

## United Rentals, Inc. (URI) Earnings Quality Review

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

*We are initiating earnings quality coverage of URI with a 4+ (Acceptable) rating.*

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

### Summary

United Rentals has been beating estimates handily in 2020 with a 76-cent beat in 4Q. Paying down \$2 billion in debt during the year and refinancing more at lower rates helped URI cut interest expense to add 46-cents in the 4Q. Bad debt reserves fell by \$6 million adding 6-cents to 4Q EPS and the valuation allowance on tax items improved by \$19 million over the year too for 26-cents, some of which may have impacted the 4Q. Even things being adjusted out of EPS were all expected. So the earnings beat was real in our view.

The adjustments added back to GAAP earnings are also understandable. We only have an issue adding back amortization of acquired intangibles, but URI gets praise for using a short amortization period.

The bigger concerns relate to heavy capital spending making EBITDA a poor way to evaluate the full situation. It also makes the low debt levels reached in 2020 more likely to rise again in 2021. Plus, the ROI was 12.9% in 2020. However, changing the assumption on the depreciation lives on the huge amount of rental equipment by only 1-year would move ROI to 11.2% or 14.1%.

### What is strong?

- Acquisition accounting quality is strong. URI buys similar companies that are easy to integrate with modest synergy targets involving combining rental centers. It pays

multiples below its own and generally assigns about half the value to equipment that will be expensed via depreciation. Intangibles beyond goodwill are amortized over 5-10 years, which we think is very conservative.

- Restructurings are limited in scope and are actually completed and go away. URI has made over \$10 billion in deals in recent years, yet restructuring has been only \$350 million – largely tied to eliminating duplicate real estate. Impairments have been minor also – not related to acquired assets.
- Adjusted EPS is often \$3-\$5 higher than GAAP EPS. However, the bulk of this is one-time or very short-term items such as refinancing debt or restructuring items following a deal. We expect the difference to decline going forward.

### What is weak?

- The largest negative we have with URI acquisitions is adding back amortization of intangibles which is half the adjustment between GAAP and non-GAAP EPS. Our view is these items cost cash and contribute to revenue and earnings – but ignoring them omits a key cost of generating that growth. We do like that URI uses short amortization lives and there should be a noticeable drop in this cost and adjustment in 2023 and 2025.
- Using EBITDA to justify how much debt URI can carry is the wrong way to view this company in our opinion. URI's \$4 billion in EBITDA ignores that URI's capital spending is normally over \$2 billion and recycling the equipment also produces about 10% of EBITDA via asset sales. Capital spending simply isn't optional and without selling used assets EBITDA would be lower. After 2020's cutback during Covid – we expect capital spending to rise much higher.
- Even URI highlights Free Cash Flow as a metric to follow for debt carrying capacity, which is normally about \$1.6 billion vs. EBITDA of \$4.0 billion. Making some modest adjustments just for rental equipment capital spending, we can quickly boost URI's debt/EBITDA ratio from 2.4 to over 3.2x.

### What to watch

- URI is carrying over \$5 billion in goodwill. It has been able to pull some cost savings out of deals and it has some tailwinds with more customers using its balance sheet to rent equipment. The ROI was 12.9% in 2020, which does not amaze us. However, changing the depreciation lives of rental equipment by only 1-year would move ROI to 11.2% or 14.1%. A one-year change in asset lives could feasibly happen, and it makes a material impact on ROI and EPS (\$1.79 - \$2.32).

- By cutting back on new equipment spending by over \$1 billion, URI was able to apply that cash along with cash that normally goes to share repurchases toward debt reduction in 2020. Debt declined by \$1.9 billion. Also as a result and refinancing debt at lower rates, interest expense was declining notably by 4Q20 – down \$45 million or 46-cents in EPS of the adjusted \$5.04. We believe capital spending will return to higher levels and likely cause debt figures to rise in 2021.
- URI carries a large debt load. It has extended maturities and locked in some lower rates of late. Over time, if rates increase, it could become a headwind for EPS. Based on 2019-2020 debt levels – a 100bp change in interest expense is about \$0.97-\$1.14 in annual EPS.
- URI spends its free cash flow purchasing shares if it has not made a sizable deal. They should get kudos for actually seeing the share count decline as a result. Shares are down from 85.6 million in 2017 to 72.9 million in 2020. This added 5.0% to EPS growth in 2020 and 4.2% in 2019. 2020 was a much smaller repurchase and 2021 may see more cash going to capital spending – so this could limit share repurchases and EPS growth.

