BEHIND THE NUMBERS
Quality of Earnings Analysis

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Iron Mountain (IRM) Earnings Quality Update
12/20 Qtr.

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

We are reducing our earnings quality rating of IRM to 1- (Strong Concern).

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

Summary

IRM's 4Q20 adjusted FFO of $0.60 beat forecasts by 7-cents. The first thing people should be aware of is IRM changed the definition of FFO (and EBITDA and AFFO) for the quarter. It now excludes the losses from its equity-method JVs when it adds back "other expenses." It also adds back stock compensation now but removes growth cap-ex for non-real estate from AFFO. IRM picked up 1-cent by adding back stock compensation. It also reported a tax benefit of -$3.7 million. That was fueled by reversing $15.8 million in allowances and accruals in its tax accounts. That amounts to 5-8 cents in FFO (Over 5-cents just looking at the $15.8 million and just under 8-cents if viewing the y/y $22.4 million swing when the allowance was rising the year before). Another catch-all of "other, net" for taxes added $4.5 million more or 2-cents in FFO. This is normally +/- a fraction of 1-cent. There is still 3-cents coming from not recognizing principal payments on financing leases. Plus, FFO adds back FX losses which were $36.1 million in 4Q. That is 10-cents in FFO (assuming it was taxed at 21% since foreign operations do not get REIT treatment). We still remain skeptical of the restructuring too. IRM continues to say that severance will be the number one expense of $450 million, yet it is only $68 million of the $243 million incurred so far. Also, shouldn't cutting people – especially during Covid – be the quickest thing to do for cost-cutting? We still wonder if the professional and management fees lumped in the restructuring charges include several ongoing costs that are being added back. Dealing with $450 million in expenses, it wouldn't take much to pick up 1-2 cents in any given quarter.

What is weak?

- **Reversing valuation allowances on taxes from 2019 to 2020 as well accruals for tax liabilities declining greater than expected along with a miscellaneous catch-all helping – allowed IRM to record a benefit for income taxes in 4Q.** (See Discussion Below). Looking at this on its own, it helped 4Q20 FFO by 7 cents. Looked at as the swing from 2019, it helped FFO by 8 cents.

- **FX added 10-cents to 4Q20 FFO.** As part of FFO, IRM adds back Other expense/(income). This account consists of FX transaction gains/losses, Valuation changes in mandatory redeemable non-controlling interests, JV income/losses, and charges related to early debt extinguishment. As part of its adjusted FFO, IRM adds back this catch-all of items. The FX transactions are broken out:

FX transactions	4Q	3Q	2Q	1Q
2020 (G)/L	$36.1	$29.6	$1.5	-$37.4
2019 (G)/L	$44.7	-$18.3	-$19.3	$17.7

  IRM is involved with foreign subsidiaries and it has borrowed money in foreign currencies so it has hedges in place and settles transactions that convert back into dollars. In other words, this is an ongoing expense. It can be lumpy. In 2Q20, they only added back $1.5 million. In 4Q20, it was $36.1. We are simply going to assume this is a non-REIT activity and net it of 21% taxes. That makes this a 10-cent benefit to reported FFO for 4Q.

- **More changes in definitions of REIT Metrics at IRM.** In previous periods, IRM has changed parts of presentations where it discloses less about the negative organic growth in records storage or the costs of servicing new clients in that business. In 4Q20, they changed the definitions of its REIT metrics of FFO, AFFO, and EBITDA. They now leave in JV losses and omit stock compensation and omit non-real estate growth capital spending. We already regarded IRM's original definitions as aggressive because several on-going cash costs were ignored such as costs to acquire a customer, pick-up/delivery costs of his records, etc. IRM books those cash costs into the financing section of the cash flow statement and capitalizes them. They aren't impacting income metrics because they add back the amortization.

- The true debt levels and dividend coverage look much weaker when accounting for all the actual cash costs. Using AFFO, which ignores many cash items like financing lease payments and service costs for records clients, investments in JVs, growth Cap-Ex, the dividend is about 80% of AFFO. On actual free cash flow, IRM isn't close to covering the dividend with internal funds. They can't do sale lease-backs forever to plug the hole. Debt to adjusted EBITDA is 5.75x. We think it is closer to 6.5x adjusting for the recurring operating cash costs. Also, those cash costs may rise after Covid and lease costs will rise with sale lease-backs.

What to Watch?

- The Restructuring called Project Summit has some odd features. The largest part of the cost and savings is always listed as cutting employees – yet the cost incurred so far has severance as only 28% of the total. It was announced before Covid. Shouldn't that have sped up lay-offs? Yet, IRM didn't seem to take advantage of that. It is also odd that the size of the restructuring charges is rising, normally the biggest charges hit early in a restructuring. We wonder of some employees targeted to be cut are still working there and perhaps having some of their wages classified into the restructuring. Also, could on-going management time/trips related to the restructuring be going into the charges too?

