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Contents

United Healthcare (UNH) EQ Review p. 1
Iron Mountain (IRM) EQ Review p.16
salesforce.com (CRM) EQ Review p.21
Macy's (M) Quick Update- Maintain BUY p.38

United Healthcare (UNH) EQ Review

Current EQ Rating*	Previous EQ Rating
5-	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 UNH with a 5- (Strong) rating

UNH's overall operating model looks solid with the company able to drive growth through a combination of making its physician base larger and its purchasing size bigger – which leverages fixed costs and enables UNH to gain larger rebates and pass savings on to customers. There is a tailwind for 2021 coming as the ACA tax will be gone. In 2019, there was a moratorium on this tax and in 2020, it is expected to be a $3 billion expense for UNH. The elimination of that tax after this year should give a strong earnings tailwind for 2021.

There are some common accounting red flags here, but they are minor, often amounting to only 1%-2% of earnings or even less. For example, the company's adjusted EPS was $15.11 in 2019. They cut bad debt reserves on receivables in 2019 and picked up 17-cents in EPS or 1%. **The issues for 3Q and 4Q of 2020 should be rising medical costs that fell during COVID as patients missed check-ups and elective procedures. As that returns to normal and people make up missed appointments, costs should rise faster than premiums and squeeze income.** That will tighten the spread between premiums received and medical costs incurred and potentially represents several billion dollars per quarter which is more in the range of $1.50-$2.50 in EPS. Rebates seem poised to help cash flow in 4Q and earnings in 2021 more. The transition headwinds due to COVID should be largely complete by year-end and then there may be more tailwinds for earnings.

Our biggest negative item is UNH's acquisition accounting. In our opinion, the disclosure of the deals is very light. Also, assumptions used such as allocating the bulk of assets to goodwill and amortizing the rest over a period 2-3x longer than that used for internal assets could be inflating earnings by as much as 22%. To UNH's benefit, non-amortization of goodwill is required by GAAP and the rules are not going to change plus, most people are going to argue this is all non-cash. So, beyond a potential future non-cash write-off in this area, we cannot argue that there is an imminent problem for earnings in this area. Using 2019 as more normalized figures, net debt to EBITDA is only 1.2x and ROI is 23%.

- **COVID caused customers to skip elective medical care while still paying premiums. The spread between premiums and medical costs is normally just over $8 billion in income per quarter. 1Q20 saw it rise to $9.6b and 2Q20 to $14.7b. This spurred earnings and cash flow.** People are returning to more normalized medical visits and there should be a backlog that needs to be cleared through the rest of 2020. Keep in mind net income is normally $3.5 billion/quarter but hit $6.7 billion in the 2Q due to lower medical costs. That could set up UNH for a headwind on earnings in 3Q and 4Q and income may dip below $3.5 billion as the backlog normalizes. This should be temporary in our view.

- **UNH runs estimated rebates through the income statement as premiums are recognized. With lower medical visit activity, UNH could not bill these rebate receivables at normal speeds to the drug companies and thus receivables in this area grew nearly $2 billion and DSOs are up from 16 to 21 days.** So, this maintained normal rates of income but sapped cash flow. It normally takes 2-5 months after medical procedures for UNH to get paid on rebates. This should represent a source

of enhanced cash flow in 2021. Management believes rebates may increase by another $1 billion in the near term which could help earnings this year and cash flow further in 2021.

- **Cash flow overall should see some pressure in 3Q and 4Q in addition to seeing medical costs grow faster than premiums.** The lag on rebates may cause that receivable to continue rising in 3Q. Medical payables fell with lower activity by $2.5 billion since 4Q and should rise again as more customers get medical care. However, other payables rose by $6.4 billion over that time and from 110 DSPs to 132. All of this looks like a short-term issue that should normalize in 2021.

- **Medical Cost Estimates may have a smaller impact on earnings in the near term. These occur when customers have procedures but not all the costs are supplied to UNH immediately.** For example, if a customer needs physical therapy that is expected but doesn't occur for two months or an ambulance ride was given, but it wasn't billed for 4 months. **UNH estimates these final costs and books it in the current period. Over time, the final bills arrive and UNH squares the estimate against the real bill.** If the estimate is too high, UNH books a favorable adjustment to income and vice versa.

- **We see two issues with the Medical Cost Estimates. The first is we would expect to see years of favorable and unfavorable adjustments. In UNH's case – every year is favorable so** this is a tailwind for earnings. **The second is COVID slowed the number of medical cases so there are fewer cases to have estimates on.** The company is already seeing a smaller amount of favorable adjustments. This is an area of favorable outcome where we expect some headwind. This has been running between 2%-5% of income in recent years. Until UNH builds up to a higher level of medical costs to restock the pipeline of estimates, we would expect fewer adjustments to help 3Q and 4Q.

- **UNH has a sizeable acquisition history and completes them in essentially every year. They consume significant cash flow and the company also highlights potential liabilities for additional payments. The overwhelming bulk of acquired assets are allocated to goodwill which stands at $68 billion and other intangibles at $11 billion compared to equity of $67 billion.**

- **UNH reports adjusted earnings that add back the amortization of intangibles. That is a fairly mild adjustment given what we see from other companies. However, it is**

clear these acquisitions consume cash. Moreover, the amortization period is 2-3x internally developed assets that are capitalized and most of UNH's work at building the business internally is expensed as incurred. If we cut the amortization period in half and assume goodwill is amortized over 40 years – this would reduce income by 22%. This is one area where some of the assumptions made have a meaningful impact on results.

- **The company tests for impairment on these assets by discounting cash flows. One issue we have is UNH noted that acquisitions made in 2019 and 2018 were immaterial to revenues and earnings even on a pro forma basis. How are immaterial results supporting nearly $16 billion of intangible asset value?** We will concede the full company is reporting a pre-COVID ROI > 20%, but these intangibles are supposed to be assigned specifically to those acquired assets, not the whole business.

