BEHIND THE NUMBERS
Quality of Earnings Analysis
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Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Iron Mountain Incorporated (IRM)
Earnings Quality Update- 9/21 Qtr.

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

We are maintaining our earnings quality rating of IRM at 1- (Strong Concern) and our Top Sell rating.

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

Summary

IRM posted adjusted FFO of $0.72, which beat forecasts by 9-cents. We would note again that under the recently changed definition of FFO used by IRM – it picked up 4.3-cents from adding back stock option expense. By not factoring in the principal payments on financing leases, IRM added another 4.0-cents, and it rounded up results by 0.4 cents.

We also find it odd that restructuring charges became larger in 3Q21 vs. 2Q21 – up $11 million. Plus, for a program that was expected to focus number one on severance, severance has been declining while third-party fees and "other" are increasing. 1-cent of FFO can be the result of only adding back $3 million of restructuring charges.

We also believe IRM's recent strategy of growth through acquisition is helping FFO too. In 3Q21 and 2Q21, IRM spent a net $204 million on deals and much of that was allocated to goodwill which is not expensed ($27 million) and PP&E ($147 million), where much of the depreciation is added back to adjusted FFO.

- **IRM is touting its record volume growth. However, it was all purchased via acquisitions.**

000's Cubic Feet	3Q21	2Q21	1Q21	4Q20	3Q20
Records	720.1	710.8	708.6	709.0	711.1
Acquired	10.7	5.0	0.0	0.0	0.3

Volume is still eroding. Volume is up 9,000 cubic feet since 3Q20, but IRM bought 16,000 cubic feet. We know that during Covid customers worried very little about their records in storage, which let volumes hold up better than before Covid. Yet, **going back to 4Q19, IRM bought 38,500 cubic feet and today cubic feet is up only 25,500 feet.** One of the acquisitions included in the last two quarters was a small art storage deal.

- **Acquisitions help FFO.** The acquisitions in 2021 also included a data center. Total acquisitions cost $204 million. Any allocation to goodwill is not amortized that was $27 million. **Because IRM is buying real estate, building improvements, and equipment, it actually allocates the bulk of acquired assets to tangible areas that are depreciated.** In 2021 YTD, $147 million of the $204 million went to items like buildings and installed equipment and fixtures.

  The issue is FFO adds back real estate-related depreciation as a proxy for REIT EPS. This would be a large part of the incremental cost incurred with an acquisition for IRM. FFO is ignoring it and FFO is boosted.

  If IRM had gained new records volume organically, it likely would have put the records into existing property. The incremental depreciation would be very small. However, it would have incurred inducement costs to sign a new customer and deal with fulfillment costs to pick up, sort, and store the files. Those would have been capitalized, expensed over time, and not added back to FFO. In the case of acquisitions, there is some value assigned to intangible assets too – but it was only $50 million of the $203 million. Also, 80% of the intangible assets went to customer relationships that are amortized over periods 2-3x as long as fulfillment and inducements. Thus in summary:

  - Organic growth includes little incremental depreciation to add back to FFO and FFO is penalized by intangibles being amortized more quickly.

- Acquired growth boosts depreciation, which FFO adds back like it never occurred. It also suffers less on intangible amortization as the expense period is longer. That also helps FFO.

- **AFFO as a proxy for free cash flow is also inflated by acquisitions. We have pointed out several times that AFFO is overstated in our view because it ignores many ongoing cash costs.** When IRM grows organically, it incurs these cash costs that appear in the investing section of the cash flow statement. On the income statement, it amortizes these costs over time and AFFO adds it back claiming that amortization is non-cash. **During Covid, these cash costs dropped as less business was being done. We expected them to bounce back stronger, but IRM is avoiding them by making acquisitions instead:**

Cash Items	3Q	2Q	1Q
2021	$17.2	$17.4	$19.1
2020	$13.9	$11.4	$17.2
2019	$22.9	$22.7	$67.9

These cash items include acquired customer relationships and inducement payments to win business and sometimes pay off the customer's existing contract with a competitor along with fulfillment costs.

