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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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January 24, 2020 | www.btnresearch.com

Lamar Advertising (LAMR) – 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 a more detailed explanation of the EQ Review Rating scale, please refer to the end of this report

We initiate earnings quality coverage of LAMR with a 4- (Acceptable) rating.

Lamar Advertising (LAMR) is a real estate investment trust (REIT) that operates outdoor billboards as well as transit displays and highway logo advertising signs. Its services include ad copy production as well as placement and maintenance of the advertising material on its displays. As a REIT, its qualifying activities are not taxed at the corporate level and in return, it must pay out at least 90% of its earnings to shareholders in the form of dividends. Investors are therefore focused on the company's yield and its ability to maintain and grow its payout over time.

A popular measure for REITs is the AFFO (Adjusted Funds from Operation) payout ratio, or the company's dividend as a percentage of AFFO. This currently stands at 68% for LAMR. It currently yields 4.1% and grew its dividend by 5% in 2019. On the surface, these measures look attractive. While we do not have any large, immediate concerns with LAMR, we are concerned that the company's AFFO measure does not adequately reflect cash requirements to replace aging advertising structures. More specifically, we note:

- The company recorded real estate-related depreciation and amortization expense of $230 million for the 12-month period ended 9/19 which it adds back in its calculation of FFO (Funds from Operation). During the same period, it recorded total capital spending of $133 million and subtracted a maintenance capex estimate of $48.5 million to arrive at AFFO (Adjusted Funds from Operation) to reflect the ongoing cost of eventually replacing advertising structures in service. LAMR depreciates its dvertising structures over 5-15 years. Dividing the current advertising structure balance by the high end of 15 years implies annual depreciation expense of $190 million. This does not include the site location intangible assets picked up from acquisitions which is also amortized over 15 years. This implies another $150 million in annual real estate-related amortization expense. We are therefore concerned that the $45 million maintenance capex figure does not adequately reflect the eventual cost the company will incur to replace its billboards as they wear out.

- LAMR has been gradually shifting its mix of billboard displays to digital boards from the traditional static billboards. Since 2011, the number of static billboards has increased by about 9% while the number of digital boards has more than doubled. Capital spending on new digital boards has exceeded that of static boards for years. These digital boards are more expensive to install but generate higher revenue and profits per board given their higher advertising rates and their ability to display multiple ads per minute. New digital boards are expected to have an average service life of 10 years. However, much of the company's installed base of digital boards were picked up in acquisitions and many may be closing in on the end of their service lives. This could cause a quick ramp-up in spending to replace them over the next few years. We are already starting to see an acceleration in capital spending on digital boards which jumped by more than 20% in the nine-month period ended 9/19.

- Dividend growth has outrun free cash flow growth in recent years and the dividend now consumes more than 80% of free cash flow. In addition, much of the growth in recent years has come through acquisition with cash spent on acquisitions far exceeding free cash flow after the dividend. The company's debt covenants require the total net debt ratio to stay below 6.5 and the secured debt ratio below 3.5. Total net debt was 4 times at the end of the 9/19 quarter, but we estimate the secured debt ratio was about 3.3.

- On the positive side, LAMR can cut its growth capex and acquisition spending quickly which can allow it to limit free cash flow declines during downturns. In the wake of the 2008 financial crisis, LAMR slashed its capital spending and actually saw free cash flow grow in 2009 and 2010.

- On January 1, 2018, the company adopted ASC 606 for revenue recognition. This had a negligible impact on the company as the bulk of its contracts were accounted for as leases under ASC 840. However, on January 1, 2019, LAMR adopted ASC 842 for lease accounting. Its contracts no longer qualified for lease accounting under the new method and the company was required to account for its contracts under ASC 606 which requires it to capitalize the cost of setting up advertising material on billboards under new contracts and amortizing it over the contract term. The company adjusted the beneficial impact out of its calculation of adjusted EBTIDA and AFFO, but not FFO. Reported FFO growth was 12.6% for the 9 months ended 9/19, but this falls to 10.8% after adjustment for the accounting change. We do not see this a huge problem given most investors will focus on AFFO. However, investors should be aware of the impact on FFO and be monitoring it going forward.

