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Mushroom cloud subsides

Evan Lorenz writes:

Artificial intelligence just might surpass the organic variety one day, but the breakthrough won't come cheap. Meta Platforms, Inc., Amazon.com, Inc., Alphabet, Inc. and Microsoft Corp. are planning to ramp up capital spending by a combined 27% in 2024, to $179 billion, according to BofA Global Research. For context, the other 496 constituents of the S&P 500 are expected to raise theirs by just 1%, to $820 billion.

Even so, this publication is bearish on Iron Mountain, Inc. (IRM on the New York Stock Exchange), which is building data centers as fast as it can to service the AI boom. Problem No. 1: The return on those centers is minuscule. Problem No. 2: Iron Mountain, a real-estate investment trust, doesn't cover its dividend.

Our story begins in 1936, as Herman Knaust buys 100 acres of land near Kingston, N.Y., for a mushroom farm. Better, however, Knaust came to perceive, to sell mushroom clouds (or the fear thereof) instead of actual mushrooms. Correctly reading the Cold War zeitgeist, the German-American entrepreneur installed a 28-ton vault door (purchased from a failed Ohio bank) on a depleted iron mine on his land and called the business the Iron Mountain Atomic Storage Corp.

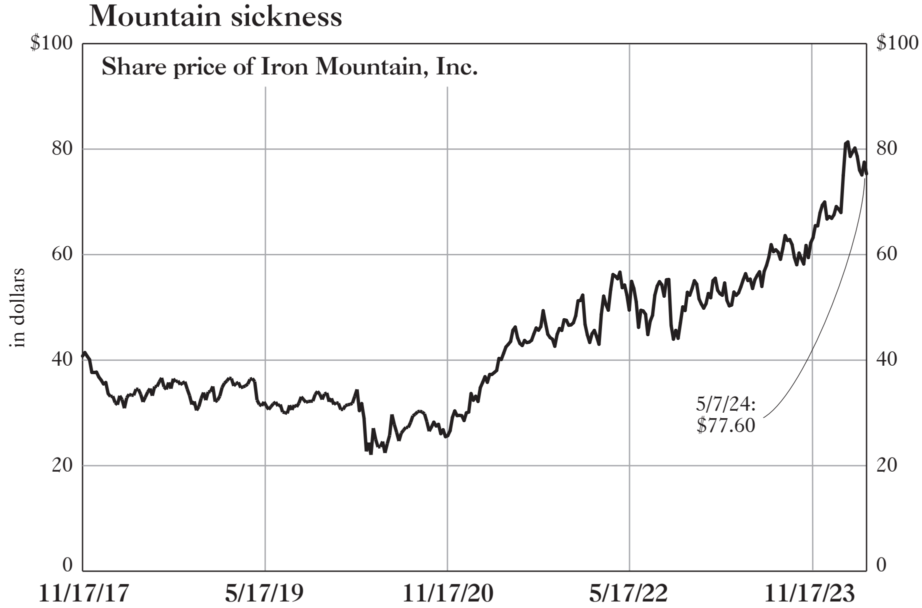
Grant's laid out the bear case on Knaust's brainchild in the issue dated Nov. 17, 2017. Digitization meant that fewer paper documents would be retained and, excluding acquisitions, the storage business would decline. While the shares were priced to a then-handsome 5.7% dividend yield (in the context of a 2.3% 10-year Treasury yield), the payout exceeded free cash flow and the junk-rated borrower's balance sheet looked stretched.

From that date until the end of 2020, the stock obligingly fell by 27.7%, a drop that reinvested dividends trimmed to 7.8%. On the same basis, the S&P 500 produced a gain of 54.6%. Then Mr. Market's attention was drawn to the fact that Iron Mountain had stabilized its legacy document-storage line while building a data-center bonanza; up went the share price. Since year-end 2020, IRM has returned 207%, beating the blue-chip average by 162 percentage points (both including dividends).

