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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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September 11, 2020 | www.btnresearch.com

Iron Mountain (IRM) EQ Review

Current EQ Rating*	Previous EQ Rating
2+	na

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 initiate earnings quality coverage of IRM with a 2+ (Weak) rating

IRM is a REIT that stores paper and digital records. The company routinely beats forecasts on various REIT stats and has operated a growth-through-acquisition model for many years. Our primary concerns are that the REIT stats are inflated by excluding many ongoing cash expenses and having maintenance spending coming in below guidance.

REIT Stats	2Q20	BTN 2Q20	1Q20	BTN 1Q20	2019	BTN 2019
Normalized FFO/share	$0.53	$0.42	$0.59	$0.47	$2.29	$1.97
AFFO	$249.5	$183.2	$231.2	$170.4	$856.3	$707.6
Adj. EBITDA	$342.9	$301.1	$363.1	$316.8	$1,437.6	$1,303.5

Above are IRM's reported stats against our estimate if we adjust for the on-going cash items. In 2019, IRM beat forecasts on normalized FFO (Funds from Operations) by 7-cents. It beat in 1Q20 by 14-cents and in 2Q20 by 10-cents. Based on some of the adjustments we will discuss below, we're not certain IRM is even meeting let alone beating forecasts if recurring cash costs are not added back to its adjusted results. That's why we rate IRM a 2 (Weak).

We assign a plus in the rating as near-term liquidity looks adequate with $900 million in cash and no short-term maturities that have not already been addressed. Also, the weakness in maintenance capital spending may improve from here and some of the heaviest costs related to the new 3-year restructuring may have been paid.

- **REIT stats make results look better when accounting for several cash flow items. Looking at AFFO – the proxy for free cash flow – IRM covered its dividend by 122% in 2019 and continues to cover it in 2020. Looking at real free cash flow, IRM only produced 20% of its dividend in 2019 and is not covering it in 2020. Even treating much of capital spending as growth-related – the coverage looks much tighter.**

- **Debt remains high at over 6x 2019's EBITDA. That omits several cash costs too and the actual ratio may be closer to 6.7x in our view. IRM appears to have the liquidity to survive COVID and maintain its plan for 2.5 more years of restructuring.**

- **What we find most troubling are several cash expenses that are recurring and running through the cash flow statement. IRM capitalizes these payments and amortizes them over time into income. However, with its adjustments to the REIT metrics, it is adding back those expenses to some or all the metrics as non-cash amortization**.

- **Intake Costs – the costs to bring records into storage in the first place is an ongoing cash outflow. IRM is capitalizing it and amortizing it over 3-years. It adds the amortization back to AFFO and it is about 1.1% of 2019's AFFO.**

- **Permanent Withdrawal Fees relate to when IRM wins business by buying out a customer's existing contract elsewhere. This is an ongoing cash outflow too which is being amortized over 7-years. It is added back and is another 1.1% of AFFO.**

- **The use of finance leases allows the income to be inflated as only the interest expense is recorded and depreciation is added back to results for FFO and AFFO. The principal payment is ignored.** The principal payment was 9-cents or 4% of 2019's FFO, and 7% of AFFO. If the principal payment was made, there wouldn't be depreciation. Depreciation was added back to FFO and AFFO and was worth 5-cents of FFO and 2% of AFFO – pick one or the other between principal or depreciation. EBITDA added back the depreciation and the interest expense without the principal payment. That was 5.5% of adjusted EBITDA in 2019.

- **Stock option expense is a recurring cost also. This is added back to AFFO and added 4% to 2019's AFFO.**

- **IRM says that maintenance capital spending should rise faster with more data center operations. However, it is cutting guidance for maintenance spending and often spending less than forecast. This also adds to AFFO. In 2020, spending is running $20-$40 million below guidance.**

- **Acquisition, restructuring, and commission costs are all largely cash expenses. Growth through acquisition is causing severance payments, relocation payments, payments to integrate and update systems, legal fees… These have been occurring for years now. They are being added back to all three metrics. This spending is running $60-$100 million per year. Every $10 million is worth about 1% of AFFO.**

- **We adjusted FFO for the finance leases and assumed one-half of the restructuring should be counted as recurring cash costs. That resulted in FFO/share falling 32-cents for 2019 and essentially 11-cents for 1Q20 and 2Q20**.