- **Share repurchases have consumed a large amount of free cash flow since 2018. UNH continues to issue new shares as stock compensation and spending billions repurchasing only aided EPS growth by 2.1% in 2019 and 0.9% in 1H20.** The company does not appear overleveraged to us and its underlying growth rate is historically stronger than what this repurchase program is producing. We'd argue UNH may be able to use that cash to lower its cost structure and drive better growth than through the repurchases. They can gain 1% earnings growth by cutting the cost structure by only 8bp. That may cost less than $4-$5 billion in cash spent annually on repurchases.

- **There is a large bond portfolio as UNH does own insurance companies. Rising interest rates would hurt the value of that portfolio, but it does not book those unrealized losses/gains into income. They instead adjust the equity position.** A 100bp move is worth about $1.3 billion. They also have a short duration of only 3.5 years and a rating of AA.

- **Where the bond portfolio could create a problem is the insurance companies would see their equity capital decline if rates move up. UNH is funded by dividends and return of capital from its subsidiaries.** Of the $10.1 billion from subsidiaries last year, $6.9 billion came from regulated entities that have to watch statutory capital. There was a sizeable cushion in December of $22.7 billion in capital against minimum requirements of $9.7 billion. This is not a major concern at this point.

COVID Tailwinds/Headwinds – Strong Cash Flow from Rising Payables and a Wider Spread between Premiums and Medical Payments Should Reverse in 3Q and 4Q

A quick review of recent results shows that UNH had a sizeable benefit from COVID in 1Q and 2Q. This is due to cash flow gained from other payables (non-medical payables) and accruals rising. Also, during the lock-down period, UNH was still collecting premiums but customers were unable to get non-essential/check-up type medical visits. Therefore, premiums were flat but medical costs fell noticeably and that became higher income:

	2Q20	1Q20	4Q19	3Q19
Med Costs Payable	$19.2	$22.8	$21.7	$20.9
Qtr Med. Costs	$34.7	$41.0	$39.3	$39.0
DSP Medical Costs	50.5	50.7	50.4	48.9
Premium Rev.	$49.4	$50.6	$47.6	$47.4
Medical Ratio	**70.2%**	**81.0%**	**82.5%**	**82.4%**
Premiums - Med Costs	**$14.7**	**$9.6**	**$8.3**	**$8.4**
Other Payables/Accruals	$25.4	$22.9	$19.0	$18.6
Other Op. Costs	$17.5	$17.7	$15.8	$15.6
DSP Other Payables	132.4	117.8	109.7	108.7

	2Q19	1Q19	4Q18	3Q18
Med Costs Payable	$20.9	$21.1	$19.9	$19.9
Qtr Med. Costs	$39.2	$38.9	$37.0	$36.2
DSP Medical Costs	48.7	49.5	49.1	50.1
Premium Rev.	$47.2	$47.5	$44.9	$44.6
Medical Ratio	**83.1%**	**82.0%**	**82.3%**	**81.1%**
Premiums - Med Costs	**$8.0**	**$8.6**	**$7.9**	**$8.4**
Other Payables/Accruals	$17.1	$16.9	$16.7	$19.0
Other Op. Costs	$16.0	$15.9	$16.3	$15.2
DSP Other Payables	97.7	97.0	93.4	114.0

- Medical Ratio is quarterly medical costs divided by premium revenue – smaller figure = higher income.

Medical cost DSPs have held at basically 50 days for the last 8-quarters. However, other DSPs have increased noticeably in 4Q19, but the next change in dollar terms was only about $2 billion y/y. Since COVID, the y/y change became $6 billion in 1Q20 and over $8 billion in 2Q20. Also, related to the medical ratio, look at the amount of income produced

by premiums less medical costs. That figure has been about $8.0-$8.5 billion for all periods pre-COVID. Suddenly, it becomes $9.6 billion and $14.7 billion. These are the areas where UNH has picked up significant income and cash flow:

	2Q20	1Q20	4Q19	3Q19
Net Income	$6.7	$3.5	$3.7	$3.6
change A/P	$0.0	$5.3	$1.6	-$0.1
Cash from Ops	$10.0	$2.9	$6.2	$3.2

	2Q19	1Q19	4Q18	3Q18
Net Income	$3.4	$3.6	$3.2	$3.3
change A/P	-$1.0	$1.5	-$2.4	$1.0
Cash from Ops	$5.9	$3.2	$2.4	$0.9

We believe there will be headwinds in 3Q and 4Q that see some of these sources of cash reverse:

- Premiums will remain flat, but customers who deferred medical care will get those elective procedures and check-ups done. That should push the medical ratio from 70% to perhaps as high as 90% in the near-term.

- The income from premiums less medical costs could drop from close to $15 million to below the normal $8 million on a quarterly basis.

- As customers clear out the delayed treatments, medical cost payables should rise and help cash flow. However, other payables and accruals may be consuming cash as they are paid down.

- During 2Q, UNH also waived some premiums and saw fewer rebates coming through cash flow as customers used less medical care – those areas should return to help results. UNH is estimating it will see $1 billion in higher rebates coming in future quarters.

- All in all, we think 1H EPS of $10.84 was likely inflated by about $3 due to net COVID impacts. We expect much of that $3 to reverse back out in the next 2-3 quarters. UNH noted on the earnings call that patients' use of medical care was

back to about 90% of normal vs 60% in April. The rising medical costs returning to normal against largely flat premiums should be the biggest part of this headwind.

Rebates Are Still Helping Earnings, but Lower Medical Activity May Cause the Time Until Cash Collection to Lag in 2020, but Helping in 2021

The way rebates work is UNH estimates the amount of rebates to be received and nets them with premium revenues. So, most rebates go through the income statement at the time premium revenues are recognized. For non-affiliated customers – rebates are netted against cost of products sold. For other product revenues, these are equal to the cost of drugs net of rebates + a dispensing fee + customer co-pays. Thus, rebates work through the income statement at the time a premium is earned and a customer is eligible for medical service. UNH sets up a receivable for the rebates, that will become cash when paid. It may bill for the rebates monthly or quarterly and typically they are paid on a lag of 2-5 months. So, rebates impact income upfront and cash flow lags.

