GRANT'S
INTEREST RATE OBSERVER®

Vol. 32, No. 09e | Two Wall Street, New York, New York 10005 • www.grantspub.com | MAY 2, 2014

Garbage time

Once upon a time, Americans were drowning in refuse. It seemed there was no place left to put it. Millions of dollars awaited any who could dig holes deep enough to absorb the fragrant overflow—in compliance with costly new federal regulations, of course.

Now unfolding is a bearish update to the formerly bullish story line. The fact is that—to quote a longtime waste-industry observer—"the entire garbage business is inverted." As America has become greener, prospects for the likes of Waste Management (WM on the New York Stock Exchange) have become dimmer. Yes, to anticipate the bullish rebuttal, WM generates lots of cash, most of which it faithfully returns to the stockholders. How much cash will be available to return in the years ahead is the question before the house. "Less," we judge.

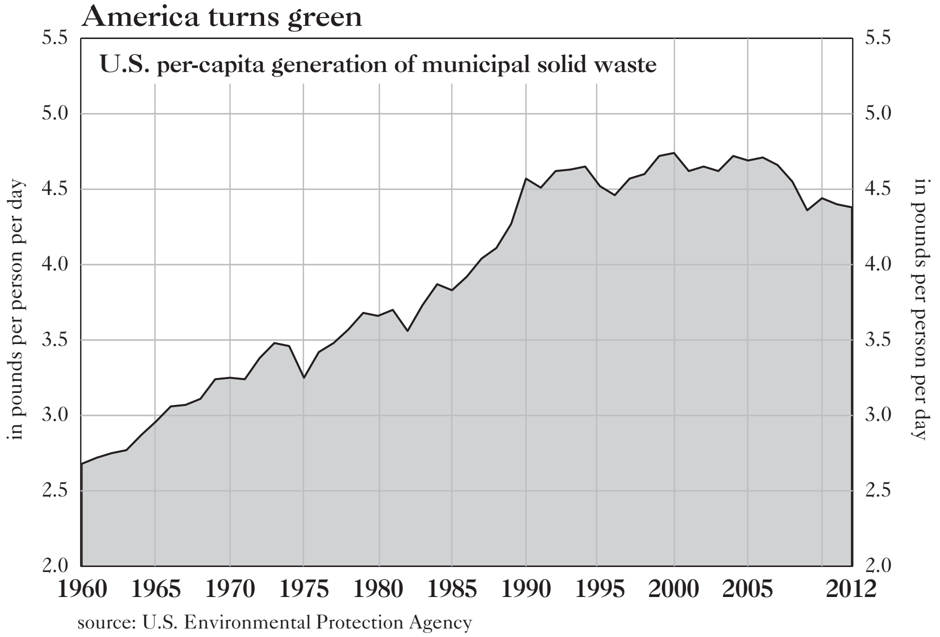
"For most of the past 30 years, garbage was a gold mine," relates colleague David Peligal. "Subtitle D of the Federal Resource Conservation and Recovery Act (RCRA), which took hold in the late 1980s, forced the closure of smaller landfills. There had been 10,000 such holes in the ground. Post-regulation, the landfill count shrank to 2,000. Most of those assets became the property of big public companies like WM."

Thirty years ago, innumerable little mounds of trash awaited burial along desolate stretches of land visible from the New Jersey Turnpike. Each such burial site could absorb between 25 tons and 100 tons of waste a day. Today, each of many fewer landfills can handle up to 10,000 tons per day. Consolidation has been the watchword. First, the public waste companies took market share from the closely held ones. Next, the public companies themselves joined forces. Waste Management today operates 267 landfill disposal sites, 390 collection operations, 310 transfer stations, 17 waste-to-energy plants, 120 recycling plants, 36 organic processing facilities and 137 landfill-to-gas-to-energy projects. Along with Republic Services (RSG on the NYSE), Waste Management controls about two-thirds of U.S. landfill capacity.