- **When we adjust AFFO for the FFO items plus the other cash charges that are treated as amortization listed above – we show it coming up 17% below 2019's reported figure and 26% below for 2020 thus far.** That starts to match what a more traditional free cash flow table is showing us.

- **We adjusted EBITDA for these items and found it was about 10% lower than IRM's reported figure for 2019 and 2020.**

- **IRM's growth through acquisition accounting with the REIT metrics looks aggressive to us too. Essentially, most of what they are buying is something they could have built and would have seen the expenses flow through the income statement. Instead, they ignore the cash outlay for the purchase as not being capital spending and treat it as being one-time in nature. Then, the expenses recorded in income – they add back as non-cash amortization expense.** With EBITDA, they even add back the financing cost. The company can double in size, borrow considerable money, report higher sales and none of it costs a single dollar under these metrics.

Basic Overview – REIT Stats Look Better than Normal Measures

Iron Mountain has two businesses: storage of documents and records that has more of the passive qualities of a REIT with a long-term monthly fee structure, and service which is driven by customer actions such as picking up or delivering documents to storage, transferring documents to new media, or shredding unneeded documents. The impact of COVID has resulted in service dropping off while storage has held steady.

Because IRM is a REIT – it uses REIT statistics to demonstrate its sustainability:

- **FFO – Funds from Operation** – which is a basic cash flow metric used as a proxy for REIT cash income that is derived as net income + real estate depreciation + gains/losses on real estate sales. IRM modifies that further to add back impairments, restructurings, FX charges.

- **AFFO – Adjusted Funds from Operation** – is a different way to show a basic free cash flow metric. It starts with FFO and adds back all amortization and depreciation of assets other than real estate. It also adds back stock compensation and subtracts a maintenance capital spending figure.

- **Adjusted EBITDA** – is used to show a broader cash flow figure to test if the company can afford growth investments and debt.

What the REIT metrics miss are areas where common expenses are capitalized. On a GAAP cash flow statement, this shows up as an upfront cash payment. For AFFO or EBITDA, that payment is not only ignored, the capitalized expense is added back as non-cash amortization. They also miss items such installing a new computer system – is that maintenance or growth spending? GAAP says its capital spending regardless. AFFO may say only 15% is maintenance. The result we see is the metrics look better than what the traditional financial picture shows.

AFFO	2Q20	1Q20	2019	2018
FFO	$152.2	$169.8	$658.8	$648.8
noncash adj.	$124.2	$82.8	$352.0	$364.0
non-R/E Cap-X	$11.8	$8.4	$62.0	$45.8
Maint. Cap-X	$15.2	$13.0	$92.5	$104.4
AFFO	$249.5	$231.2	$856.3	$862.6
Dividend	$178.2	$181.3	$704.5	$673.6

Compare that to a more traditional free cash flow model which would still add back stock option expense but it would also show the cash outflow for restructuring. We left out acquisitions, but added back the cash outlays that IRM made toward commissions and customer inducement items that it capitalizes and adds back as amortization in AFFO:

Normal Cash Flow	2Q20	1Q20	2019	2018
CFO	$313.7	$125.4	$966.7	$936.5
CapX	$103.1	$97.1	$693.0	$460.1
Other Cap. Costs	$11.4	$17.2	$131.7	$98.7
Free Cash Flow	$199.2	$11.1	$142.0	$377.7
Dividend	$178.2	$181.3	$704.5	$673.6

You can adjust the capital spending figures down considerably and this still looks really tight. This is simply accounting for cash expenses as cash rather than amortization which is a big part of the difference. Plus, in the current environment, there is a squeeze on the service side of the business with fewer customers moving their stored records around so income is under pressure too.

From a debt standpoint, IRM was already drawing cash from monetizing receivables. Last June, it issued more debt and repaid that facility and essentially has no near-term maturities. It uses EBITDAR (EBITDA + Rent expense) to view leverage with leases. This is at 5.6x against its target of 4.5-5.5x. The problem we have is when we adjust EBITDA for some of the recurring cash items being omitted in IRM's definitions, we think their figure is about 10% too high as we will show later in this report. On a net debt/adjusted 2019 EBITDA figure, IRM would say they are at 6.1x. We would have them at 6.7x.