### Supporting Details:

#### EBITDA May Be Too Aggressive of a Metric to Focus Upon at United Rentals

United Rentals is very clear that it wants to keep its debt at between 2-3x adjusted EBITDA. On the surface that does not sound terribly high and they are at 2.4x after 2020. Adjusted EBITDA was \$3.9 billion in 2020 and the forecast is for 2021 is \$4.1 billion. Total net debt is \$9.5 billion.

The over-riding issue we see is much of URI's income and EBITDA comes from heavy capital spending and selling used equipment. This essentially makes depreciation a cash expense in our view:

	2020	2019	2018	2017	2016	2015	2014
Rent Eq. Depreciation	\$1,601	\$1,631	\$1,363	\$1,124	\$990	\$976	\$921
Rent Eq. Purchases	\$961	\$2,132	\$2,106	\$1,769	\$1,246	\$1,534	\$1,701
Rent Eq. Sold	\$858	\$831	\$664	\$550	\$496	\$538	\$544
Net Purchases	-\$103	-\$1,301	-\$1,442	-\$1,219	-\$750	-\$996	-\$1,157
Gross PP&E	\$14,206	\$14,852	\$13,962	\$11,571	\$9,413	\$9,022	\$8,527
Gross PP&E/Deprec.	8.9	9.1	10.2	10.3	9.5	9.2	9.3

We think it is important to keep in mind that:

- URI recycles capital by selling older equipment as it starts to reach 7+ years old
- Having newer equipment is key to keeping customers happy and even though some have 20-year lives, URI has determined that it gets a better balance on resale value if it recycles by about years 8-10.
- Based on recent results, the net capital spending on new rental equipment largely consumes all the cash provided by depreciation. This does not look discretionary to us. During Covid – URI spent more on new equipment net of sold units, but cut spending by over \$1 billion. That may be tough to repeat.
- This is not all of URI's capital spending or depreciation which also includes real estate items, and purchases and sales of non-rental equipment.
- While ignoring capital spending on equipment or cutting back can be done for a year or maybe two – it is unlikely for it to be possible without impacting EBITDA.
- We would argue that at least \$1 billion of depreciation going into EBITDA will be a necessary cash outlay to sustain the business.

**In addition, URI is reporting income from selling used equipment. This is about 10% of gross profit (\$332 million vs. \$3.2 billion) – and we will guesstimate it would make up about 10% of EBITDA after being netted against some SG&A costs. If URI was keeping equipment longer – to reduce capital spending, it would not have equipment to recycle and sell. The income from used equipment sales would vanish from EBITDA. One of the costs of achieving this income is purchasing equipment through capital spending.**

Then there are assets that URI leases and in turn re-rents out to customers. These assets are not producing depreciation as they are operating leases. The amount of income being made is fairly small - \$18 million in 2020 and \$13 million in 2019. But, there are operating leases not being included in debt as a result of these deals. URI reports \$727 million for the present value of operating leases. Much of this is real estate rent for various operating locations. We wouldn't want to add back more than about \$300 million as equipment on lease being rented to clients. That should boost the actual debt level too.

We would argue that just the depreciation to capital spending deficit and the need to include the income from equipment sales in EBITDA justifies about \$1.0 billion in lower EBITDA. That cash is simply not available to service debt. It would add \$300 million of lease obligations to debt. These are not firm numbers, but it shows a more realistic view of basic EBITDA in this case. \$9.5 billion of debt over \$4.1 billion in EBITDA for 2021 is 2.3x. But it quickly rises to 3.2x with debt of \$9.8 billion over \$3.1 billion of more realistic EBITDA.

**What we find interesting is even United Rentals points to Free Cash Flow in the 10-K as, “Management believes that free cash flow provides useful additional information concerning cash flow available to meet future debt service obligations and working capital requirements.”**

Obviously, cash from operations already has interest expense lowering the starting figure and adds back all depreciation and amortization of acquired intangibles too. URI also deducts all capital spending – both rental equipment and non-rental equipment and gives itself credit for the asset sales too. Basically, management is using GAAP figures and accounting for all the ongoing necessary cash outlays describing free cash flow in the 10-K. This is more punishing than the adjusted EBITDA figure we described above:

	2020	2019	2018
CFO	\$2,658	\$3,024	\$2,853
Rent Eq. Purchases	-\$961	-\$2,132	-\$2,106
Other Purchases	-\$197	-\$218	-\$185
Sales of Eq.	\$858	\$831	\$664
Other Sales	\$42	\$37	\$23
Insurance proceeds	<u>\$40</u>	<u>\$24</u>	<u>\$22</u>
Free Cash Flow	2440	1566	1271

Again, it looks obvious that 2020 was at least \$1 billion light on buying new equipment and was the difference between United Rentals posting \$2.4 billion instead of \$1.4 billion in free cash flow.