Rebates accrue in "other current receivables." It is defined as amounts due from pharmaceutical manufacturers for rebates and Medicare Part D drug discounts, accrued interest, and other miscellaneous amounts due to the Company. UNH details this annually. For December 2019, total other current receivables were $9.6 billion, with $4.7 billion being rebates and $2.3 billion Medicare Part D discounts – so 73% of that account.

As we would expect with the COVID lockdowns, the premium revenue kept coming in with estimated rebates accruing, but the volume of actual medical activity was down meaning the UNH couldn't bill for rebates. Thus, the receivable account rose and consumed cash flow:

Rebate DSOs	2Q20	1Q20	4Q19	3Q19
Other A/R	$11.4	$10.3	$9.6	$10.2
Premium Rev.	$49.4	$50.6	$47.6	$47.4
DSOs	21.1	18.5	18.5	19.5

Rebate DSOs	2Q19	1Q19	4Q18	3Q18
Other A/R	$8.4	$7.6	$6.9	$7.3
Premium Rev.	$47.2	$47.5	$44.9	$44.6
DSOs	16.3	14.7	13.9	14.5

As noted above, UNH generates rebates and discounts from more than just premium revenue, but that is the largest part of revenues. This account has grown more of late which we think is partially due to Medicare Part D changes. At both December 2019 and 2018 – UNH reported 9.0 million Medicare Part D users in its system. In 2019, it had a receivable of $2.3 billion for discounts for Medicare Part D vs. only $0.8 billion in 2018. The difference is about 2 days of receivables. We think this trend is why United Health expects to see rebates increase going forward too.

However, we can see that receivables rose over $1 billion on a slight sequential dip in revenues in 2Q20. We would expect to see that receivable number and DSO figure to decline by the end of 3Q and into 4Q as customers get their normal medical care and prescriptions. This should also offset some of the lost cash flow from lower earnings as medical costs rise faster than premium revenues.

Adjustments to Medical Costs Payable May Be a Headwind for the Rest of 2020

When UNH customers visit the doctor, the doctor submits a bill to UNH. UNH records this as a cost and a payable. The company reports that 90% of these bills are settled within 90 days. But there are some complications and estimates to the process:

- The patient may have had a procedure done by multiple healthcare providers. Some may submit a bill much quicker than the others.

- There may be follow-up procedures in some cases and the bills are not submitted for several months.

- There may have been complications that resulted in additional bills that are not completely known yet either.

- A patient has knee surgery that will require the knee to heal for a couple of months – then have 3 months of physical therapy.

UNH will estimate what the total expense may ultimately be and record it as an expense. It will then compare the actual costs to the estimate when the final figure is known. If the actual cost comes in below estimate – UNH will adjust by lowering costs recorded in a

future period when the resolution is known. If the cost comes in above estimates – UNH will record an adjustment to boost costs in that future period.

This can create a significant change in the costs if the estimate is +/- only a small percentage. Based on 2019 results, there is a sensitivity for +/- 75bp on income:

2019 sensitivity	-75bp	-50bp	-25bp	25bp	50bp	75bp
Medical Costs ($mm)	$584	$388	$194	-$193	-$384	-$575

So basically there is a $200-$600 million swing for adjusting this estimate between 25-75bp. To put this in some perspective, UNH had over $156 billion in medical costs in 2019. However, pretax earnings were about $18 billion in 2019. So, this small sensitivity range is 1-3% of income.

The first issue is we would think UNH could see periods when this estimate review produced both favorable and unfavorable adjustments. But we are not seeing that. Every period is showing a positive outcome. This continually helps earnings:

Estimate chg.	1H20	1H19	2019	2018	2017	2016	2015
Fav. Med Costs	$660	$400	$580	$320	$690	$220	320
Pretax Income	$13,370	$8,758	$19,685	$17,344	$15,209	$11,863	$10,231
% of Income	4.9%	4.6%	2.9%	1.8%	4.5%	1.9%	3.1%

The factors UNH is looking at when making these estimates include tracking similar cases at certain times of the year, percentages that have complications or hospitalizations historically, economic strength that may encourage/discourage patients from having procedures, and its own ability to control costs for procedures or completing the payment more efficiently.

We believe COVID may also have a negative impact on this earnings source in 3Q20. Many people wouldn't go to the doctor in 1Q and 2Q. Elective surgeries were delayed as well as annual check-ups. Even after that started to be available again in 3Q, schedules were not ramped up immediately. Also, we know of people who were rescheduled – but delayed again for having a COVID test that was too many days prior to their surgery or had visited another state within 14-days. In most quarters UNH is continually settling older estimates, but it also normally is incurring new ones. We think that has not been the case

in 2020. Thus, the backlog of estimates to be resolved may be low at this point. Look at the changes to total medical costs and adjustments in 2020:

Estimate chg.	2Q20	2Q19	1Q20	1Q19
Current Med Costs	$35,338	$39,584	$41,000	$38,939
Fav. Adjustment	-$80	-$100	-$580	-$300

Current medical costs dropped noticeably in 2Q (after spiking in 1Q), and the favorable adjustments did not create much of a drive to earnings. The company notes that it normally settles all bills within 90 days and all estimates are normally resolved within 12 months. We think the level of unresolved estimates has likely declined since March, creating less room for additional favorable adjustment. What drove earnings in 2Q was premiums still grew, but there was $4 billion in lower medical costs as people didn't go to the doctor. In 3Q and 4Q, there could be a bounce back in medical costs overall, which could reflect normal spending levels and picking up delayed procedures. At the same time, there may be a much smaller backlog of estimates to show a favorable adjustment.

This can also be seen in the account called IBNR – (Incurred But Not Reported) – Medical Costs. This account normally has some seasonality where it declines in 4Q. However, it normally rises y/y and that is not happening in the last two quarters:

$ in bills	4Q	3Q	2Q	1Q
IBNR 2020			$13.7	$14.3
IBNR 2019	$13.8	$14.2	$14.5	$14.3
IBNR 2018	$13.2	$13.8	$13.5	$13.3

This is unlikely to go to zero, but it may be a 1% tailwind for earnings instead of 3%-4% until the quantity of estimates rebuilds.