Data centers, outwardly bland structures crammed with servers, data-storage drives, network equipment, etc., exist to facilitate whatever trick Silicon Valley next has up its sleeve, not forgetting AI. Iron Mountain's data-center revenues have leapt to an annualized $575.7 million in the first quarter of 2024 from $37.7 million in calendar 2017.

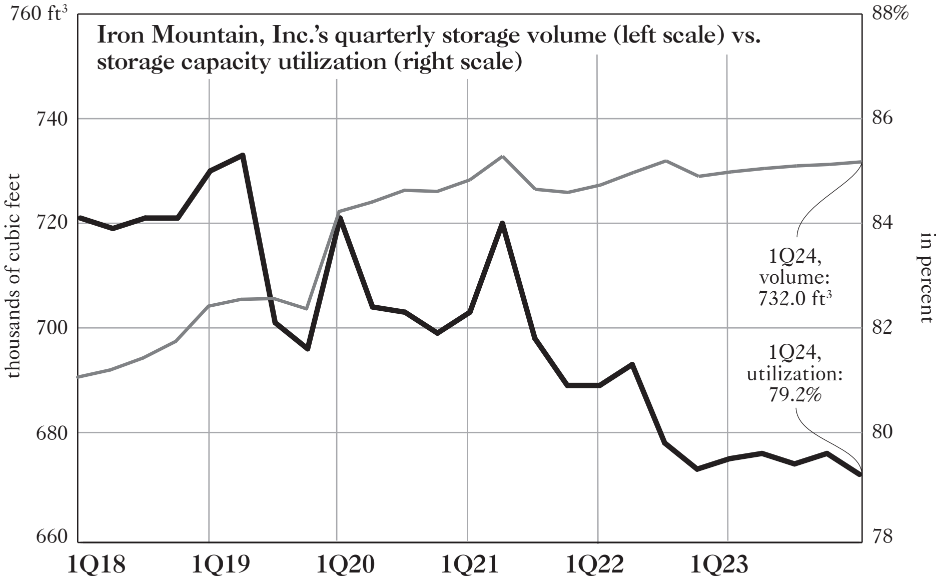
Three operating divisions generated $5.6 billion in sales in the 12 months ended March 31: the legacy records- and information-management unit, which includes document and computer-media storage, retrieval and destruction (84.1% of sales); data centers (9.3%); and corporate and "other," a hodgepodge including art handling and storage and computer recycling (6.6%).

Mountain sickness



source: The Bloomberg

Volumes rise though utilization falls



source: company reports

When we had our say six-and-a-half years ago, record and information volumes, excluding acquisitions, were dwindling. In the first quarter of 2024, they rose by 0.3%. Better, from the bulls' perspective, are the price increases, reckoned by square foot of consigned material, that Iron Mountain has managed to push through: by 8.6% in the first quarter and by a cumulative 19% over the past three years.

The data-center business continues to prosper, with revenues leaping by 28.2% in the three months ended March. Up and running today are 26 buildings housing a combined 261.4 megawatts of electrical capacity. Under construction is an additional 233.7 MWs of capacity; in the pipeline is a further 365.7 MWs' worth. "We are continuing to see our deep relationships with several of the major hyperscalers [i.e., companies like Microsoft and Alphabet] result in considerable incremental opportunity, and a large portion of that is AI," declared CFO Barry Hytinen at a Morgan Stanley conference in March.

Iron Mountain entered the computer-rehabilitation business with the acquisitions of ITRenew (for $925 million in 2022) and Regency Technologies ($200 million in 2024). So far it's to little avail. At the closing of the ITRenew purchase in January 2022, management guided for $450 million in revenues in the remaining 11 months of the year; sales failed to reach half of that goal, at $213.1 million, before declining to $177.1 million in 2023.

The division decommissions computers and servers and sells the used hardware. Volatile pricing for electronic components was the flaw in the business plan. For instance, the price of DDR4 DRAM, a type of memory chip, plunged by 62% between year-end 2021 and September 2023 (*Grant's*, March 15).