### Some More Notes on Debt

URI is likely to always have a fairly high debt balance given the level of capital investment here. On the positive side – the company only has its securitization facility that needs to roll over in 2021. There are no maturities until 2024. And, it has locked in some lower interest rates.

On the negative side, given how little URI spent on new rental equipment in 2020, we expect it to boost its debt in 2021 returning to more normal spending if not exceeding it. Also, while not an immediate issue given how the debt stands now, URI’s earnings could face headwinds if new debt comes in at higher rates and/or other debt has to be refinanced at higher rates. We see this as more of a threat beyond 2021.

It is also worth noting that EBITDA is inflated by URI adding back stock compensation, which is a recurring expense. Plus, it does not adjust EBITDA down from the principal payments made on capital leases. Neither of these is a game-changer in moving EBITDA up or down significantly.

## The Basics of URI Past Acquisitions Do Not Appear Aggressive

United Rentals largely uses its free cash flow to make some acquisitions and repurchase stock. This is still not a heavy growth-through-acquisition story. Many deals are very small and the large ones do not happen frequently:

	2020	2019	2018	2017	2016	2015	2014
Cash from Ops	\$2,658	\$3,024	\$2,853	\$2,209	\$1,941	\$1,995	\$1,801
Purchased Equip.	-\$961	-\$2,132	-\$2,106	-\$1,769	-\$1,246	-\$1,534	-\$1,701
other CapX	-\$197	-\$218	-\$185	-\$120	-\$93	-\$102	-\$120
Sold Equipment	\$858	\$831	\$664	\$550	\$496	\$538	\$544
Other sold Equip	\$42	\$37	\$23	\$16	\$14	\$17	\$33
Free Cash Flow	\$2,400	\$1,542	\$1,249	\$886	\$1,112	\$914	\$557
Acquisitions	\$2	\$249	\$2,966	\$2,377	\$28	\$86	\$756
Stock Repo	\$286	\$870	\$817	\$56	\$528	\$789	\$613

- With URI trading at 8.2x trailing adjusted EBITDA and 7.8x forecasted EBITDA for 2021, the company has not paid a premium for its larger deals:

Acquisition	Year	Price \$bill	Pr/EBITDA
Blueline	2018	\$2.1	6.7
Baker	2018	\$0.7	9.0
Neff	2017	\$1.3	6.3
NES	2017	\$1.0	6.2

- URI also should have some likely synergy targets such as consolidating equipment sites with fewer employees – yet they didn't make forecasts for outlandish cost savings:

Acquisition	Synergy \$mm	EBITDA \$mm	Adj EBITDA price
Blueline	\$45	\$313	5.4
Baker	\$19	\$79	6.6
Neff	\$35	\$207	5.4
NES	\$40	\$155	4.3

We don't see EBITDA as the proper metric to use at URI given that net capital spending for rental equipment is generally equal to or greater than the depreciation of the rental equipment – effectively making depreciation a cash expense. But on the surface, we see many companies trading for 9-10x EBITDA making a purchase at 16x and claiming that really they only paid 6-7x

because there is so much synergy to find. Thus, URI paying a lower multiple than it is trading for and not promising to eliminate half the operating costs of the acquired target builds in some conservatism for forecasts.

There is goodwill here too, but URI is amortizing other intangibles over a reasonable time frame. When URI builds internally, it amortizes the primary asset (rental equipment) over 2-20 years. The acquired intangibles are largely customer relationships and are being amortized over 5-10 years. Also, rental equipment is a large part of these, deals normally 50% or more, which are depreciated at the same rates as other URI equipment:

Acquisition	Rental Eq.	Goodwill	Intang	
Blueline	\$1,081	\$690	\$230	5 yrs
Baker	\$268	\$247	\$166	8 yrs
Neff	\$550	\$587	\$153	10 yrs
NES	\$571	\$209	\$138	10 yrs

Goodwill is about one-third of the assets here and is not being amortized. Again, that is a far cry from many deals we see at other companies where it is 70%-80%. Plus, other intangibles are being amortized over a reasonable period and rental equipment is about the acquired assets.

### Looking at Adjusted EPS – There Are Acquisition Items Making a Difference

URI makes several adjustments to EPS. The majority are related to acquisitions. We still think one of the largest distortions is not amortizing the \$5.16 billion of goodwill. If that was expensed over 40-years, it would lower GAAP EPS by \$1.77 per share.

