GRANT'S
INTEREST RATE OBSERVER®
Vol. 35, No. 22d Two Wall Street, New York, New York 10005 • www.grantspub.com NOVEMBER 17, 2017

About this dividend

The paperless office never quite arrived. Nor has Iron Mountain, Inc. (IRM on the NYSE), the big document disposal and storage company, ever left. A part of old Wall Street—where's "Iron Mountain?" curious pedestrians in lower Manhattan would silently wonder as the company trucks rumbled by—our subject is likewise a symbol of the new Wall Street. Financial leverage, bespoke accounting, a problematic dividend, stock-market indexation: IRM is as contemporary as taking a knee. In preview, *Grant's* is bearish on it.

Iron Mountain is the world's largest repository of business records. It rents space to more than 230,000 customers in its 1,400-plus buildings across 53 countries. Paper files, physical computer media, fine art, original movie prints and what-have-you fill the company warehouses. The service end of the business carts away such items, stores them, retrieves them or (on strict orders from the client) destroys them. In this digital age, data centers, too, figure in the business mix.

Storage rental fees are the name of the game. In the first nine months of the year, they contributed 61.8% of total revenues, 81.9% of gross profit. While Iron Mountain is a global business, the company is substantially a home body. In the third quarter, North American operations contributed 73% of adjusted EBITDA before corporate expense and other charges.

Iron Mountain is an REIT—it so established itself on the first day of 2014. Add, then, "scratching the income itch" to the company's contemporary profile; the transformation has allowed a boost in the annual dividend to $2.35 a share, based on the latest quarterly declaration, from $1.08 in 2013.

"It's a curious kind of REIT," colleague Evan Lorenz points out. "Income from the company's services businesses (as well as the income from some of the international storage operations) is taxed at the corporate, rather than the individual-shareholder level. So, in the first three quarters, Iron Mountain generated $195.9 million in pre-tax profits and paid $29.5 million in taxes. The overall tax rate was 15%."

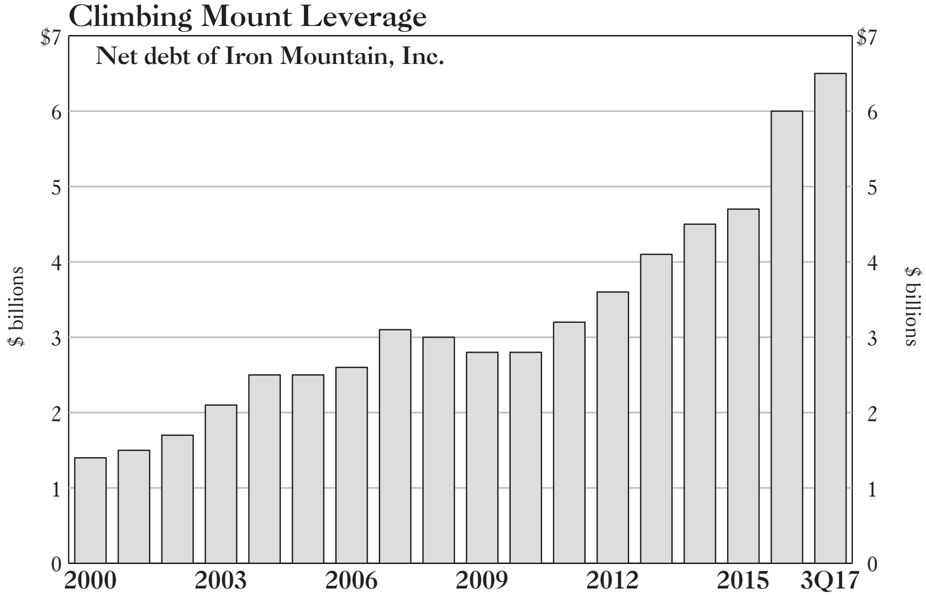
The bull case for Iron Mountain begins with the 5.7% dividend yield. It's an outlier. On average, industrial REITs and U.S. data-center REITs are priced to yield 2.8% and 2.9%, respectively.

Projected earnings growth furnishes a second part of the sell-side story. The Street is penciling in a 7.5% increase in operating income for 2018. At the June 15 Stifel, Nicolaus & Co. Industrials Conference in New York, Melissa Marsden, head of investor relations for Iron Mountain, said the company projects a 7% rise in the dividends next year: "[T]hereafter, we would expect it to grow more in line with the growth in the business."

The target customers for document storage are the ones under regulatory or legal injunction to retain original copies. No doubt, the bankers and lawyers will continue to squirrel away papers. But retrieving them from a vault? You can find a digital duplicate in the cloud. So it is that, except for acquisitions, the service side of Iron Mountain's business is shrinking. In the third quarter, after adjusting for the impact of foreign currencies, service revenue showed a year-over-year dip of 1.6%.

That Iron Mountain fails to cover its

Climbing Mount Leverage



source: The Bloomberg

dividend with free cash flow is the opening gun of the bear case. Through the first nine months of 2017, cash flow from operations weighed in at $518.9 million. Subtracting capital expenditures ($243.7 million) and marketing and promotional expenses ($56.9 million, on which more later) produces free cash flow of $218.2 million. It falls short by exactly $74.4 million of the $293 million in dividends paid (mark the word "paid") through Sept. 30.