A rebound duly followed. From September through the end of April, DDR4 memory prices rallied by 24%, helping SK hynix, Inc., the largest holding of pick-to-click SK Square Co., Ltd., beat first-quarter revenue and earnings expectations. The recovery in computer-component prices should also underwrite better results for Iron Mountain.

There's a green angle to the bull case, too. Iron Mountain recycles the documents that its customers ask it to destroy. Its data centers glean 100% of their power from renewable energy sources. And the old-computer reclamation business refurbishes equipment that might otherwise end up in a landfill.

The March 31 balance sheet is testament to the high cost of conducting the business. Some $15 billion in net debt and operating leases summed to 6.3 times trailing Ebitdar (that is, Ebitda plus rent expenses). In the first quarter, operating income covered interest expense by no more than 1.5 times. Iron Mountain is rated Ba3/double-B-minus, or the upper end of non-investment-grade, by Moody's Corp. and S&P Global Ratings.

First-quarter revenues climbed by 12.4% and heavily adjusted Ebitda by 12.6%. In exchange for growth, investors are settling for a 3.4% dividend yield (versus the 4.5% on offer from the 10-year Treasury) and paying 15.8 times enterprise value to Ebitdar.

Out of 10 analysts on the case, 7 say buy and 2 say sell (1 is on the fence).

Iron Mountain, Inc. at a glance
all figures in $ mns except per share data

	TTM*	2023	2022	2021	2020
revenue	$5,642.8	$5,480.3	$5,103.6	$4,491.5	$4,147.3
operating income	926.7	921.8	1,049.9	854.2	934.8
net income	193.7	184.2	557.0	450.2	342.7
cash flow from ops.	1,114.8	1,113.6	927.7	758.9	987.7
capital expenditures**	-1,557.7	-1,456.1	-1,027.2	-761.5	-531.5
free cash flow	-442.9	-342.5	-99.5	-2.6	456.1
dividend payments	-749.1	-737.7	-724.4	-718.3	-716.3
cash	191.7	222.8	141.8	255.8	205.1
debt	12,707.3	11,933.2	10,569.0	9,271.9	8,703.3
operating leases	2,826.9	2,854.2	2,717.9	2,431.1	2,294.8
total assets	17,829.6	17,473.8	16,140.5	14,450.0	14,149.3

*12 months ended March 31, 2024.

**As defined in the article.

source: company reports

Short interest sums to 3.4% of the float, down from 17.5% at the start of 2021. Insiders sold 714,113 shares over the past 12 months for proceeds of $48.8 million.

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Iron Mountain is in the "records and information management" business in more ways than one. Disclosure concerning the document-storage unit resembles the flickering glow of a failing light bulb. It's a problem for a business segment that generates 90% of company-wide Ebitda before expenses.

As recently as 2018, management reported growth in documents-storage volume in three geographical sectors: North America, which accounted for 72% of segment Ebitda; Western Europe; and "other international."

But when North American volumes began to decline, the number of geographical sectors shrank to two—"developed" and "other international"—and then, after the third quarter of 2019, to none. By the second quarter of 2022, even the functional segmentation of the storage business (e.g., documents relating to TV and film studios, or those pertaining to a joint venture serving retail customers) had gone by the boards. This pulling down of the statistical window shades happened to coincide with a 1.1% segment-wide slip in storage volumes in April–June 2022.

Now the analyst must guess as to the health, or lack thereof, of this cash-flow-rich department of Iron Mountain. While reported overall volumes are gradually rising, as previously mentioned, storage-capacity utilization is falling, to 79.2% in the first quarter from 84.1% in the same quarter four years ago. Are volumes growing in the consumer joint venture while declining in the core corporate records-management unit? Management isn't saying.

The customers are more forthcoming. Respondents to the Better Business Bureau's review site give Iron Mountain 1.07 stars out of a possible five. Many critics complain about the price jumps.

"There have been 3 price increases in the last 12 months," said one. "When we've inquired or disputed the price changes, the customer service department has delayed responding. Our payables department reached out to the rep assigned to the account with no response."