Capex Is Lagging Depreciation and Maintenance Capex Seems Light

As a real estate investment trust (REIT), LAMR is a capital-intensive business on which investors are mainly focused on its ability to maintain and grow its cash distributions. As a REIT, it is required to pay out at least 90% of its earnings as dividends to shareholders. This leads to investors focusing on cash-related measures of performance including earnings before taxes, depreciation and amortization (EBITDA), Funds from Operation (FFO) and Adjusted Fund from Operation (AFFO). The components of those measures are shown below for the last three trailing 12-month periods ended September:

Table 1

Trailing 12 Months as of:	9/30/2019	9/30/2018	9/30/2017
Adjusted EBITDA	$764.531	$705.566	$666.681
		-	-
Reconciliation of Net Income to FFO			
Net income	$365.051	$296.703	$311.037
Depreciation and amortization related to real estate	$230.436	$210.572	$194.569
Gain from disposition of real estate assets and investments	-$4.709	$8.279	-$6.883
Non-cash tax benefit for REIT converted assets	-$17.031		
Adj. for uncons. affiliates and non-controlling interest	$0.824	$0.644	$0.867
Funds from Operations (FFO)	$574.571	$516.198	$499.590
		-	-
Reconciliation of FFO to AFFO			
Straight-line income	-$2.033	-$0.592	-$0.358
Impact of ASC 842 adoption (lease accounting standard)	-$6.955	$0.000	$0.000
Stock-based compensation expense	$24.776	$25.284	$15.970
Non-cash portion of tax provision	$2.535	$1.242	$0.066
Non-real estate related depreciation and amortization	$14.724	$12.780	$12.663
Amortization of deferred financing costs	$5.270	$4.916	$5.206
Loss on extinguishment of debt		$15.429	$0.071
Capitalized expenditures—maintenance	-$48.543	-$41.812	-$42.908
Adj. for uncons. affiliates and non-controlling interest	-$0.824	-$0.644	-$0.867
Adjusted Funds from Operations (AFFO)	$563.521	$532.801	$489.433
Diluted AFFO per share	$5.63	$5.39	$4.99

EBITDA excludes depreciation and amortization which makes it very misleading as a measure of how much money is available for distribution to shareholders. LAMR owns and leases the parcels of land on which it constructs its advertising billboards. It adds to these assets both by developing its own sites as well as obtaining them via acquisitions. These structures represent the bulk of the assets on its balance sheet. They are recorded under PPE and are depreciated over a period ranging from 5-15 years. When the company makes an acquisition, it records some of the purchase price under property, plant and equipment (PPE), but the largest component of an acquisition is typically an intangible acquisition entitled "site locations" which it amortizes over a 15-year period. The following table shows the gross balances for both:

Table 2

	12/31/2018	12/31/2017
Advertising Structures (in PPE)	$2,817	$2,704
Site Locations in Intangible Assets	$2,229	$2,072
	$5,046	$4,776

Using the high end of 15 years gives us a rough annual depreciation expense for PPE of about $190 million ($2.8 billion/15 years). Likewise, an amortization period of 15 years for site locations implies another $150 million in amortization expense. The company's calculation of FFO from Table 1 above shows the company adding back $230 million to net income in the most recent trailing 12-month period to net income to arrive at FFO, far below the combined depreciation of advertising structures plus amortization of site locations of $340 million. Not all of the site location intangible assets pertains to actual advertising structures, but we still believe there is still an element of replacement cost reflected in the balance that should be reflected in real estate amortization. As such, the company's reported depreciation and amortization expense related to real estate seems low.

Adding back this depreciation and amortization does not account for the cash flow that the company will have to spend in the upcoming years to replace these assets as they wear out. LAMR does disclose a breakout of capital spending on an annual basis that gives more detail on growth capex versus maintenance and improvements:

Table 3

	12/31/2018	12/31/2017	12/31/2016
Gross Real Estate Assets Beginning Balance	$3,074.046	$2,998.540	$2,856.243
Capex on New Advertising Displays	$54.151	$49.946	$50.799
Capex on Improvements/redevelopments of Existing Displays	$12.781	$6.265	$12.031
Capex Other Recurring	$34.758	$32.523	$26.254
Land Acquisitions	$15.368	$14.904	$30.283
Acquisition of Advertising Displays	$82.617	$32.109	$69.821
Assets Sold or Written-off	-$70.494	-$61.306	-$47.317
Foreign Exchange	-$1.793	$1.065	$0.426
Balance at End of Year	$3,201.434	$3,074.046	$2,998.540

The total of the "Capex on Improvements and Redevelopments" line and the "Capex Other Recurring" line is $47.5 million which is reasonably close to the "Maintenance Capex" amount for that period of $43 million. However, given the company's reported depreciation and amortization of real estate and our estimate of depreciation and amortization of advertising structures and site locations, we question how realistic a mid-$40 million maintenance capex figure is. Therefore, we believe reported AFFO does not adequately reflect how much cash the company will have to spend in the future to replace aging assets. As we discuss below, we believe the growth in true maintenance capex will accelerate in upcoming years due to the shift to digital billboards.

Digital Boards May Drive Acceleration in Maintenance Capex Growth

We also believe that in the future, the maintenance capex number is likely to rise faster than the addition of new boards given the mix shift to digital boards.