IRM's Tax Assumptions Drove the 4Q Results

Because IRM has a REIT structure, many would expect taxes to be a minimal issue here. However, 38% of revenue and 39% of long-lived assets are overseas. Those countries do not necessarily recognize real estate as a tax-free proposition. It also has equity-method investments overseas. IRM still has operating entities that manage the real estate assets. These are labelled at TRS (Taxable REIT Subsidiaries) and they pay corporate taxes. Some states tax REITs and TRS different than the Federal IRS. Thus ordinarily, IRM's tax table shows up as Income at 21% tax rate, a non-TRS adjustment, and a state and foreign adjustment. An examination of these parts shows what would be expected – a fairly stable tax rate:

IRM normal Taxes	2020	2019	2018
Pretax Income at 21%	$78.3	$68.9	$86.2
REIT tax Adjustment	-$60.4	-$40.6	-$35.2
State taxes	$2.3	$2.1	$1.6
Foreign Difference	$9.5	$8.6	$1.0
Disallowed Foreign issues	$20.2	$14.2	$0.9
Taxes owed	$49.9	$53.2	$54.5
Effective Tax Rate	13.4%	16.2%	13.3%

The next thing is IRM has disputes in its taxes where it has accrued liabilities. When there are settlements, the time for the IRS to dispute lapses, or the size of the accrued liability declines, this accrual can get larger or smaller. Then there are NOLs that can be used at times to lower taxes and combined with the accrued liabilities, IRM has a valuation allowance against these items that can change based on the likelihood these tax items will be realized or not. There is also a catch-all of "Other" which IRM does not explain. When we look at what changed from the table above to the company's actual taxes owed – the changes in three accounts are the difference:

IRM normal Taxes	2020	2019	2018
Taxes Owed from above	$49.9	$53.2	$54.5
Taxes on Income Stmt.	$29.6	$59.9	$42.8
Difference	$20.3	-$6.7	$11.7
Chg in Accrual/Settlement	-$7.4	$0.5	-$14.0
Chg in Valuation Allowance	-$8.3	$6.2	$3.6
Other Tax Issues	-$4.5	$0.0	-$1.4
Total	-$20.2	$6.7	-$11.8

Coming into 2020, IRM guided that it could reach a net benefit from settlements and reversing accruals of $4.6 million. It saw a net $7.4 million figure. In 2018 and 2019 it was boosting the valuation allowance meaning it viewed its ability to recover its tax assets like NOLs as less likely. During Covid, they suddenly reversed this reserve by $14.5 million? Looking at several years, the Other tax issues are normally a small +/- figure. In 2020, it's a $4.5 million benefit.

Also, we think all this tax benefit hit heavily if not all in 4Q. In 1Q, the tax rate was 13% - which is largely the normal rate. In 2Q, income was only $2.6 million so the effective income tax was much higher because the foreign tax issues were a much larger part of the total picture. In 3Q, the tax rate was 26.5% because much of the restructuring charges occurred in the US REIT assets – which being non-taxable entities did not provide a tax shield from the restructuring charges.

Look at 4Q, restructuring was $65.7 million vs. $48.4 million in 3Q – so the tax rate should have had upward pressure just from that. Instead, the tax rate fell to -1.5% a benefit of $3.7 million. There are several ways to view this:

- The reversed accrual came in as a $7.4 million benefit which is 3-cents. Or one could say it exceeded guidance from 2019 by $2.8 million and added 1-cent to FFO.

- The decrease in the valuation allowance was $8.4 million, which added 3-cents. Or one could say that the valuation allowance swung by $14.5 million y/y and added 5-cents to FFO.

- The Other was another 2-cents in positive and is normally immaterial.

In our view, the entire "beat" on estimates came from these tax issues. It is also worth considering that even though this 4Q20 negative tax rate came from out of the blue – a couple of signs point to a rising tax rate for IRM:

- It expects another $200 million restructuring charge in 2021 against tax free assets so there isn't a tax shield there.

- IRM is trying to expand internationally more – which also plays against the REIT structure.

Iron Mountain Redefined Its Metrics

We already had issues with IRM's non-GAAP metrics as they were already ignoring several ongoing costs and they provided a far different picture of the actual operations than cash flow did. The basics for REITs are:

- FFO – Funds from Operations – designed to show REIT cash income as Net Income + real estate depreciation + gains/losses on real estate sales. IRM already modified this to add back restructuring costs, transaction costs, and "other income," which is primarily FX gains/losses, JV income/losses, and debt financing costs. It has modified it again keep JV income in the mix and add back stock compensation – it has effectively been increased:

FFO changes	4Q20	3Q20	2Q20	1Q20
Old definition	$173.4	$176.2	$152.2	$169.8
New definition	$173.5	$181.7	$166.2	$172.1

- Adjusted EBITDA makes the same additional adjustments as FFO. It will add back stock option expense and leave in the JV losses.