EPS Adjusted	2020	2019	2018
GAAP EPS	\$12.20	\$15.11	\$13.12
Merger Costs	\$0.00	\$0.01	\$0.32
Intangible Amort.	\$2.22	\$2.48	\$1.76
Depreciation Chg	\$0.08	\$0.39	\$0.19
Mark Up of Acq. Equip	\$0.51	\$0.72	\$0.59
Restructuring	\$0.18	\$0.18	\$0.28
Asset Impairment	\$0.37	\$0.05	\$0.00
Early Debt Calls	\$1.88	\$0.58	\$0.00
Adj. EPS	\$17.44	\$19.52	\$16.26

**While URI makes many deals, most are fairly small. Some of these costs are only called out for adjustment if it involves a material deal. So, we give URI a positive mark for that.**

- Merger costs are the legal fees, advisory fees, banking fees to complete a large deal. **These tend to be one-time in nature and only occur when URI makes a significant**

**deal.** For all those reasons, we do not view it as aggressive to add them back especially since URI's operating model is not based on chasing ever more deals.

- **Intangible asset amortization. Here we give mixed reviews.**
  - Positive – URI uses a short amortization period – several of the acquisitions have already seen these intangibles become fully amortized or soon will and the difference between GAAP and adjusted earnings will shrink.
  - Positive – As noted above, this is a small part of the overall purchase price at about 10%-14% of total acquired assets. The largest part is actual rental equipment which URI is depreciating and not adding back.
  - Negative – URI did spend cash on these assets, it did see revenue and earnings rise from the acquired assets – thus income would be lower without the deal. Also, if they built the assets in-house, 100% of those costs would be expensed and not adjusted out of income.
  - Overall – we would not add this back. It is worth noting that the amortization of Blueline will be complete in 2023 and is 47-cents of annual amortization, Baker in 2025 as 21-cents, and the rest in 2027.
- Depreciation change comes from marking the acquired rental equipment to fair value at the time of the deal. That boosts the amount to be depreciated and thus the expense rises and penalizes EPS. At the same time, URI is often extending the forecast for the useful life of these assets, and that in turn lowers depreciation. This figure is the net change from moving both the valuation and the time-frame for depreciation. It should be viewed with the next item in concert.
- **The mark-up of the value for acquired equipment also impacts the earnings when URI sells the equipment. That creates a higher cost of sales for the used equipment and penalizes earnings too. Looking at the pros and cons here:**
  - Positive – by marking up the value of equipment to fair value, URI has more assets that will be depreciated as opposed to more goodwill that will not – that makes earnings quality higher overall.
  - Positive – this transition period and amount of adjustment for equipment that stays in the fleet longer is very minor and ends quickly. After two large deals in 2018, this transition jumped to 39-cents in 2019, but was only 8-cents in 2020 for a company with adjusted EPS of \$18-\$20. Also in 4Q20, this had become a source of GAAP earnings that was being reversed out in adjusted results (4-cents).



- Negative – when equipment is sold soon after the acquisition, this has the biggest impact on EPS because the higher fair value has not been reduced by depreciation. It effectively becomes a quick writedown of some of the purchase price that is being added back.
- Mitigating factor – we understand why something gets sold quickly as part of an integration. Let's say, URI has 40 forklifts and acquires 30 more in a deal. 45 are from one manufacturer, 28 another, and 2 are from a third – selling the last two eliminates spare parts and additional maintenance. Or maybe, of the 30 being acquired, 5 were idle and it makes more sense to sell those and buy new equipment in greater demand.
- Restructuring is something where we cannot knock URI much. We see too many other companies announce a restructuring for \$800 million over 18-months and you look back and see that the restructuring became \$5 billion over 12-years. URI's history is actually fairly clean:
  - \$350 million in total restructuring spent since 2008. This after spending over \$10 billion on what it would call material acquisitions. That's only 3% of the total.
  - The five restructurings focused on modest items such as combining offices and eliminating unneeded real estate and streamlining some operations.
  - The restructuring plans went away quickly too after completing the simple work described and the income adjustment was short-lived and minor.
- Asset Impairments do not stem from writing off intangibles or goodwill. They come from exiting small areas of business that URI didn't see as much future. They are not even Covid related. The write-offs are for leasehold improvements.
- Refinancing debt, extended credit lines, and calling other debt early is something we do consider to be one-time items. Normally, this type of work boosts liquidity and or lowers financing costs and should be good things overall.

Our conclusions are URI's adjusted EPS is of higher quality than many other companies we see making acquisitions. We believe that the amortization of intangibles should not be adjusted back. That is about \$2 or 10%-15% of adjusted EPS. However, we can see that this adjustment will decrease in size in the near future thanks to the more realistic amortization life assumptions. Several of the other transitional items from acquisitions actually improve earnings quality here or are very minor compared to the size of deals or the adjusted EPS.

## Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

## Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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