Overall, IRM likely has the liquidity to wait for more of the business to return to normal. We have issues with several capitalized costs helping income while straining cash flow. Its restructuring should further strain cash flow and we wonder if they are spending enough on maintenance at this time.

Recurring Costs Ignored – Intake Costs

IRM stores records for customers and charges a fee. The records need to get to the IRM facility in the first place. Those activities require labor and transportation costs. Sometimes the customer pays for some of that and other times, IRM does it free to win the business in the first place. The two keys are that these costs consume cash and recur as a normal part of the business. IRM capitalizes these intake costs and amortizes them over 3-years and they show up in the company's line-item for depreciation and amortization as an expense.

COVID probably impacted the growth rate of this asset in 2Q20, but this gross and net carrying amount of this capitalized asset has been growing:

Capitalized Intake	2Q20	2Q19	1Q20	1Q19	2019	2018
Gross Asset	$39,798	$34,915	$40,585	$36,155	$41,224	$39,748
Net Asset	$16,331	$15,517	$16,970	$15,114	$17,645	$15,244
Intake Amortization	$2,802	$2,835	$2,779	$2,679	$10,144	$10,380

New intake costs use cash and are boosting the gross asset account. **At just over $10 million per year in amortization, the net asset figure would be zero very shortly if IRM wasn't spending more cash to move in even more records. This amortization of an ongoing cash cost is added back to AFFO and Adjusted EBITDA.**

Recurring Costs Ignored – Permanent Withdrawal Fees

One way IRM wins new business to existing facilities is to poach it. It agrees to buy out a customer's existing contract at a competitor. This is definitely a cash expense. The below table shows what IRM has been spending in this area and reports in the investing section of the cash flow statement:

Perm Withdrawal Fees	2Q20	1Q29	2019	2018
Cash Spending	$1,200	$1,700	$46,100	$63,600

They capitalize this spending and amortize it over 5-15 years (7 years on average). The amortization reduces Service Revenues. This expense has been:

Perm Withdrawal Fees	**2Q20**	**2Q19**	**1Q20**	**1Q19**	**2019**	**2018**
Amortization	$2,348	$2,598	$2,465	$2,740	$9,993	$11,408

This is another on-going cash cost that amounts to about $10 million per year under GAAP using the capitalization process. The cash drain is clearly much higher. **This ongoing cost is being added back to AFFO and adjusted EBITDA.**

Recurring Costs Ignored – Finance Leases

Iron Mountain also uses finance leases for some of its property and equipment. In general, this lease payment is viewed as debt. The lease payment is split into interest expense that is recognized through the income statement and a principal payment that appears in the financing section of the cash flow statement. The asset is also depreciated and that runs through the income statement but is added back on the cash flow statement. The net effect of finance leases in most situations are:

- It inflates income because the bulk of the lease payment is not recognized
- It inflates operating cash flow because it starts with inflated income and adds back depreciation

IRM Breaks down the finance leases as follows:

Finance Leases	2Q20	2Q19	1Q20	1Q19	2019
Interest Exp.	$4,929	$2,925	$4,844	$6,142	$21,031
Depreciation	$3,431	$3,113	$3,163	$3,504	$13,364
Principal Payment	$11,214	$14,521	$12,739	$16,625	$58,033

With an operating lease – the full lease payment (interest and principal) would be recognized as an expense and there would not be depreciation. So, looking at this, pick either the principal payment or the depreciation.

The interest expense is recorded with other interest expense and is a cash expense. Adjusted EBITDA adds that cost back.

Depreciation is recorded with other real estate deprecation. That is added back to Adjusted FFO, AFFO, and Adjusted EBITDA.

The principal payment is a cash item and it is excluded from all the REIT measures FFO, AFFO, and Adjusted EBITDA.

IRM's normalized FFO was $658.8 million in 2019 – not treating $58 million in principal payments as an expense is a big part of FFO.