- AFFO – Adjusted Funds from Operation – Is a metric to show basic free cash flow. It starts with FFO and adds back stock compensation, all amortization, non-real estate depreciation and subtracts a maintenance capital spending figure. IRM already had an inflated AFFO in our view because it capitalizes several ongoing expenses that are capitalized, amortized and added back to AFFO. It also added back reductions in revenue from below-market leases and withdrawal fees. It was subtracting the recurring maintenance capital spending on real estate and growth capital spending on non-real estate. The latest definition will benefit from the higher FFO to start with and will now use a recurring capital spending figure for all businesses. AFFO has also been increased due to these changes as capital spending is lower and FFO is higher along with some changes in tax reconciliations:

AFFO Changes	4Q20	3Q20	2Q20	1Q20
Old definition	$187.0	$213.1	$249.5	$231.3
New definition	$190.8	$216.4	$249.7	$230.7

We consider the new metrics to further overstate actual results. People count on stock compensation as part of their pay – it should not be ignored as a recurring expense. Plus, we can look at all the cash expenses at IRM in operating the business such as picking up and delivering records, payments to acquire customers, and financing lease payments that AFFO is ignoring under both the new and old definition and compare it to actual cash flow, and the real numbers look much more subdued.

Here is the picture IRM shows for its dividend:

	2020	2019
AFFO New	$887.5	$867.0
Dividend	$716.3	$704.5
Payout %	80.7%	81.3%

Here is the actual cash flow at IRM – and this adds back stock compensation too:

	2020	2019
Cash from Ops	$987.7	$966.6
Capital Spending	$438.3	$693.0
Acquisitions	$118.6	$58.2
Acquired Customers	$4.3	$46.1
Customer Inducements	$10.6	$9.4
Fulfill costs/commiss	$60.0	$76.2
JV Investments	$18.3	$19.2
Principal on Fin. Leases	$47.8	$58.0
Free Cash Flow	$289.8	$6.5
Dividend	$716.3	$704.5

Obviously, IRM is not covering the dividend at all. It is making up the shortfalls by borrowing and doing sale-leasebacks on real estate assets. That's fine in the short-term, but they can't do that forever and the following years they have a new lease expense to pay that lowers cash flow and they still have a dividend to pay without more assets to sell. People should note that the storage business where these various cash costs occur is already a negative growth business. What happens if IRM does not pay to acquire new records to store and pick them up? Also, let's consider a couple of other points:

- If we assume just the maintenance capital spending IRM uses in AFFO of $143 and $138 million instead of total capital spending of $483 and $693 million – That difference of $340 and $555 million still isn't enough to plug the shortfall. Plus, IRM is planning to continue growing the data center business – they have to pay for it somehow.

- 2020 spending on acquiring new customers and fulfillment was depressed due to Covid. Those figures will likely rise going forward.

- Cash flow from operations is also helped by IRM securitizing receivables. That added $85 million in 2020 and $272 million in 2019.

- Borrowing forever seems unlikely too. IRM can tout its EBITDA of $1.5 billion the last two years and the net debt of $8.5 billion is still 5.75x EBITDA. But, if we adjust for the fulfillment costs, customer inducements, and finance lease payments – which are all cash outflows – EBITDA is closer to $1.3 billion. Debt net of cash is $8.5 billion is closer to 6.5x (2021 adjusted EBITDA or $1.477 billion less cash costs is $1.354 billion and we believe those costs were about 50 million light from Covid). That's before adding in higher operating lease costs.

We also want to point out that this is not the first time IRM has changed its presentation of results. In recent quarters, is started to lump more costs together and it stopped showing the decay of its storage business which used to give figures for how much was lost, how much was shredded, and how much pricing helped/hurt.

The Restructuring Plan Has Some Peculiar Issues

Iron Mountain is certainly not the first company to do a big restructuring program. The goal is to spend $450 million and achieve $375 million in cost savings. We are just looking at the plan and several things look odd:

- The number one target for cost savings is severance and getting rid of employees. It is also routinely listed as the first item on where the $450 million will be spent.

- However, severance has been a small part of total spending – at only 28%. It was $20.9 million spent in 4Q19 and then only $47.3 million more in all of 2020. IRM is saying 70% of all its workforce reductions were completed at the end of 2020. That is surprising too – why wouldn't that accelerate with Covid and be completed by now?

- As part of the severance, IRM will cut upper management of VP and above by 45%. Those should be larger salaries and generate cost savings. What we wonder is "are some of these people still working there?" Also, are some wages for actual IRM work being lumped into these restructuring charges and added back as one-time events?

- Also surprising to us is the size of the restructurings are getting larger as time moves forward. We normally see a restructuring have the biggest impact in the first period it is announced as leases are bought out, assets marked down, a large number of lay-offs occur. At IRM, the charges are rising a year later. Plus, 44% of the total spending is estimated to occur in the last year (2021):

	4Q20	3Q20	2Q20	1Q20	4Q19
Restructuring	$65.7	$48.4	$39.3	$41.0	$48.6

- So far, the item labeled "professional fees and other costs" is 72% of the restructuring cost. The bulk of the restructuring is for the US-based records storage business. IRM has been around since 1951. Who are these professionals coming in who know more about that business than IRM people? The sheer size of this relative to the severance also makes us wonder if there are some ongoing costs in here too. Is a VP who is staying allocating one-third of his salary to the restructuring in 2020 for example? Is a trip by management to visit locations in California and Colorado being added to the restructuring as they went to oversee restructuring plans there? One of the other things in here is data conversion costs – that sounds like that could include normal ongoing expenses of converting customers' paper records to digital.

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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