BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Iron Mountain Incorporated (IRM)
Earnings Quality Update- 3/21 Qtr.

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

We maintain our earnings quality rating of IRM at 1+ (Weak).

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

Summary

IRM beat forecasts for FFO by 7-cents and the company raised the high-end of guidance by essentially 1% in all areas such as Revenue, EBITDA, and AFFO. The higher guidance is being driven by acquisitions. The FFO beat includes 4-cents added back from stock compensation, under IRM's newly changed definition of FFO. It had another 4-cents from not adjusting for financing lease principal payments also.

We also see that IRM benefited from some expense lag of returning to normal operations post-Covid with items like transportation being down $8.1 million y/y as they actually saw the service side of records management start to normalize later in 1Q and sales commissions were up. There are still furloughed employees starting to come back so labor was down $14.5 million but should likely grow going forward. Every $4 million of costs like this is worth about 1-cent in FFO. Even Information Technology Costs grew during Covid in 2020. In 1Q21, those costs were down $1.8 million. According to IRM – it expects to see margin pressure of 200-300bp in 2Q and 3Q and then deliver a back-loaded benefit in 4Q to hit forecasts. 200-300bp of margin is 6-9 cents of pressure on quarterly FFO. That guidance would seem to indicate that many of these timing differences between returning revenues and costs should reverse from 1Q21 through the fall.

Overall, we still believe IRM is touting growth – but ignoring the costs to get that growth including picking up and delivering data files, commissions paid to bring in business, buying out existing contracts at competitors, offering below-market rates as initial inducements and low maintenance capital spending. The cash flow statement shows many of these extra ongoing costs and paints a much weaker picture than the REIT stats IRM uses.

What is weak?

- All the sale-leasebacks IRM has done with property is starting to show up as rent expense rising faster than revenues. In 1Q21, operating lease expense rose 7.6% y/y after growing 8.7% in 2020. That is outpacing storage revenue of 3.5% and 2.7% growth respectively. IRM completed $565 million in asset sales like this in 2020. IRM only had $12.5 million in 1Q21 but guided to $125 million for 2021.

- Covid slowed cash outflows to acquire new customers. Despite this and pulling cash in from asset sales, and securitizing receivables ($257 million of a $300 million limit) – debt is up and that is before looking at higher lease costs. Where is the cash coming from to chase new customers in a non-Covid world?

	1Q21	2020	2019
Net LT Debt	$8,867.6	$8,592.3	$8,557.9
Cash from Operations	$68.8	$987.7	$966.7
Cash flow from Wrk Cap	-$159.3	$134.4	$8.8
Capital Spending	$145.5	$438.3	$693.0
Acquisitions	$0.0	$118.6	$58.2
Acquired Customers	$0.9	$4.3	$46.1
Inducements to Customers	$1.5	$10.6	$9.4
Fulfillment Costs	$16.7	$60.0	$76.2
JV Investments	$6.5	$18.3	$19.2
Finance Lease Payments	$12.4	$47.8	$58.0
Free Cash Flow	-$114.7	$289.8	$6.6

Capital spending is expected to rise in 2021. Working capital will likely be rebuilt but was 14% from cash from operations in 2020. And fulfillment and inducements will likely rise too. In 2020, IRM brought in $565 million from asset sales, but that's only forecast to be $125 million in 2021.

- The dividend is $725 million, where is that cash coming from in 2021? Free cash flow and asset sales will not do the job. IRM wants to tout its AFFO guidance of $1 billion for 2021 as covering the dividend easily. We believe the ongoing expenses that AFFO ignores will amount to more than $200 million in 2021. These include the principal payments on financing leases that should be over $50 million and stock compensation also about $50 million. Then there are withdrawal fees paid to poach customers, commissions paid to third parties to pull in customers, and other acquisition and inducement costs paid to customers. These are all recurring costs and they are seen on the cash flow statement. Maintenance capital spending was $143 million in 2020 and $64 million in 4Q20 – it came in at only $29 million in 1Q21. We think a realistic figure is much higher and that also would reduce AFFO. And there are the continual restructuring costs that consume cash as well. IRM will likely borrow the shortfall. The problem is while debt to EBITDA is 5.5x under the company's definition – the interest expense and principal payment on financing leases would cut their forecasted EBITDA by over $70 million and the inducement costs are also being ignored. We can see the debt figure being over 6x a more realistic EBITDA already.

- Restructuring continues into another year. We are going to voice our same concerns as in the past. The largest cost of the plan is supposed to be severance from eliminating employees and managers. Yet, the total percentage spent on severance fell to only 25% in 1Q21. Two-thirds of the $450 million total budget has been expensed at this point, years into this program. Why wouldn't Covid have been the time to accelerate lay-offs? The much larger source of payments is going to internal costs to develop and implement the restructuring and professional 3rd party consultant fees. Internal costs sound like an area where ongoing wages, travel, etc. could be pulled out of normal G&A costs and assigned to restructuring that gets added back in adjustment figures. If a manager looks at closing a facility, but visits 3 other locations on the same trip – do all the wages and other expenses get assigned to restructuring? We also remind investors that the bulk of the restructuring is to pull costs out of the old-tech business of paper storage. We're still curious how many consultants there are who know more about that business than IRM? But the bulk of the restructuring is coming in those areas - $36 million in 1Q21 or roughly 9-cents in FFO.

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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