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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Iron Mountain (IRM) EQ Update- 9/20 Qtr.

Current EQ Rating*	Previous EQ Rating
2+	2+

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

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

We are maintaining our earnings quality rating of 2+ (Weak)

IRM beat its normalized FFO estimate by 8-cents in 3Q20. It picked up 3.3 cents by not accounting for finance lease principal payments in FFO. It also enjoyed a $3 million decline in bad debt expense for 0.8 cents more. Paper shredding volumes fell by 17% and $3 million; however, IRM was helped by a 20% increase in recycled paper prices. We estimate this added about 1 cent more. IRM noted on the call that paper prices are already back to lows. It also added back a nearly $30 million FX loss in 3Q vs. $1.5 million in 2Q – this was about 8-cents in FFO. Plus, we are also skeptical that one-year AFTER announcing a huge restructuring that IRM saw a surge in restructuring charges that were fully added back to FFO. These included accrued consulting and management fees rising from $16.0 million to $33.4 million and severance accruals from $6.6 million to $11.8 million. Before 3Q20, accruals were not seeing this level of increase. Every $3.5 million in essentially wages of people still working at IRM being accrued and added back is worth 1-cent in FFO. We still think the AFFO shows even less quality.

What Worsened?

- Negative volume growth continues and IRM continues to cut spending that focuses on adding new customer volumes.

- Maintenance spending also continues to decline which inflates AFFO.

- When we adjust AFFO for ongoing cash costs and areas of underinvestment, we believe IRM does not cover its dividend.

- IRM is transferring debt to other areas such as doing sale-leasebacks and raising future lease expense and increasing debt at JVs.

What Improved?

- IRM was able to refinance debt and extend maturities. It has room on its revolver to meet near-term cash needs.

- Debt refinancing also eliminated bonds with a debt ratio of 6.5x and now the tightest is 7.0x. The company's ratio on adjusted EBITDA is 6.2x. We believe that adjusted EBITDA is overstated, and the real ratio is above 6.7x.

What to Watch?

- The bulk of the restructuring spending is going to severance and professional fees that includes management activities. We believe there may be ongoing costs in that.

- The huge surge in accruals for professional and manager fees in 3Q20 for this restructuring – a year into the program – is also odd in our view.

- IRM's main business has been reporting negative growth for some time. It offsets that with acquisitions which consumes cash flow. That cash has to come from more borrowing.

Iron Mountain Changed Its Presentation of Key Costs in 3Q

The most significant change is it now lumps capitalized intake costs and capitalized commissions together. Both of these items are the result of winning new storage business and paying the employee for the sale and paying the costs to gather, transport, and place the items in storage. Both are amortized over 3-years. Both are cash costs. There are also inducement costs paid to poach customers from competitors. These are cash costs too and represent withdrawal payments made to settle the new customer's old account somewhere else.

Until 3Q20, IRM not only reported these items separately, it showed the amortization expense for each. That has now changed and can be ferreted out by looking at footnotes in various presentations but not in one spot in the 10-Q as before. Our view remains the same – IRM continually pays these costs in cash to generate business. That is an on-going expense for the company and it is being ignored. First, they ignore an upfront cash cost. Then they add back the amortization in the REIT stats as being non-cash. (It does not add back the amortization of commissions to AFFO.)

They report these ongoing cash costs in the investing section of cash flow. So, they also do not negatively impact cash from operations, nor are people looking at them as a negative for free cash flow. Look at the actual cash going out the door and keep in mind – IRM is producing negative organic volume growth already.