For several years, LAMR has been expanding its collection of digital billboards more quickly than its traditional static billboards. Table 5 below shows the breakdown of its static versus digital billboards since 2011 and the percentage of revenue coming from digital boards:

Table 5

	2018	2017	2016	2015	2014	2013	2012	2011
Total Billboard Displays	156,900	149,900	149,000	144,000	144,000	145,000	144,000	143,000
Growth	4.7%	0.6%	3.5%	0.0%	-0.7%	0.7%	0.7%	
Static Billboards	153,800	147,100	146,400	141,700	141,900	$143,120	142,300	141,600
Growth	4.6%	0.5%	3.3%	-0.1%	-0.9%	0.6%	0.5%	0.0%
Number of Digital Billboards	3,100	2,800	2,600	2,300	2,100	1,880	1,700	1,400
Growth	10.7%	7.7%	13.0%	9.5%	11.7%	10.6%	21.4%	0.0%
Digital Rev. % of Total Billboard Rev.	24%	22%	21%	19%	18%	18%	15%	14%

We can also see the focus on digital boards in the company's breakdown of its capital spending by category which is shown below for the last three trailing 12-month periods ended September:

Table 6

	9/30/2019	9/30/2018	9/30/2017
Billboards - traditional	$48.570	$36.237	$37.387
Billboards - digital	$53.226	$43.860	$37.992
Logo	$11.591	$10.205	$8.769
Transit	$3.280	$6.662	$0.675
Land and buildings	$8.312	$12.116	$9.987
Operating equipment	$8.165	$7.977	$8.423
Total capital expenditures	$133.144	$117.057	$103.233

Since 2011, the company has increased its number of static billboards by about 10% while it has more than doubled its number of digital billboards. The gradual shift to digital boards is a key part of the company's overall growth strategy as digital boards draw considerably higher rents per ad than static boards. In addition, the displays multiple ads per minute, allowing one board to display ads from multiple advertisers. Profitability per board is, therefore, higher than that of a comparable static board despite the higher cost to acquire.

The estimated life of new LED billboards is about 10 years. Therefore, boards placed into service in the 2010-2011 time frame are nearing the end of their lives and will be needing replacement. It is key to realize that much of the increase in billboards has come from acquisitions. While the company does not give consistent detailed information on the number of boards acquired and divested each year, we do know that it acquired approximately 9,300 billboards in acquisitions made during 2018. This implies that without the acquisitions, the number of billboards at the end of 2018 would have been approximately 147,600 which is 1.5% below the ending number of billboard displays as of 2017. We know that the company does divest assets, so the 2018 number was likely reduced by that. Therefore, it is possible that the 1.5% acquisition-adjusted decline estimated above is too pessimistic. Regardless, the data indicates that acquisitions have been a key driver in the recent growth in the installed base of billboards. This is important from the standpoint of depreciation and upcoming replacement costs since one cannot assume that all the digital billboards added in recent years were new and have ten years left on their lives. The ones picked up in acquisitions could actually be nearing the end of their lives and will require replacement in the not-too-distant future. In fact, we can see from the capex breakdown in Table 6 above that capital spending on digital billboards rose by more than 20% ($53.2 M vs $43.9 M) in the trailing 12-month period ended 9/19. We would expect this trend to continue going forward which could eat into both free cash flow and AFFO growth.

The Dividend Is Growing Faster Than FCF and Acquisitions Are Consuming More

The following table shows that while LAMR's cash flow from operations is growing, cash spending on the dividend is growing even faster:

Table 7

	T12 9/19	2018	2017	2016	2015	2014
Cash flows provided by operating activities	$602.727	$564.846	$507.016	$521.823	$477.650	$452.529
Capital expenditures	$133.144	$117.638	$109.329	$107.612	$110.425	$107.573
Free Cash Flow	$469.583	$447.208	$397.687	$414.211	$367.225	$344.956
Dividends/distributions	$380.305	$443.088	$244.201	$293.965	$265.510	$238.800
Dividends/distributions % of FCF	81.0%	99.1%	61.4%	71.0%	72.3%	69.2%
Acquisitions	$643.807	$477.389	$297.305	$585.054	$153.877	$65.021
Free Cash After Dividend and Acquisitions	-$563.211	-$473.269	-$143.819	-$464.808	-$52.162	$41.135

Note that the spike in the dividend in 2018 was driven by the timing of the payment of the dividend. Regardless, the dividend now consumes over 80% of free cash flow compared to less than 70% in 2014. If capital spending accelerates due to older digital boards requiring replacement as we explored in the above section, this will cut into free cash flow growth and push the dividend percentage of free cash flow even higher.