Growth Through Acquisition Issues

UnitedHealth routinely makes acquisitions often adding new types of services to offer existing clients. In 2019 and 2018, the company noted that acquisitions were immaterial to revenues and earnings after spending $14 billion:

"The results of operations and financial condition of acquired entities have been included in the Company's consolidated results and the results of the corresponding operating segment as of date of acquisition. Through December 31, 2019, ***acquired entities' impact on revenues and net earnings was not material.*** *Unaudited* ***pro forma revenues for the years ended December 31, 2019 and 2018 as if the acquisitions had occurred on January 1, 2018 were immaterial for both periods. The pro forma effects of the acquisitions on net earnings were immaterial for both years."***

From a cash flow perspective, UNH routinely spends all of its free cash flow on acquisitions, dividends, and share repurchases.

$ in bills	1H20	2019	2018	2017	2016	2015
Cash from Ops	$13.0	$18.5	$15.7	$13.6	$9.8	$9.7
Cap-Exp.	$0.9	$2.1	$2.1	$2.0	$1.7	$1.6
Acquisitions	$3.5	$8.3	$6.0	$2.1	$1.8	$16.2
Free Cash Flow	$8.5	$8.1	$7.7	$9.5	$6.3	-$8.0
Dividends	$2.2	$3.9	$3.3	$2.8	$2.3	$1.8
Repurchases	$1.7	$5.5	$4.5	$1.5	$1.3	$1.2

Given that acquisitions are material and frequent – we would consider them to be part of capital spending. That leaves the dividend at about 50% of free cash flow. Remember that so far in 2020, free cash flow as benefitted from customers being unable to visit doctors as they paid premiums. Thus, we do not consider the recent 26% payout ratio to be a realistic picture. The dividend looks solid enough at this point, as the share repurchases can be seen largely as a plug-figure in our view even though they are expected by investors.

Our issues with the acquisitions include the following:

- **Nearly all of the acquisition prices are allocated to intangible assets and goodwill.** In 2019, $9.9 billion spent on acquisitions was allocated as $2.0 billion in intangibles and $6.9 billion of goodwill. In 2018, $1.6 billion went to intangibles and $5.2 billion to goodwill.

- **The goodwill is not amortized at all, and the intangibles are amortized over 17 years for 2018 and 13 years for 2019 acquisitions. That compares to internally created assets that are either fully expensed immediately as wages and lower-income or are depreciated or amortized over a much shorter period.** Furniture/equipment is

depreciated over 3-10 years and capitalized software over 3-5 years. We think a case can be made that amortization should be happening at least twice as quickly.

- **UNH adds back all the amortization as a non-cash charge to adjusted earnings too. We would argue that the acquisitions clearly consumed huge amounts of cash and are ongoing every year**. If we look at the difference between UNH's adjusted EPS to GAAP EPS and then an EPS with a more reasonable amortization schedule (subtracting a double amount of amortization for intangibles and accounting for some amortization of goodwill) – it is obvious that a sizeable amount of UNH's EPS (about 22%) is due solely to the accounting assumptions behind acquisitions:

EPS issues	2019	2018	2017
Adjusted EPS	$15.11	$12.88	$10.07
Amortization added back	$0.78	$0.69	$0.57
GAAP EPS	$14.33	$12.19	$9.50
2x Amortization	$0.78	$0.69	$0.57
Goodwill on 40-year Amort.	$1.70	$1.50	$1.41
BTN Adjusted EPS	$11.85	$10.00	$7.52
EPS % from assumptions	22.0%	22.0%	25.0%

- 2017 also had a one-time adjustment on deferred taxes for tax reform that amounted to -$1.22 in EPS. Thus, actual GAAP EPS was $10.72 in 2017. We do consider that to be a one-time event and left its impact out of this table.

- **Also, supporting that these are actually cash expenses is UNH has $9.3 billion in liabilities that is a catchall for several items including,** *"__obligations associated with contingent consideration and payments related to business acquisitions__, certain employee benefit programs, amounts accrued for guaranty fund assessments, unrecognized tax benefits, and various long-term liabilities."* These are not quantified in more detail and clearly from the list, the full $9.3 billion is not solely an issue for acquisitions, but contingent payments for acquisitions is listed first. This may still be several billion dollars.

- **We cannot fully square how UNH is doing impairment tests for goodwill and the other intangible assets. It computes fair value of business units that are carrying the goodwill and intangibles on a discounted cash flow method** which makes forecasts for revenues, costs, productivity, and future capital needs. That is very

common and we don't have an issue with that method. **The problem we have is the company specifically says in the 10-K that the recent acquisitions had immaterial revenues and earnings.** The company is carrying $67.9 billion in goodwill and $10.6 billion in intangibles. For the 2019 and 2018 deals, that is $15.7 billion of these intangible assets. We would think to justify those large carrying values, there would need to be material revenues and earnings to result in some sizeable discounted cashflows.

- **There is almost no disclosure about the acquisitions either.** There are no details quantifying how much if any revenue growth or earnings growth came from deals. There are no details for multiples of EBITDA or sales paid. If there is one deal or twenty deals, they are all lumped together by year for total purchase price and total allocation of assets.

Our conclusion for the acquisitions from a positive standpoint is UNH can afford this source of growth. Cash flow more than covers deals in most years. Nor is UNH terribly leveraged – 2019 EBITDA pre-COVID was $22 billion vs. net debt of $26 billion.

Our conclusion for acquisitions from a negative standpoint is UNH earnings are being boosted by aggressive assumptions regarding expenses related to deals. The huge cash outlays and contingent payments point to acquisitions being a cash cost in our view. Also, we think the risk of an impairment of intangibles may be higher than many believe simply due to the significant amount of intangibles as the company also says some fairly large deals had immaterial earnings and revenues.