Recurring Costs Ignored – Stock Option Expense

Most people know our view of this – employees view this as actual money and if IRM didn't award stock compensation it would need to boost cash wages. The later would be expensed and reduce income and cash flow. **As part of the adjustments made, IRM adds stock option expense back to AFFO:**

	2Q20	2Q19	1Q20	1Q19	2019
Stock Comp	$20,145	$12,501	$6,527	$8,519	$35,654

Recurring Costs Understated – Maintenance Capital Spending

In the 10-K, IRM notes that:

> "***Our data center expansion in particular requires significant capital commitments.*** *Our data center expansion and other new ventures are inherently risky and we can provide no assurance that such strategies and offerings will be successful in achieving the desired returns within a reasonable timeframe, if at all, and that they will not adversely affect our business, reputation, financial condition, and operating results."*

FFO and EBITDA are expected to approximate operating cash flow. **However, AFFO also makes an attempt to show the full operating base business and acknowledges that the real**

estate and equipment must be updated and maintained to preserve asset values and the ongoing cash flow stream. Given the move into data centers – we would expect to see maintenance spending increasing at IRM. Its guidance for spending is actually falling. It has underspent guidance in recent years. In 2020, it is dramatically underspending at this point:

Maintenance	1H20	2019	2018	2017
Guidance in $mm	$140-$160	$145-$155	$155-165	$150-170
Actual	$48	$155	$150	$146
Underspending	$22-$42	$0	$5-$15	$4-$24

Recurring Costs Ignored – Significant Acquisition Costs, Restructuring, Commissions

The previous several items are related to the company's on-going base business. However, IRM also grows via acquisition. Since 2016, it has completed over $2.5 billion in acquisitions. In most years, that is about $200 million for buying other companies and another $50 million in customer acquisition costs.

The Significant Acquisitions Costs are largely cash related also. These include advisory fees, other professional fees, costs to get regulatory approval and legal issues, costs related to severance, moving facilities/employees, and upgrading systems. There are also third-party commissions that show up every year too.

	2Q20	1Q20	2019	2018	2017	2016
3rd Party Comm.	$1,758	$2,363	$7,957	$5,713	$6,530	n/a
Sig. Acquisition Costs	$0	$0	$13,293	$50,665	$84,901	$131,944

This is now transforming into a new line item called Restructuring as part of Project Summit. Project Summit is expected to cost $240 million from 2019 to 2021. It also sounds like largely cash costs related to severance and updating/integrating systems, professional fees. So far, this has cost a decent amount of money:

	2Q20	1Q20	2019
Project Summit	$39,298	$41,046	$48,597

All three of these stats – Normalized FFO, AFFO, and Adjusted EBITDA add back these costs. Given the recurring nature, we believe at least half of these costs should be considered regular cash outflows.

Adjusting for Recurring Cash Costs Lowers IRM's Reported Results

As IRM moves to normalized FFO – it added back all COVID costs, all restructuring costs, and impairments. We used that as a starting point and adjusted for the full lease payment on financing leases as well as half the various restructuring and integration costs as those are largely cash and recur.

FFO Adj.	2Q20	1Q20	2019
Normalized FFO	$152,214	$169,767	$658,835
Finance Lease Principal	$11,214	$12,739	$58,033
Half 3rd party Comm.	$879	$1,182	$3,979
Half Sig. Acq Costs.	$0	$0	$6,646
Half Project Summit	$19,649	$20,523	$24,299
BTN Adj Norm. FFO	$120,472	$135,323	$565,878
Shares	288,071	288,359	287,687
BTN FFO per share	$0.42	$0.47	$1.97
IRM's reported FFO	$0.53	$0.59	$2.29

If you want to give IRM the benefit of the doubt and call the restructuring charges truly one-time and only adjust for the financing leases, the EPS would still be lower than IRM's figures at $0.49 for 2Q20, $0.54 for 1Q20, and $2.09 for 2019.

AFFO builds off Normalized FFO. BTN Normalized FFO subtracts the lease costs and half the restructuring/integration charges described in the previous table. We then added the full set of adjustments that IRM makes to get to AFFO. We then backed out the intake costs, withdrawal fees, the stock compensation (that was part of what was added back in the IRM adjustments) and the mid-point of how much lower maintenance spending was than guidance.