What's new is the dwindling growth in garbage. That discarded Poland Spring bottle is lighter than it used to be. Your iPhone does duty for an airline boarding pass. Green shoppers port their own reusable bags to the kale store. Though Americans still toss out prodigious volumes of "municipal solid waste"—as the U.S. Environmental Protection Agency styles everything from banana peels to sofas to snow tires to soccer trophies—refuse growth has flattened. In 1960, Americans generated 2.68 pounds of municipal solid waste per capita per day. They materialized 3.25 pounds of MSW in 1970, 3.66 pounds in 1980, 4.57 pounds in 1990, 4.74 pounds in 2000 and 4.38 pounds in 2012. The 2012 reading was the lowest of the past 22 years.

One may thank "Reduce, Reuse and Recycle," a kind of secular 11th commandment, for these adverse developments—that is, adverse for WM and its peers and their shareholders. Recycling, so observes our previously quoted, unnamed authority, is a "much less profitable, if not money-losing,

America turns green



source: U.S. Environmental Protection Agency endeavor, and it has caused the volume of garbage going into landfills to level off. As a result, the marketplace has become competitive for these disposal volumes, while the amount of recycling, which requires more processing as well as the need to sell recycled materials such as old newsprint and old corrugated containers into the Chinese marketplace, increases. In essence, there is more competition in the most profitable aspect of solid waste while the least profitable service, recycling, is growing." As a percentage of MSW, the recycling rate has leapt to 34.5% in 2012 from 9.6% in 1980. Reciprocally, the percentage of waste consigned to landfills—where Waste Management earns its highest margins—is way down, to 53.8% in 2012 from 88.6% in 1980.

The garbage business is a high fixed-cost asset business, as Peligal observes: "After you make your breakeven, the incremental margin is terrific (as Waste Management's mid-20s EBITDA margins attest). When you think about the incremental cost of the last 1,000 tons of a 6,000-ton-per-day landfill, it doesn't cost a whole lot more to bury. In fact, it's extraordinarily profitable, as the associated cost of those additional 1,000 tons is negligible. It's reciprocally painful when volumes shrink. The other side of the coin of 'incremental' profitability is 'decremental' profitability, and this is what WM is facing."

Could Waste Management not lower its prices to stimulate volume? David Steiner, president and CEO, considered that question on the 2013 fourth-quarter earnings call. Lower the price of shoes and people buy more. Lower the price of garbage removal and people would not necessarily generate any more coffee grounds, grass clippings or milk cartons. Could the company not raise prices, then? It could and it has. The rub is that the disposal business is increasingly competitive. As prices go up, volumes tend to go down. We say "prices"; the Waste Management executive suite prefers the phrase "internal revenue growth from yield on the collection and disposal business." Anyway, in the first quarter of 2014, higher prices delivered 2.6% year-over-year revenue growth, while falling volumes erased 1.8% of those gains. Like Janet Yellen, Waste Management aspires to 2% top-line growth and frets that it's hard to achieve.