Share Repurchases Are Consuming Tremendous Cash Flow for Minimal EPS Growth

To UNH's credit, it does not add back stock compensation expense to adjusted EPS. We consider that a conservative policy. However, UNH is routinely issuing 10 million new shares annually from the exercise of stock options and realizing far lower cash inflow than it is spending to prevent the dilution. In 2019, it finally picked up some EPS growth from buying back twice as many shares as were issued and the impact was only 2% incremental EPS growth.

Repurchases	1H20	2019	2018	2017	2016
Fully diluted Shares	960	966	983	985	968
Shares Issued	8	10	10	26	9
Shares Purchased	6	22	19	9	10
Proceeds from Issuance	$870	$1,037	$838	$688	$429
Cash spent on Repurchases	$1,691	$5,500	$4,500	$1,500	$1,280
EPS Impact of Repurchases	$0.03	$0.25	$0.02	-$0.19	-$0.01
EPS growth rate from Repurchases	0.9%	2.1%	0.0%	-2.6%	0.0%

We showed the total spending on capital investments, acquisitions, dividends, and repurchases earlier. In our view, it will be difficult for UNH to maintain such large cash outlays on shares going forward. More importantly, the repurchases are not really adding much to EPS growth in most years. The yield on the stock is only 1.6% and the best year for share repurchases was 2019 with an incremental 2.1% EPS growth. Most years the repurchases are producing under 1% incremental EPS gains. We'd argue that investors would be better off if the repurchase money was spent on lowering operating costs or boosting revenue. Earnings growth of 1% could be achieved with $170 million in lower expenses against total expenses in 2019 of $222 billion. That's only 8bp of improvement and achieving that goal may cost less than $5.5 billion.

Interest Rate Risks May Not Have a Negative Impact on Earnings

Obviously, interest rates have declined during the COVID issues and may well increase as more normalcy reemerges. UNH has a $36 billion fixed-income portfolio with a duration of about 3.5 years. It is essentially one-half US government bonds, municipal bonds, and agency mortgage backs along with the other half in corporate bonds. The average rating is AA.

UNH notes that a 100bp move in interest rates causes a $1.3 billion swing in fair market value for the portfolio. The key is they carry these securities as Available-for-Sale. While they account for unrealized gains or losses, they are reported in comprehensive income:

> *"The Company **excludes unrealized gains and losses on investments in available-for-sale debt securities from net earnings** and reports them as comprehensive income and, net of income tax effects, as a separate component of equity."*

That means, UNH's reported earnings didn't benefit from falling interest rates and is unlikely to see much pressure from rising rates unless they sell the securities. The low

duration should also be a mitigating factor and enable the company to roll over maturing securities at higher rates under that scenario. The bulk of its debt is fixed too. We do not see much earnings risk from interest rates – and if rates rise for debt on roll-over, it should rise for securities rolling over too.

Dividends from Subsidiaries Is a Risk Worth Understanding but Is Not a Problem at this Time

If there is a risk from rising interest rates it may be in this area. A big part of UNH's parent company cash flow that pays the common stock's dividend, funds acquisitions, and share repurchases comes from dividends paid by subsidiaries plus other payments classified as return of capital. Some of these subsidiaries are regulated insurance companies which are likely where the bulk of the bond investments are located. So, if there is a 100bp rise in interest rates, it may not impact UNH's earnings, but it would lower the capital base at those subsidiaries. Here is the statement from the 10-K:

> *"**For the year ended December 31, 2019, the Company's regulated subsidiaries paid their parent companies dividends of $5.6 billion, including $1.3 billion of extraordinary dividends**. For the year ended December 31,2018, the Company's regulated subsidiaries paid their parent companies dividends of $3.7 billion, including$1.1 billion of extraordinary dividends. **The Company's regulated subsidiaries had estimated aggregate statutory capital and surplus of $22.7 billion as of December 31, 2019. The estimated statutory capital and surplus necessary to satisfy regulatory requirements of the Company's regulated subsidiaries was approximately $9.7 billion as of December 31, 2019**."*

This sounds like there is a considerable cushion and we do not want to overhype this as a risk factor. We just want to point out there are some considerations here and it is not always easy to move cash out of a captive insurance company. Also, all the subsidiaries paid $5.6 billion in dividends plus $4.5 billion was received as a return of capital – of that $10.1 billion, $6.9 billion came from the regulated companies.

At this point, we would only point out that all of the consolidated cash flow generated by UNH's subsidiaries may not be easily or fully accessible for the benefit of the parent company and its stockholders.

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:

> "***<u>Our data center expansion in particular requires significant capital commitments.</u>*** *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.

salesforce.com, inc. (CRM) EQ Review

Current EQ Rating*	Previous EQ Rating
4-	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 CRM with a 4- (Acceptable)

We have no major concerns with CRM's earnings quality at this point. On the surface, the company is displaying some red flags in the area of revenue recognition but at this point, we believe they have benign explanations and simply deserve attention in future quarters. Like most tech companies CRM adds back stock compensation and amortization of acquired intangibles. These adjustments are relatively high for CRM as they account for a large majority of adjusted profits. We also note the sensitivity of earnings to the company's selection of a benefit period for capitalized costs to obtain contracts. This report specifically discusses:

- Unearned revenue days of sales has been falling for the last several quarters. This is ordinarily a concern for a software company that recognizes ratably over its subscription terms as it can be an indication of either a slowdown in bookings or the company becoming more aggressive in recognizing revenue upfront. We do not see either as being the case with CRM and believe the decline is likely due to the acquisition of MuleSoft and Tableau. Both companies have a license component to their products which is recognized at the time of sale which could skew the percentage of CRM's revenue that is deferred. In addition, the remaining performance obligation under existing contracts continues to grow north of 20% which seems to rule out a slowdown in bookings. Nevertheless, the Tableau deal laps after the 10/20 quarter so we will view a continued decline in unearned revenue days after that with more concern.