IRM stopped showing the amount of negative decay in its presentations a year ago. Essentially the quarterly change for developed markets for records management was 5.0% of records were shredded and 1.6%-1-7% were removed by customers. Offsetting that was current customers sending them 3.7%-3.8% growth in new records and they were winning new customers for 1.7%-2.2% in new growth. Now they talk on the conference call about how much change they have in cubic feet of records – down 1.1 million cubic feet in 3Q20 and 3.9 million cubic feet in 2Q20. For other international, the existing clients providing more documents vs. what was lost or shredded was already a negative growth figure last year. **What happens to its growth model if it stops paying these costs to bring in new business?**

Cash Costs	3Q20	2Q20	1Q20	4Q19	3Q19
Inducement	$1.3	$2.6	$4.3	$1.9	$1.6
Fulfillment	$12.0	$7.6	$11.1	$13.1	$11.7
Acq. Customers	$0.6	$1.2	$1.7	$3.1	$9.6
Total Cash Spent	$13.9	$11.4	$17.2	$18.1	$23.0

IRM is not reporting these cash outflows in its AFFO figures. Further, it is adding back the amortization of these costs in producing its AFFO figure. This is a big reason why we think the AFFO figure is inflated.

Three More Key Items Also Inflate AFFO – Finance Leases, Recurring Cap-Ex, Professional Fees

The use of finance leases continues to bump up the company's stats. Only the interest expense is impacting income, which is the base figure to start computing FFO, AFFO, and EBITDA. The principal payment for the finance leases shows up in the financing section of the cash flow statement and does not even impact free cash flow.

	3Q20	2Q20	1Q20
Finance Lease Payments	$12.1	$11.2	$12.7
% of FFO	6.8%	7.4%	7.5%
% AFFO	5.7%	4.5%	5.5%

Maintenance capital spending also continues to drop. This is despite the company's recurring statements that its business requires investment to avoid negative impacts to the business:

	3Q20	2Q20	1Q20	2019	2018
Recurring CapEx	$20.3	$15.2	$13.0	$92.9	$105.4
y/y drop	-$3.1	-$12.4	-$2.8	-$12.5	-$2.3
Under from $105mm	-$6.0	-$11.1	-$13.3	-$12.1	$0.0

We are also going to call out the company's restructuring – Project Summit. The goal is to spend $450 million to save $375 million in annual expenses. The bulk of this spending is to pay severance to employees and professional fees for advice on the deal. When we look at the restructuring allocation – 33% has gone to the paper records management business

and 66% has focused on the corporate office. IRM has been in this business since 1951. Are there a ton of outside consultants who know more about this business? Yet here are comments:

- 4Q19, we incurred approximately $48,600 of Restructuring Charges **primarily related to employee severance costs and professional fees.**

- 1Q20, we incurred $41,046 of Restructuring Charges, **primarily related to employee severance costs and professional fees.**

- 2Q20, we incurred $39,298 of Restructuring Charges, **primarily related to employee severance costs,** internal costs associated with the **development and implementation of Project Summit initiatives and professional fees.**

- 3Q20, we incurred $48,317 of Restructuring Charges **primarily related to employee severance costs**, internal costs associated with the **development and implementation of Project Summit initiatives and professional fees**.

In every quarter, the company is reporting that this spending is going primarily to severance and professional fees. Look at how it defines "professional fees"

> "**professional fees, primarily related to third-party consultants** who are assisting with the design and execution of various initiatives **as well as project management activities.**"

The use of the term "project management activities" makes us believe these huge restructuring charges also include ongoing management pay being allocated to the restructuring, which is being added back. Also, look at the level of accruals for professional fees vs. severance:

	3Q20	2Q20	1Q20	2019
Pro. Fees Accrued	$33.4	$16.0	n/a	$13.0
Severance Accrued	$11.8	$6.6	n/a	$4.8

The accruals for professional fees are 3x the level of severance accruals and they doubled last quarter! Our view is these will be cash costs and a decent percentage of the restructuring may include ongoing costs.