FFO Adj.	2Q20	1Q20	2019
BTN Adj Norm. FFO	$120,472	$135,323	$565,878
IRM Adjustments from FFO to AFFO	$97,251	$61,476	$197,487
Less Intake Costs	$2,802	$2,779	$10,144
Less Perm. Withdrawal Fees	$2,348	$2,465	$9,993
Less Stock Comp.	$18,857	$5,086	$35,654
Less Mid-Pt of Underspend on Maint.	$10,533	$16,118	$0
BTN Adj AFFO	$183,183	$170,351	$707,570
IRM Reported AFFO	$249,465	$231,243	$856,322
Decline	-27%	-26%	-17%

The largest parts of this change are including the full lease payment for the financing leases from FFO, not adding back stock compensation, and of course, the huge decline in maintenance spending from 2020 guidance as IRM told investors to expect its maintenance spending to rise going forward. **Guidance for 2019 was for AFFO of $870-$930 million so IRM missed that forecast even without our adjustments. Guidance for 2020 is for $930-$960 million and IRM may hit that with the huge drop in maintenance spending. But, would that be a quality beat?**

Adjusted EBITDA adds back all Interest, Depreciation, Amortization, COVID, and Restructuring Charges among a few other accounts. We started with IRM's figures.

Adjusted EBITDA	2Q20	1Q20	2019
IRM adjusted EBITDA	$342,884	$363,077	$1,437,605
less Fin. Lease Interest	$4,929	$4,844	$21,031
less Fin. Lease Principal	$11,214	$14,521	$58,033
less Intake Cost	$2,802	$2,739	$10,144
less Perm. Withdrawal Fees	$2,348	$2,465	$9,993
Less 1/2 Restructuring Cost	$20,528	$21,705	$34,924
BTN Adj. EBITDA	$301,063	$316,803	$1,303,480
Decline	-12%	-13%	-9%

We treated the finance lease as though the full payment – debt and interest came out of operating income and would therefore hurt EBITDA. The other various adjustments that were added back in amortization but are recurring cash costs in our view were also adjusted out. Our EBITDA figure comes out about 10% below IRM's figures.

In our view, the more conservative figures would mean IRM would have missed guidance of $1.42-$1.53 billion in 2019. As it was, IRM came in at the low-end at $1.44 billion.

We Have Several of Our Common Complaints with IRM's Acquisition History

IRM has spent $2.6 billion on acquisitions since 2016. It believes this is part of its operating and growth strategy to achieve greater economies of scale and also gain access to faster-growing markets.

Our first problem is pretending that there is not a single dollar of cost to any of this process. Despite making deals nearly every year, they are not counted as capital spending. No amount of internal cash flow needs to support this growth plan is the theory – they can just borrow what they need. So AFFO, which is supposed to approximate free cash flow – doesn't see this as a cash outflow. Plus, as we noted earlier, IRM has annually had an income statement item called Significant Acquisition Costs. This includes costs for legal fees, consultants, severance, closing and relocating facilities, and upgrading acquisitions to IRM's systems. These are largely cash costs and yet IRM adds back every nickel of it as one-time expenses that simply occur every year. Now, it has moved on to a three-year restructuring plan that will cost $240 million more. That is being added back. Then the assets being acquired are largely intangible – that will either not be amortized or added back to the REIT metrics as being non-cash charges. Thus, $2.6 billion in cash went out the door to make these deals. So far, $410 million has been spent restructuring and integrating these deals. All the amortization of assets has been added back to results. So magically, IRM has added all these new companies and is reporting the higher sales and income from them – but according to normalized FFO, Adjusted AFFO, and Adjusted EBITDA – that growth came with zero cost. Adjusted EBITDA even adds back the interest expense on the borrowed money.

The second complaint is much of what IRM bought, they could have built themselves. There would have been labor involved, marketing programs would have been paid that would have been expensed as incurred. Capital spending would have resulted in some reductions to cash flow and AFFO. Some non-real estate depreciation would not have been added back to FFO. The depreciation period for computers and software is 2-5 years, other equipment is 1-10 years or the lease term. Acquired goodwill is not amortized at all. Acquired customer relationships are amortized over 17 years. That is a considerable amount of expense that will never be realized and much of what is recorded is added back.

And third, the company metrics only show the good side of this type of growth as there are no expenses to it – even EBITDA adds back the interest cost. The balance sheet is carrying $5.8 billion in intangibles against only $1 billion in equity. The debt is 8.7x equity and as we noted earlier the debt covenant of EBITDAR shows debt is 5.6x based on 2019 figures. That is likely higher now as EBITDA is falling with the squeeze on the service unit.

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 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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