- CRM's accounts receivable DSOs rose by 7.9 and 5.6 days, respectively. This is likely a reflection of the company extending payment times and slower collections in the COVID environment which the company has referenced multiple times.

- As required by accounting regulations, CRM capitalizes the costs of obtaining new contracts such as commissions paid to its sales force and bonuses paid to non-sales employees whose incentive pay is linked to contracts acquired. CRM amortizes these capitalized costs over 4 years for all contracts. This is longer than the average contract term as the estimate reflects the chance a customer will renew. CRM currently keeps 90% of its customers every year so a 4-year assumed benefit period does not seem unreasonable. This is a similar term utilized by some of CRM's peers. However, it is worth noting that if the company lowered the estimated benefit period to 3 years, it would take about 9 cps per quarter off EPS or an approximate 12% reduction.

- The amount of cost to obtain contracts that was capitalized in the first six months of 2020 rose to 4.8% of sales from 3.8% in the comparable year-ago period. Given that this could be impacted by the timing of signing contracts as well as the unusual nature of the current environment, we are not overly concerned about the change at this point. However, this should be monitored in future quarters.

- Like most tech companies, CRM chooses to add back stock-based compensation to its non-GAAP adjusted results. This adjustment is huge for CRM, amounting to 50-80% of non-GAAP operating income over the last few quarters. Also, if stock compensation was a cash expense, it would reduce free cash flow by about 60%. The share base grows by about 5% annually adjusted for acquisitions as the company does not currently buy back shares. This illustrates our point that stock option expense should be viewed as a cash expense as the company must choose to pay employees in cash, spend cash to buy back shares, or regularly dilute the shareholders.

- CRM also adds back the amortization of acquired intangibles to its non-GAAP results. This amounts to another 20-40% of adjusted earnings over the last few quarters. The bulk of these amounts are developed technology and customer relationships, assets which the company would have been required to spend its own cash on had it developed them internally. We are generally more concerned when we see amortization add-backs by a company that relies on acquisitions to post growth or where free cash flow can not cover distributions plus the acquisition spending. Neither is currently the case for CRM.

Revenue Recognition and DSO Increase

CEO Marc Benioff was one of the early promoters of the concept of "software as a service" under which companies would forego the old method of purchasing software to be installed on their servers and instead pay a subscription to access the service over the Web. In fact, CRM's first marketing statement was "The End of Software." It should therefore come as no surprise that the bulk of the company's revenue is in the form of Cloud services and support and update services. While the company's 2018 acquisition of MuleSoft and 2019 acquisition of Tableau Software did introduce some license software into the mix, licenses still represent less than 10% of CRM's revenue.

Under subscription services, the company books the revenue ratably over the subscription terms which typically run from 12-36 months. Customers are generally billed annually so the cash flow is received upfront while the associated revenue is deferred and recognized over time. The company has an excellent discussion in its SEC filings illustrating how the seasonality of billings and receipts impact revenue, receivables, unearned revenue, and operating cash flow. We also applaud the company for warning in its risk factor section that its revenue recognition method will result in a lag between business slowdowns and a slowdown in reported revenue growth:

> *"We generally recognize revenue from customers ratably over the terms of their subscription and support agreements, which are typically 12 to 36 months. As a result, most of the revenue we report in each quarter is the result of subscription and support agreements entered into during previous quarters. Consequently, a decline in new or renewed subscriptions in any one quarter may not be reflected in our revenue results for that quarter. Any such decline, however, will negatively impact our revenue in future quarters. Accordingly, the effect of significant downturns in sales and market acceptance of our services, and potential changes in our attrition rate, may not be fully reflected in our results of operations until future periods. Our subscription model also makes it difficult for us to rapidly increase our revenue through additional sales in any period, as revenue from new customers must be recognized over the applicable subscription and support term."*

As with most software companies, the early warning signs which could be indicating an upcoming revenue slowdown would include a sudden increase in accounts receivable or contract assets, a decline in unearned revenue days of sales, and/or a drop off in remaining performance obligation (RPO). We will evaluate these measures below:

Unearned Revenue

Most of the company's subscription agreements are on a calendar year time frame. Therefore, the company sends most of its bills in the fourth quarter and cash is received in the first quarter. When the bill goes out, a receivable is recorded with an offset to unearned revenue. A contract asset is recognized when the amount of revenue recognized under a contract exceeds what is billed. The unearned revenue account is reduced as revenue is recognized ratably over the subscription period. Cash flow is weighted towards the first quarter as the receivables are paid.

A decline in unearned revenue relative to sales could be an indication that either the company has signed up less contracted revenue to be booked in the future, or it has become more aggressive in recognizing revenue upfront. The following table shows deferred revenue on a days of sales basis for the last eight quarters:

Table 1

	7/31/2020	4/30/2020	1/31/2020	10/31/2019
Sales	$5,151	$4,865	$4,851	$4,513
Unearned Revenue	$8,711	$9,112	$10,662	$6,858
Unearned Revenue Days of Sales	155.6	168.6	202.2	139.8

	7/31/2019	4/30/2019	1/31/2019	10/31/2018
Sales	$3,997	$3,737	$3,603	$3,392
Unearned Revenue	$7,142	$7,585	$8,564	$5,376
Unearned Revenue Days of Sales	164.4	180.6	218.7	145.8

	7/31/2018	4/30/2018	1/31/2018	10/31/2017
Sales	$3,281	$3,006	$2,865	$2,701
Unearned Revenue	$5,883	$6,201	$6,995	$4,392
Unearned Revenue Days of Sales	165.0	183.6	224.6	149.6

We can see that deferred revenue days of sales has been declining for the last several quarters. While this would ordinarily be a red flag, one must consider that in the 7/18 quarter the company acquired MuleSoft and in the 10/19 quarter it acquired Tableau Software. Both of these companies' models include both software licenses and service and support services with the license components being booked upfront and the service and support components being booked over time. Sales associated with these acquired operations would naturally have a smaller amount of deferred revenue associated with them which would depress the company's overall deferred revenue days calculation.