"Not that the financial statements relinquish that information to any but the determined inquisitor," Lorenz points out. "At a glance, you read that dividend payments were actually down in 2017. You look again, because you know that dividend payments were actually up. Finally, staring harder, you understand. Iron Mountain paid the first quarter dividend on April 3 (the quarter closed on March 31). It paid the second-quarter dividend on July 3 (the quarter closed on June 30). It paid the third-quarter dividend on Oct. 2 (the quarter closed on Sept. 30). This was a new thing in 2017: In 2016, dividends were paid in the quarter in which they were declared.

"The effect of the 2017 rejiggering is to create an appearance that the nine months' dividend outlay encompassed only the first six months of the year—Oct. 3, of course, falls in the fourth quarter. The point of this shaggy-dog story is that actual dividend payments pertaining to the first nine months came in at $439.4 million, more than twice the $218.2 million in free cash flow earned over the same period."

To fund its dividends, as well as $194.1 million in year-to-date M&A, Iron Mountain has issued debt, including a 4⅞% senior unsecured 10-year note that came to market on Sept. 6. From Dec. 31, 2016, through Sept. 30, 2017, net debt has increased by $529.4 million to $6.5 billion, an amount equal to 5.7 times trailing EBITDA. Rated double-B-minus, IRM is a happy beneficiary of some of the lowest interest rates since the Copper Age.

But radical monetary policy can only do so much. Iron Mountain must service its debt (in the third quarter, operating income covered interest expense by a ratio of 2:1) and stay within the chalk lines of its most restrictive debt covenants (which allow a ratio of debt to EBITDA no greater than 6.5:1, compared to the third-quarter reading of 5.7:1).

Perhaps tellingly, Iron Mountain filed a registration statement on Oct. 5 which allows the issuance of up to $500 million of stock in an at-the-market (a.k.a., "ATM") program. Of course, any shares issued would start accruing dividends, which would further strain cash flows. No press release accompanied the filing.

It's old news (as the bear case continues) that document storage is no growth industry. A millennial would rather read a newspaper than pay for a slot in a warehouse in which to stack, ugh, paper. Third-quarter results (as well as a study by the Boston Consulting Group that the Iron Mountain front office commissioned on this very question) validate one's suspicions: Excluding acquisitions, cubic feet of documents stored in North America declined by 0.2% from the like period a year ago.

"Perhaps even this understates the rate of underlying decline," Lorenz comments. "Year-to-date, Iron Mountain spent $43.6 million acquiring customer relationships (buying business from competitors) and $13.3 million on customer inducements (offering perks and freebies to win business). These costs are run through cash flows from investing and are capitalized on IRM's balance sheet.

"In addition to the recurring expense to keep reported organic volumes roughly flat, Iron Mountain has spent $2.7 billion in acquisitions since becoming a REIT in 2014, a material number relative to the company's $10.9 billion market cap. The largest of these acquisitions was Recall Holdings Limited, which was completed on May 2, 2016, in a cash and stock deal worth $2.2 billion."

And after Recall? There are likely no needle-moving storage competitors left to buy, says Morningstar, Inc. analyst Eric Compton. "Recall was the last big one," Compton tells Lorenz. "They were the second-largest player globally, and even acquiring Recall they still had to divest branches to the next largest competitor, Access. They couldn't go out and acquire Access without having to divest everything they would buy. I think that is it."

How, then, does Iron Mountain justify an unsustainable dividend? Through the magic of non-GAAP real-estate investment trust accounting. Funds from operations (FFO) is the standard accounting metric for REIT earnings. It's defined as net income plus depreciation, less the sum of dividends on preferred shares and net gains on property sales. It's the law that REITs must pay out at least 90% of net income each quarter. The sustainability of those dividends is another matter. The test on that score is adjusted funds from operations (AFFO), which is FFO less maintenance capital expenditures.

As readers of the accompanying analysis of CAPREIT may have already noted, the distinction between "maintenance" capital spending and "investment" capital spending can be wavering and arbitrary. Iron Mountain classifies most of its capex as growth investment rather than as maintenance investment. So, instead of deducting $243.7 million in capital spending, management subtracts the $74.3 million which it deems to qualify as maintenance capex.

"Not since 1998," Lorenz observes, "has the company invested so little as $74.3 million on capex. In that long-ago year, revenues amounted to just $384 million—a tenth of the $3.8 billion recorded in the 12 months ended Sept. 30. AFFO is further boosted by adding back the $78.8 million in the amortization of customer relationship expenses, i.e., the costs required to keep business from declining. This allows Iron Mountain to report an AFFO payout ratio of 73% for the dividends declared in the first nine months."

What about the shareholders? Are they not pressing management for clarity? Well, passive investment giants Vanguard Group, BlackRock, Inc. and State Street Corp. hold 27.2% of Iron Mountain's outstanding shares; perhaps their interest is more conceptual than granular. We do know, and have benefited from, the knowledge of one class of investors. They are the young founders of a new, short-biased hedge fund, Matador Global. Leave it to the bears to read the footnotes.

The Street is lukewarm on IRM with three buys, three holds and one sell; 8.4% of the Iron Mountain float is sold short. Management seems to see things as Matador and we see them: In the last 12 months, the insiders have sold 119,828 shares for net proceeds of $4.5 million.

•

Grant's authorizes use by CLAYTON ISOM only. © 2025 Grant's Financial Publishing, Inc. Reproduction or distribution without written permission is prohibited.