AFFO	$1,399	$1,316	$1,192	$992	$649

	2020	**2019**	**2018**	**2017**	**2016**
AFFO per EQIX	$2,189	$1,931	$1,659	$1,437	$1,078
BTN AFFO	$1,399	$1,316	$1,192	$992	$649
% lower	-36%	-32%	-28%	-31%	-40%
Dividend	$948	$836	$739	$622	$500
Dividend payout	68%	64%	62%	63%	77%

EQIX can still fund the dividend under some more realistic views of what actual free cash flows are, but it is much tighter than the 43% payout under its definition of AFFO.

We also want to highlight two other items that impact cash from operations and AFFO – capitalized costs and installation revenue. The costs consist of commissions owed, marketing, and incentives given to sign a contract. EQIX capitalizes these costs and amortizes them over 5-years. Installation revenue is considered non-recurring and consists of payments received up-front for a contract and are listed as deferred revenue and recognized as revenue over the life of the contract.

In cash flow, these payments can be lumpy – adding cash upfront for installation and also paying commissions on new contracts. They would be recognized in this lumpy manner and the smoothing impact of amortization that impacts income would be adjusted out for cash flow. For AFFO, EQIX says that adjustments it makes in this area are designed to isolate the cash impacts of these items vs. what is reported on the income statement. We will give them some kudos for trying to recognize these issues even though it remains a lumpy part of AFFO. It also consists of fairly small adjustments. We know finance lease payments are 5.3% of AFFO at $115 million. The net impact of the capitalized costs and deferred revenue for installations were -$35 million in 2020 and -$30 million in 2019.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor “red flag”, but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company’s recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company’s recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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