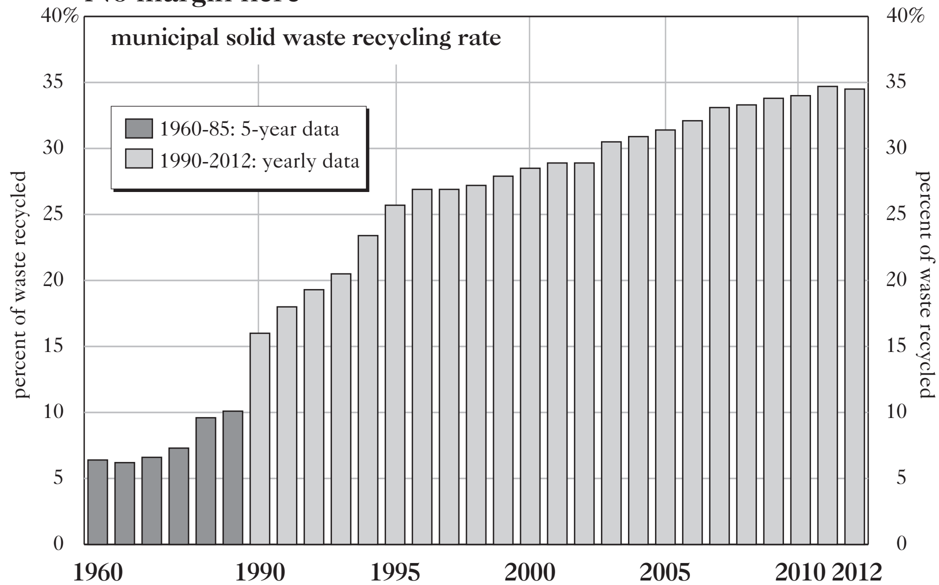
The deflationary cast in the garbage-disposal business is attributable to the fact that the competitive advantage has shifted. Once the owners of landfill capacity had it. Now it belongs to the independent collection companies. Playing the field, they can haul their cargo to the most cost-efficient landfill or recycling location. If the arithmetic is favorable, they bypass WM's locations for cheaper ones. A dozen years ago, the city fathers of New York didn't know where to dump the 11,000 tons of trash the residents of the five boroughs emitted every day. The glut of landfill capacity solved that particular problem.

Growth is a problem in search of a solution. In 2004, when Steiner took command, Waste Management earned $12.5 billion of revenues, $3 billion of EBITDA, $1.7 billion of income from operations, $939 million of net income and $1.61 of diluted earnings per share. Nine years later, in 2013, with Steiner still at the helm, the company chalked up $14 billion of revenues (a rate of growth merely equal to the CPI would have delivered $15.3 billion), $3.4 billion of EBITDA, $2.1 billion of income from operations, $1.1 billion of net income and $2.15 of diluted earnings per share. In February, the company absorbed a $1 billion goodwill and asset-impairment charge related to waste-to-energy and recycling assets, landfills in eastern Canada and an investment in a majority-owned waste-diversion technology business. Applied to 2013 results, the write-down knocks the stuffing out of GAAP earnings. Thus, net income is reduced to $98 million, rather than the hypothetical $1.1 billion that would have been posted in the absence of a charge. In 2012, the company chalked up $817 million.

Wall Street shrugged off that $1 billion shrinkage in asset value, preferring to focus instead on the Waste Management cash-generation record. It is commendable. "We returned $922 million to shareholders through dividends and common stock repurchases in 2013," Steiner pointed out in the 2013 annual report. Free cash flow in 2014, bolstered by the first-quarter divestiture of a Chinese waste-to-energy joint venture, may reach $1.5 billion, management speculates, up from $1.3 billion in 2013. At $44 apiece, on a projected dividend of $1.50, the shares yield (or, rather, are expected to yield) 3.4%. What should the prudent investor—even the prudent investor desperately seeking income—pay for a 3.4% yield? It depends, of course, on the outlook for interest rates. And it depends, too, on expectations for corporate earnings growth. In the case of Waste Management, the prognosis for the latter appears guarded.

An ideal short-sale candidate exhibits insider selling and a deteriorating balance sheet. Let the record show that WM exhibits neither. As to financial leverage, the company's debt sums to three times its earnings before interest, taxes, depreciation and amortization, not an imprudent ratio for the garbage

No margin here



source: U.S. Environmental Protection Agency disposal trades. Moody's rates the WM debt Baa3, S&P three notches higher. Still and all, Waste Management's total equity is less today than it was at the end of 2004.

Within the garbage industry, Waste Management is the company that seems willing to try just about anything. It has been in and out of medical waste. It has been in—and recently got out of—a Chinese waste-to-energy joint venture. Laudable though its adventurousness may be, it can't be said to have yielded tangible results so far. The acquisition of Oakleaf Global Holdings in July 2011 makes for an illustrative case study.