With acquisitions, IRM not only ignores these cash costs but also the cash costs of the deals themselves. Our view is IRM should not be ignoring any of these costs. The base business is in decay and whether it is replenished with new organically collected record volumes or acquired volumes – IRM is spending cash.

- **AFFO adjusted for the cash costs still does not cover the dividend.** AFFO as defined by IRM adds back the amortization of all the recurring cash costs, all the depreciation, restructuring costs, and deducts a maintenance capital spending figure. By this accounting, the dividend is only 72% of AFFO so far in 2021. We do not think it can cover the dividend at all. We started with IRM's AFFO with all amortization added back less maintenance capital spending, then we subtracted cash expenses for acquiring new business, principal payments on financing leases, and recurring stock compensation:

	YTD 2021	YTD 2020
IRM's AFFO	**$744.9**	**$696.8**
Cust. Relations	$4.8	$3.5
Inducements	$5.1	$8.3
Fulfillment	$43.7	$30.7
Lease Principal	$35.4	$36.0
Below Mrk Leases	$6.6	$7.6
Noncash Rent	$13.1	$8.3
Stock Comp	$45.9	$32.1
Acquisitions	$203.8	$118.6
BTN's AFFO	**$386.5**	**$451.7**
Dividends	$538.9	$537.9
Div % IRM AFFO	72%	77%
Div % BTN AFFO	139%	119%

These are all recurring expenses and even if one wants to exclude stock compensation, IRM still doesn't cover the dividend.

- **IRM's dividend is getting a cash infusion from the company doing sale-leasebacks on property.** This added $215 million in 2021 and $117 million in 2020 during the first 9 months of each year. In 2021, it also divested an investment for another $214 million. **The sale-leaseback deals come with rising future lease expense too that is growing faster than IRM's storage business that is paying for it:**

	3Q21	3Q20	2Q21	2Q20	1Q21	1Q20	2020	2019
Op Lease Cost	$140.6	$122.7	$135.1	$119.2	$132.7	$123.3	$499.5	$439.6
Lease increase	14.6%		13.3%		7.6%		13.6%	
Storage Rev Growth	2.3%		2.5%		1.7%		1.7%	

The growth in storage revenue is coming from price hikes as we know organic volume growth is still negative.

- **Project Summit spending quality continues to be troublesome.** Normally a restructuring program sees heavier charges early in the process and tends to decline noticeably as the process winds down. With IRM, the 8th quarter of the process, 3Q21, saw spending accelerate. And based on forecasts of $450 million in total spending, it may rise even more in 4Q21 and the program is still expected to largely wrap up by the end of 2021.

Restructuring	4Q	3Q	2Q	1Q
2021	$77.3e	$50.4	$39.4	$39.8
2020	$65.7	$48.4	$39.3	$41.0
2019	$48.6			

Severance continues to be listed as the first item for the restructuring. Yet, it is still only 22% of the total restructuring so far. With Covid especially, it seems like all the severance would have happened already when IRM was experiencing lower fulfillment operations. While severance has been getting smaller over time, it's still occurring after 8-quarters. **We would question if some ongoing wage costs are part of this and are being added back in the restructuring.** AFFO and FFO both add this restructuring back and 1-cent would only be $2.9 million:

Severance	4Q	3Q	2Q	1Q
2021		$6.8	$3.9	$3.8
2020	$16.2	$13.6	$11.5	$6.1
2019	$20.9			

The remaining costs that are still growing consist heavily of third-party professional fees and implementation costs to transition the new footprint. All of that sounds like items that should have hit more heavily early in the plan, not later in the process. We would be concerned that regular ongoing costs are being added to the restructuring at this point – items like management travel and pay to look at new locations or consolidate existing locations but those wages will recur after the restructuring.

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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