Therefore, we are not overly alarmed by the sustained decline in unearned revenue, but note that the Tableau deal will lap itself after the 10/20 quarter so a continued decline in deferred days after that will generate much more concern.

Accounts Receivable:

Accounts Receivable arise when the company has sent a bill for new subscriptions or renewals but the cash has not been received. Most subscriptions are on a calendar year, so receivables rise in the fourth quarter as the company sends bills out to customers. For most industries, the main concern from an increase in accounts receivable relative to sales is that the company is pulling revenue into the current quarter at the expense of future quarters by offering more attractive payment terms. Given that CRM bills a year in advance this is much less of a concern. In CRM's case, a rise in DSOs more likely indicates delays in collection. The company's DSOs have, in fact, been increasing for the last two quarters, rising 7.9 days and 5.6 days year-over-year in the 7/20 and 4/20 quarters, respectively. The company has stated that it offered "financial flexibility" to customers in the first quarter to help with conditions created by COVID. Also, it made the following disclosure in the 7/20 10-Q:

> *"In the second quarter, payment delays from some of our customers affected by the COVID-19 pandemic continued. These delays in payments, in addition to changes in billing frequency for new business and investments in our go-to-market efforts, resulted in a negative impact to our operating cash flows during the quarter."*

We expect that most of these receivables will be collected and are not overly concerned by the increase in receivables at this point. The company does not disclose the allowance for doubtful accounts so we do not know the extent to which it has reserved for uncollectible accounts.

Capitalization of Costs to Obtain New Contracts

Under ASC 606 and ASC 340-40, CRM must capitalize all incremental costs to obtain a new contract. Consider the description in the company's 7/20 10-Q:

"The Company capitalizes incremental costs of obtaining a non-cancelable subscription and support revenue contract. The capitalized amounts consist primarily of sales commissions paid to the Company's direct sales force. Capitalized amounts also include (1) amounts paid to employees other than the direct sales force who earn incentive payouts under annual compensation plans that are tied to the value of contracts acquired, (2) commissions paid to employees upon renewals of subscription and support contracts, (3) the associated payroll taxes and fringe benefit costs associated with the payments to the Company's employees, and to a lesser extent (4) success fees paid to partners in emerging markets where the Company has a limited presence."

CRM also has leeway in selecting the amortization period for these capitalized costs. The following excerpt from the 7/20 10-Q discusses the company's selection of an amortization period.

"Costs capitalized related to new revenue contracts are amortized on a straight-line basis over four years, which, although longer than the typical initial contract period, reflects the average period of benefit, including expected contract renewals. *In arriving at this average period of benefit, the Company evaluated both qualitative and quantitative factors which included the estimated life cycles of its offerings and its customer attrition.* ***Additionally, the Company amortizes capitalized costs for renewals and success fees paid to partners over two years.***

The capitalized amounts are recoverable through future revenue streams under all non-cancelable customer contracts. The Company periodically evaluates whether there have been any changes in its business, the market conditions in which it operates or other events which would indicate that its amortization period should be changed or if there are potential indicators of impairment."

While accounting standards require the company to capitalize incremental commission costs, the company does have several areas of judgement which impact the expenses it recognizes.

First, standards do allow the company to immediately expense contract acquisition costs for terms less than one year. This is the case for software peer ANSYS. However, disclosures appear to indicate that CRM elects to capitalize all such costs. This likely has a limited impact for CRM given that most of its contracts run at least a year.

Also, the company must utilize judgment in the amortization period. In the case of CRM, it elects 4 years for all contracts. This is longer than the average subscription term, but takes into account the expected time that a new customer will continue to benefit the company by considering the likelihood of renewals. CRM disclosed that its attrition rate was less than 10% in the twelve months ended 7/30/20. If the company keeps more than 90% of its clients every year, then an estimated average benefit period for a new customer of 4 years does not seem unreasonable. By comparison, Citrix Systems' assumed benefit period for new customers is between 3-5 years. Note that CRM identifies the amortization period for capitalized contract costs as being a critical accounting estimate.

With this in mind, let's look at the development of the capitalized contract costs account for the last eight quarters which is shown in the table below:

Table 2

	7/31/2020	4/30/2020	1/31/2020	10/31/2019
Capitalized Contract Costs Beginning Balance	$2,052	$2,274	$1,916	$1,891
Capitalized New Contract Costs	$455	$25	$557	$246
Amortization of Costs to Obtain New Contracts	$250	$247	$253	$221
Capitalized Contract Costs Ending Balance	$2,257	$2,052	$2,274	$1,916

	7/31/2019	4/30/2019	1/31/2019	10/31/2018
Beginning Balance	$1,935	$2,020	$1,666	$1,668
Costs Capitalized to Obtain New Contracts	$173	$124	$550	$186
Amortization of Costs to Obtain New Contracts	$217	$209	$139	$190
Ending Balance of Capitalized Contract Costs	$1,891	$1,935	$2,020	$1,666

We are not overly concerned with the level of amortization expense for capitalized costs to obtain new contracts. As the following table shows, with the exception of an unusually low figure in the 1/19 quarter, amortization expense has remained fairly constant as a percentage of the average capitalized contract cost balance:

Table 3

	7/31/2020	4/30/2020	1/31/2020	10/31/2019
Amortization of Costs to Obtain New Contracts	$250	$247	$253	$221
Average Capitalized Contract Costs	$2,155	$2,163	$2,095	$1,904
Amortization % of Average Capitalized Costs	11.6%	11.4%	12.1%	11.6%

	7/31/2019	4/30/2019	1/31/2019	10/31/2018
Amortization of Costs to Obtain New Contracts	$217	$209	$139	$190
Average Capitalized Contract Costs	$1,913	$1,978	$1,843	$1,667
Amortization % of Average Capitalized Costs	11.3%	10.6%	7.5%	11.4%

This is a good place to point out that amortization of contract costs amounts to about 21 cps per quarter. Thus, cutting the amortization period to 3 from 4 years would shave about 9 cps off EPS each quarter which is about 12% of a typical quarter's adjusted EPS. Again, we are not arguing that CRM should be using 3 years, but this illustrates how material a change in assumption would be.