Before entering the Waste Management fold, Oakleaf was a private equity-backed broker of trash removal services. It managed a nationwide network of third-party haulers. Wal-Mart Stores was its biggest and most dazzling client. By acquiring Oakleaf, Steiner et al. reasoned, Waste Management could enlarge its national customer base. In the flush of those hopes, the WM front office wrote a check for $432 million to Oakleaf's owners, New Mountain Capital LLC.

Shortly after the transaction closed, the CEO of Oakleaf, Steve Preston, left WM. And today, as Waste Management tries to raise prices, some of the national clients that Oakleaf brought in are leaving, too. As the clients saw the situation, they were paying a fair price. From WM's vantage point, the prices were uneconomically low.

"We lost a couple of residential contracts that folks bid at prices that we weren't willing to go to," said Steiner on the first-quarter earnings call last week. "And then we have our largest national account [one guesses Wal-Mart, which conjecture the company declines to confirm] that, quite frankly, was a low single-digit margin and someone came in and undercut the price on that, even though ours was low single-digit and we weren't going to go there. We said, 'Look, we'd rather not have the work than have the volume.' So we lost that volume starting April 1, so you'll see a little bit tougher comp in the second quarter. The good news is we lost that volume—it came with virtually no earnings. And so we'll take that trade-off every day. We now can redeploy those trucks to going out and getting higher-margin business, which, from an earnings point of view, will be accretive to us." What remains to be seen is whether Waste Management can win new business at earnings-accretive prices with which to continue to amortize the fixed costs of its landfills.

Waste Management, with its $20 billion market cap, is the biggest fish in the garbage sea; it trades at 17 times the consensus 2015 earnings estimate. Republic Services, the No. 2 public company with a $12.5 billion market cap, trades at 16 times the 2015 estimate. Waste Connections (NYSE: WCN), a $5.5 billion market-cap company, changes hands at 20 times. Based on the West Coast, WCN enjoys a kind of moat in the franchises it controls.

"If our thesis is correct," observes Peligal, "all of these companies will eventually run into problems and trade at lower multiples. Waste Connections trades at the highest multiple because it has higher EBITDA margins than the other two. It is also the smallest of the three companies, has financial flexibility, and is run by a thoughtful CEO. Furthermore, in a franchised market, they essentially control all the volumes."

It says something un-bullish about the garbage industry that none of the Big Three chose to buy Veolia Environment's U.S. solid waste business when that division was put up for auction in 2012. Highstar Capital, an infrastructure-focused, private-equity firm, was rather the buyer, paying $1.9 billion. The lack of action by WM, RSG and WCN, which presumably could extract the most value from Veolia, makes for a notable silent commentary on the consensus view of the prospects for profitable growth. Ronald Mittelstaedt, CEO of Waste Connections, called Peligal earlier this week during a break from the WasteExpo 2014 conference in Atlanta. "We did participate in making an offer on Veolia," said Mittelstaedt. "We were outbid by a decent amount. We didn't view it as being worth $1.9 billion."

"Also noteworthy, "Peligal says, "was Waste Connections' 2012 purchase of R360 Environmental Solutions for $1.4 billion. R360 is a leading provider of non-hazardous E&P waste treatment, recovery and disposal services—a business that shares some characteristics with one of the businesses managed by Clean Harbors (*Grant's*, Feb. 7). R360 makes up about 16% of WCN's overall business today; the legacy solid-waste business constitutes the remainder. Granted, the E&P waste business is a sexier, and newer, business with some interesting growth characteristics that came about as a result of the advent of hydraulic fracking. But it's also linked to a commodity, i.e., to the price of crude oil. So instead of paying up and making an acquisition in solid waste, Mittelstaedt felt more comfortable deploying that capital into a tangential business line that won't be so attractive if crude oil ever falls by 40%. If the CEOs of some of these waste companies don't seem that comfortable investing in their own legacy solid-waste businesses, why should you?"

"Reduce, Reuse and Recycle"—and, in the case of Waste Management, especially, "Re-rate." WM may be viewed as a Garpy stock without the growth, or, alternatively, as a value stock without much value. The shares will find a new identity, eventually, we think, at a lower valuation.

•