As we noted above, the company has been growing more in recent years from acquisitions. Cash spending on acquisitions has more than consumed cash after the dividend for the last several years, which has driven debt-to-adjusted EBITDA to 4.0 from 3.6 at the end of 2017. The company's debt covenants require it to keep its total debt ratio below 6.5 and its secured debt ratio below 3.5. Total net debt to adjusted EBITDA was approximately 4x at 9/19 and we estimate the net secured debt ratio was approximately 3.3x.

LAMR Can Cut Growth Capex in the Event of a Slowdown

LAMR reorganized as a real estate investment trust (REIT) during 2014. As such, it is required to pay out at least 90% of earnings in the form of distributions and dividends. Since that time, it has grown its dividend, posting 5.2%, 9.9% and 12.2% growth for 2019, 2018, and 2017, respectively. Given what we have shown above- the rising payout, the large amounts of cash spent on acquisitions leading to higher debt ratios, and the possibility of rising capex from aging digital boards, we believe dividend growth may come under continuing pressure in the years ahead.

This situation might seem to raise concern of a dividend cut in the event of an economic slowdown. However, we should point out that in the past, the company's free cash flow has held up surprisingly well during times of economic stress. It takes a few months for its contracts to begin to wind down and in that time, the company is able to scale its growth capital spending back significantly. Below is an interesting slide the company used to include in its investor presentations that demonstrates how it was able to salvage free cash flow in the wake of the Financial Crisis by cutting capex:

Lamar Advertising Co. ($mm)	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	9 months ended Sept 2014
Adjusted EBITDA[1]	**$555.9**	**$512.1**	**$440.5**	**$467.0**	**$484.3**	**$511.3**	**$545.1**	**$407.4**
Less:								
Interest expense, net	155.3	153.0	177.1	168.7	152.0	139.0	131.4	77.0
Current tax expense (benefit)	31.0	(10.7)	(16.0)	1.1	2.8	1.9	4.0	8.7
Preferred dividends	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.3
Capital expenditures	220.5	198.1	38.8	43.5	107.1	105.6	105.7	83.9
Free cash flow	**$148.7**	**$171.3**	**$240.2**	**$253.3**	**$222.0**	**$264.4**	**$303.6**	**$237.5**

Lamar has the ability to reduce maintenance capex, allowing it to protect AFFO even in difficult economic cycles

Obviously, the company can completely discontinue acquisition spending in the event of a crisis. Cutting growth capex and acquisitions would obviously eat into growth, but this puts in perspective that an economic slowdown does not automatically translate to a dividend cut for LAMR at this point.

Change in Accounting Method Adding Slight Boost

On January 1, 2018, LAMR adopted ASC 606 for revenue recognition. The main difference for the company was the requirement to capitalize the cost of installing advertising material on displays under new contracts and amortize the cost over the period the ad was expected to run. At that time, the bulk of the company's contracts were accounted for as leases under ASC 840, so the adoption of ASC 606 had an immaterial impact on results at that time. However, on January 1, 2019, the company adopted ASC 842 for lease accounting. Its contracts do not qualify for treatment as leases under the new method, so the company was required to account for its contracts under ASC 606. LAMR explained this in its 9/19 10-Q as follows:

> *"The majority of our billboard, logo, and transit advertising space contracts commencing prior to January 1, 2019 are accounted for under ASC 840 and will continue to be accounted for under the topic until they are completed or modified.*

Advertising space contracts commencing or amended on or after January 1, 2019 which do not meet the criteria of a lease under ASC 842 are accounted for under ASC 606, Revenue. ***The majority of our new and modified advertising space contracts do not meet the definition of a lease under ASC 842.***

Due to the transition of our advertising space contracts into ASC 606 we are now required to capitalize our costs to fulfill a contract and expense the costs over the contract period. These costs include our costs to install advertising copy onto billboards. These costs were expensed as incurred under ASC 840*. During the [9-month] period ended September 30, 2019, we capitalized $19,348 of costs to fulfill a contract which is included in other current assets on the Condensed Consolidated Balance Sheets, net of expensed costs of $9,364. The expensed costs are recorded in direct advertising expenses (exclusive of depreciation and amortization) in the Condensed Consolidated Statements of Income and Comprehensive Income."*

Referring back to Table 1 above, one can see that LAMR adjusted the net impact of the adoption of ASC 842 out of its calculation of AFFO, and it is taken out of its Adjusted EBITDA figures. However, the impact is not taken out of FFO. For the nine months ended 9/19, reported FFO grew by 12.6%, but this falls to 10.8% after adjustment for the accounting change. We realize most investors will be paying more attention to adjusted EBITDA and AFFO, but they should be aware of the impact on FFO.

Explanation of EQ Rating Scale

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