Also, it is important to monitor the amount of contract costs capitalized relative to sales. We can see from table 2 that the company capitalized an unusually low amount of contract costs in the 4/20 quarter which we suspect was related to COVID stalling new business signings. However, it made up for this with an unusually high amount of capitalization in the 7/20 quarter. Therefore, we will compare the amount capitalized for the six-month period ended 7/20 to the trailing 6-month sales to the comparable year-ago period:

Table 4

6 Months Ended:	7/31/2020	7/31/2019
Trailing 6-month Capitalized Costs to Obtain Contracts	$480	$297
Trailing 6-month Sales	$10,016	$7,734
% of Sales	4.8%	3.8%

CRM capitalized a larger amount of costs to obtain contracts as a percentage of sales in the most recent 6-month period compared to last year. However, this could be impacted by factors such as the timing of contract signings. Therefore, we are not especially alarmed by this for now, especially given the impact of COVID on the quarter. Nevertheless, this is an area to keep an eye on in the future.

Adding Back Stock Compensation Skews Profits

Like many tech companies, CRM chooses to add back stock-based compensation to its non-GAAP earnings figures. This expense is particularly large for CRM, and has ranged from 50-80% of non-GAAP operating income over the last eight quarters:

Table 5

	7/31/2020	4/30/2020	1/31/2020	10/31/2019
Non-GAAP Operating Income	$1,040	$635	$745	$874
Stock-based expense	$578	$504	$511	$543
% of Non-GAAP Operating Income	55.6%	79.4%	68.6%	62.1%

	7/31/2019	4/30/2019	1/31/2019	10/31/2018
Non-GAAP Operating Income	$573	$682	$596	$572
Stock-based expense	$388	$343	$329	$351
% of Non-GAAP Operating Income	67.7%	50.3%	55.2%	61.4%

In addition, the expense has been growing on a year-over-year basis for the last several quarters. This is likely due to the issuance of new shares in the 8/20 acquisition of Tableau for $14.8 billion making more employees eligible for stock-based compensation plans. CRM is currently not buying back shares, so even after adjusting for the shares issued in the acquisition, the share base increases by 10-20 million shares per quarter. This represents more than a 5% increase to the share base every year. While shareholders are being diluted by the increase in the share base, the company has more than adequate cash flow to buy back shares to offset the dilution if it chose to. However, this proves our point about stock-based compensation- it is a very real expense to shareholders. CRM will either have to pay the expense in cash, spend cash to buy back shares, or continue to dilute shareholders. Therefore, we consider the non-GAAP adjusted results to be very misleading as profits including this expense would be less than half what the adjusted results imply.

Also, let's consider what the company's cash flow would look like if it had to pay stock compensation in cash:

Table 6

	7/31/2020	7/31/2019	7/31/2018
T12 Operating Cash Flow	$4,218	$3,875	$3,101
T12 Capex	$743	$640	$541
T12 Free Cash Flow	$3,475	$3,235	$2,560
T12 Stock Compensation Expense	$2,136	$1,411	$841

In the most recent trailing 12-month period, free cash flow would have been reduced by 60%, versus 43% and 32% in the comparable 2019 and 2018 periods, respectively. As noted above, CRM does not spend cash buying back shares and it does not have a dividend. Cash and short-term investments exceed debt by more than $6 billion. Cash flow and liquidity

are clearly not problems. However, the size of stock compensation expense relative to free cash flow indicates how unrealistic it is to simply ignore it when analyzing adjusted profits.

Acquisitions and Adding Back Amortization

In addition to adding back stock-based compensation to non-GAAP results, CRM also adds back the amortization of intangible assets from acquisitions. The following table shows the size of these add-backs relative to non-GAAP operating income:

Table 7

	7/31/2020	4/30/2020	1/31/2020	10/31/2019
Non-GAAP Operating Income	$1,040	$635	$745	$874
Amortization of Intangible Assets	$284	$271	$270	$266
% of Non-GAAP Operating Income	27.3%	42.7%	36.2%	30.4%

	7/31/2019	4/30/2019	1/31/2019	10/31/2018
Non-GAAP Operating Income	$573	$682	$596	$572
Amortization of Intangible Assets	$127	$129	$130	$129
% of Non-GAAP Operating Income	22.2%	18.9%	21.8%	22.6%

The acquired intangibles consist of both developed software technology and customer relationships. CRM would have incurred expenses if it had developed these assets in-house, so to exclude them when analyzing profits is very unrealistic in our opinion. In addition, over 80% of goodwill and intangibles is comprised of goodwill which is not amortized at all under GAAP.

We are most concerned by adding back amortization when a company relies on acquisitions to drive growth and when free cash flow is unable to fund shareholder distributions and the acquisition spending. Neither is the case for CRM. As we noted in the previous section, the company utilized stock to make its $14 billion acquisition of Tableau last year. In 2018, cash flow after acquisitions was negative due to the $6.4 billion acquisition of MuleSoft, but cash flow has been adequate to fund acquisition activity since and cash exceeds debt by over $6 billion.

As far as growth goes, the company's revenue growth after backing out revenue from acquisitions is still in the 20% range, so it is hardly reliant on driving growth through debt-driven acquisition spending.

Macy's 2Q Quick Update

After 2Q results for August – Macy's noted that nearly all its stores had opened by the end of June. Sales were improving sequentially each month. The issue after 1Q had been inventory levels that were too high for the lower rate of sales. Macy's did successfully reduce inventory by $1.35 billion. DSI's are now 120 days vs 180 after 1Q. Y/Y DSIs are down from 135. The company should be set to see rising gross margins going forward through a combination of higher sales and less discounting. At the same time, they continue to expand offerings via the Vendor Direct program it built before COVID. We maintain our Buy recommendation as the company's liquidity has improved and the business is building back.

Explanation of EQ Rating Scale

Rating	Explanation
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.

Disclosure

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