AFFO vs. Actual Cash Flow Shows the Dividend Coverage is Poor

The company's Reported FFO and AFFO show ample cash for the dividend:

	3Q20	2Q20	1Q20	2019
Normalized FFO	$176.2	$152.2	$169.8	$658.8
Non R/E Depreciation	$32.6	$33.8	$33.9	$139.5
Amortization	$33.3	$34.5	$31.9	$136.1
Amort. Def. Fin. Costs	$4.1	$4.5	$4.5	$16.7
Withdrawal fees	$2.4	$2.6	$2.7	$13.7
NonCash Rent	$2.8	$3.0	$2.5	$4.8
Stock Comp.	$8.1	$18.9	$5.1	$35.7
reconciled taxes to cash	-$5.4	$27.0	$2.2	$5.5
Less non R/E investing	-$20.7	-$11.8	-$8.4	-$62.0
less Maint. Cap Ex	-$20.3	-$15.2	-$13.0	-$92.5
AFFO	$213.1	$249.5	$231.2	$856.3
Dividend	$178.4	$178.2	$181.3	$704.5

If we make some modest adjustments to reflect actual cash costs that are being incurred continually that are left out of these stats, IRM's results look much weaker:

	3Q20	2Q20	1Q20	2019
AFFO	$213.1	$249.5	$231.2	$856.3
Less Finance Lease payment	-$12.1	-$11.2	-$12.7	-$32.7
Less Cash to add Customers	-$13.9	-$11.4	-$17.2	-$131.7
Less underspending on maint. Cap Ex.	-$6.0	-$11.1	-$13.3	-$12.1
Less half Restructuring	-$24.2	-$19.7	-$20.5	-$24.3
Less Stock Comp.	-$8.1	-$18.9	-$5.1	-$35.7
Adjusted AFFO	$148.9	$177.3	$162.4	$619.9
Dividend	$178.4	$178.2	$181.3	$704.5

Suddenly, IRM isn't covering its dividend and it loses about 30% of its reported AFFO simply viewing ongoing cash costs as items that IRM will need to cover going forward. Let's also not forget that IRM has a negative growth story going on for its records management business and that's why they are restructuring there and laying people off.

However, it also devotes much of its efforts to making acquisitions in records management to add to the business as well. How should we look at that spending? It's consuming cash

and has been a sizeable item for years that negatively impacts cash flow by another $100-$200 million per year:

	9mths 20	2019	2018	2017	2016	2015
Acquisitions	$118.6	$58.2	$1,758.6	$219.7	$292.0	$113.6

Debt Remains High and IRM Is Borrowing More in Non-traditional Methods

IRM owes $9.1 billion in debt. That already includes $270 million from pledging receivables. We think debt is rising further with recent actions:

- IRM is moving debt off the balance sheet by investing in Equity JVs that carry high debt levels too. It announced a JV in Germany where it invested $100 million in a €300 million deal. IRM expects to add a "couple hundred million euros" in debt to the deal and will cash out its $100 million and retain a 20% equity interest.

- IRM is also selling facilities as sale-leaseback deals. This brings in some cash up-front, but also adds to future lease expense. At the end of 2019, IRM was using a 7.1% interest rate on leases. So this may not be the cheapest form of new financing.

IRM touts its adjusted EBITDA to evaluate how much debt it has. Adjusted EBITDA for the last 12-months is $1.46 billion – so debt to EBITDA is 6.2x.

We believe their adjusted EBITDA has several flaws as it omits ongoing costs too. It leaves out the fulfillment costs to acquire new customers of $61 million in the last twelve months and $48 million in financing lease payments. We still believe that the $177 million of restructuring charges are cash and include some ongoing expenses.

We believe the real EBITDA is closer to $1.27-1.35 billion depending on 0%-50% of the restructuring is included. That makes that debt/EBITDA figure 6.7-7.2x in our view. It is worth noting that the company cheered on the conference call that was able to refinance debt and extend maturities and it eliminated the last of its bonds with a 6.5x covenant for leverage and now their tightest one is 7.0x.

Explanation of EQ Rating Scale

Rating	Description
6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

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

Key Points to Understand About the EQ Score

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

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

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