Like many another business, Iron Mountain has conducted its own customer-satisfaction surveys and presented the results as a "net promoter score." The company went so far as to link a portion of its management's bonus awards to the results. All was well until, in 2022, the score tailed off (not every customer cheered paying higher prices). In 2023, NPS disappeared from incentive comp. and management stopped reporting the scores.

Iron Mountain incurred $40.7 million in restructuring costs in the first quarter and $175.2 million last year; for context, operating income registered at $245.6 million in the first three months of 2024 and $921.8 million in 2023. The restructuring charges relate to a 2022 initiative, dubbed Project Matterhorn, to overhaul sales and marketing. It was no one-off: Iron Mountain has amassed an average of $133.3 million in restructuring charges every year since 2019.

A relative newcomer to data-center construction, Iron Mountain does not yet face the problems of obsolescence that established operators confront (e.g., pick-not-to-click Digital Realty Trust, Inc.; see *Grant's*, Dec. 8, 2023). Between 2017 and 2020, average power consumption across the data-center industry surged to 8.4 kilowatts (kW) per rack from 5.6 kW, the commercial real estate–focused platform Bisnow reported last month, and some AI servers now demand 200 kW of power per rack.

"The inability of many older data centers to handle higher-density workloads centers primarily around their power management and cooling systems," according to Bisnow. "Most data halls were designed to support a narrow range of voltages, with cabling and other power equipment that can't even be connected to today's state-of-the-art IT gear.... Cooling is often an even greater challenge." In many cases, it's cheaper to build a new center than to refurbish an existing one.

Profitability is the rub for Iron Mountain. Its centers cater to the kind of large hyperscaler, like Microsoft or Amazon, that can dictate rock-bottom rents. Thus, in the first quarter, the data-center unit generated $246.3 million in annualized adjusted Ebitda, or 5.5% on the business unit's operating assets (that is, the segment's assets less properties under development). Compare and contrast the cost of the company's 7% senior unsecureds of 2029, which are priced to yield 6.6%. A business whose returns on capital fail to cover the marginal cost of its debt is no surefire candidate to increase intrinsic value.

In contrast, the business of managing records and information, which is likely losing volumes in its most profitable geography, has consistently generated pretax returns on capital between 10% and 12% over the past decade, according to Rob Simone, who rates Iron Mountain a sell for Hedgeye Risk Management, LLC.

If you peruse the statement of cash flows, you'll find multiple line items that contribute to total investment spending: capital expenditures (self-explanatory), acquisition of customer relationships (buying volume in the documents business), customer inducements (buying volume by another name), contract costs (the expense to move customer documents into company buildings) and investments in joint ventures (what it sounds like).

Reverting to the core complaint of our 2017 analysis, Iron Mountain still doesn't cover the cost of its dividend with free cash flow. In 2023, it generated $1.1 billion in cash flow from operations, spent $1.5 billion in capex (as defined above) and paid out $737.7 million in dividends for a net draw of $1.1 billion. Even if we add back the entire $981.4 million in capex that built the data centers, free cash flow less dividends was negative $98.7 million. Not that last year was a fluke. Free cash flow has not covered the dividend in any of the past 10 years.

Nor has Iron Mountain excelled in the growth department. Over the past five years, management has spent $4.6 billion on capital investment and $1.2 billion on acquisitions, a sum equal to 26% of Iron Mountain's current market capitalization. Yet, between 2019 and 2023, cash flow from operations increased at an annual rate of just 3.6%. This is a remarkable amount of investment for such little return, especially as much of this growth likely came from price hikes in the document-storage business.

The company's "biggest mistake," Simone tells me, was its 2014 decision to convert to a REIT. "In doing so they actually put themselves into a perpetual capital deficit. Unlike most

REITs, they lease more locations than they own.... That means they have lower depreciation than your run-of-the-mill REIT, so, therefore, higher taxable income, which forces them under REIT requirements to effectively overdistribute relative to cash flow [specifically, the law requires, to pay out 90% of net income]. And what they're doing to amplify it and make it worse is going further and further into a very, very capital-intensive data-center business."

Maybe AI has the answer.

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