GRANT'S
INTEREST RATE OBSERVER®

Vol. 39, No. 21d 233 Broadway, New York, New York 10279 • www.grantspub.com NOVEMBER 12, 2021

King cockroach

Evan Lorenz writes:

The past decade was famous for many things—the fall in bond yields, the rise of cryptocurrencies, the rise and rise of the Kardashians—but robust enforcement of the securities laws wasn't one of them. Concerning the latter, though, Gary Gensler has plans. Last month, the chairman of the Securities and Exchange Commission solicited public comment on a rule to claw back executive incentive pay after earnings restatements.

This was a long time coming. Congress told the SEC to incorporate some such rider into the 2010 Dodd–Frank Act, but the commission dragged its feet under both Democrat and Republican administrations. With this in mind, *Grant's* takes a look at Rollins, Inc. (ROL on the New York Stock Exchange), a potential restatee. In preview, we are bearish.

A rural Virginia radio station, 1460 WRAD, was the first seed of what turned into a family conglomerate; the enterprising Rollins brothers, John W. and O. Wayne, bought it in 1948. They subsequently added billboards, truck leasing, hazardous-waste disposal, cable TV, oil services, what have you. In 1964, they pivoted to insects and vermin with the purchase of Orkin Pest Control for $62 million ($544 million in today's dollars), which they now contend was "the first leveraged buyout in American history."

Whether or not Rollins was a trailblazer in corporate finance, Orkin was a pioneer in the pest business. Founded in 1901 by namesake Otto Orkin, the company quickly moved from selling rat poison door-to-door to a subscription service called "clean-out." Exterminators would pay regular calls to bait and trap the creatures that the customers wanted no part of. Testament to the success of the new business model—recurring contracts rather than scattershot sales—is that pest control was one of only two service industries that the government deemed "essential" during World War II.

Over the past 73 years, Rollins has continued to acquire anti-pest operations while divesting other business lines. There were 26 such acquisitions in the first nine months of 2021 and 31 in 2020. Residential pest control (the "Orkin Man") was the top contributor to third-quarter sales (47%), followed by commercial pest control (34%), termite control (18%) and franchisee fees (1%). Domestic sales accounted for 93% of the quarter's top line, although Rollins operates in every continent except Antarctica.

That said, the U.S. extermination market is mature and slow-growing. According to competitor Rentokil Initial plc, the global pest market summed to $22.1 billion last year, of which North America accounted for $11.2 billion. In the five years ended 2020, North American pest-control services grew at a compound 4.2% annual rate, which would have matched nominal economic growth except for the pandemic-cum-lockdown recession that knocked GDP for a loop.

But tell that to Mr. Market, who chooses to value ROL at 54.2 times trailing earnings. Perhaps investors are focused on the top line rather than reported organic growth, the latter measuring just 4.7% per annum over the 2015–20 span (of which more below).

As for revenue, it climbed at a 7.8% compound rate over the same half-decade, thanks to the rapid-fire acquisition of smaller exterminators. Management shelled out a cumulative $831.4 million on these purchases, a material sum compared to Rollins's $17.4 billion market capitalization.

Acquisitions do more than burnish the top line. They enhance the strategy of creating what's known in the trade as dense routes. Clusters of clients reduce the time an exterminator needs to spend behind the wheel. They also allow the cross-selling of ancillary products, such as wildlife removal and mosquito extermination. Thus, over the five years ended 2020, diluted earnings per share compounded at an 11.3% rate, a full 3.5 percentage points faster than the top line. Best of all from an investor's perspective, Rollins funds most of its M&A through cash flows instead of through borrowing. The Sept. 30 balance sheet showed net debt, including operating leases, of $203.4 million, or one-third of trailing Ebitda.

Otto Orkin's century-old innovations mean that around four-fifths of Rollins's revenue is recurring—another investor-pleasing plus. Pests, too, recur, in good times and bad, and the Orkin top line continued to grow through the housing bust. Covid-19 gave the industry a bump, as homebound employees noticed the bugs and critters that had frolicked unseen while they, the humans, had been at the office. Orkin's revenue swelled by 7.2% in 2020, including 3.8 percentage points of organic growth, and by 11.4% in the third

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Growth in the share price certainly

source: the Bloomberg

quarter of this year, driven by 9.2% organic growth.

Of the five analysts who cover ROL, only one says sell, while short interest equals just 4.2% of the float. Over the past 12 months, insiders have stood pat.

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Gary Rollins, age 76, the second-generation chairman and CEO, controls 51.5% of shares outstanding through direct holdings and family trusts, and he lets his public investors know who's in charge. Key data, such as customer counts, customer retention and, at times, the drivers of costs in a given quarter, go unstated in SEC filings.

"It's a very well-managed and very well-run company," Michael Hoffman, who rates ROL a hold for Stifel Financial Corp., tells me, "but they give you information with an eyedropper. As an outsider looking in, as part of my job you have the bare bones of what they are required to disclose and nothing incremental. It makes it challenging when there are nuances about what's causing things to happen."

Even when forced to divulge more, Rollins shares the bare minimum. In 2013, for example, in response to the SEC's order to state what proportion of revenue growth stemmed from price increases, the reply—"less than 2%" in five years, "around 1%" in two years and "approximately 1%"—was vague and perhaps self-serving. If prices were essentially flat, then organic growth (plus acquisition growth) must have been reciprocally strong. Interestingly, Brett Ponton, CEO of Terminix Global Holdings, Inc., told listeners-in on his Nov. 2 earnings call that, over the long haul, price increases of 3% have been the industry norm.

Organic growth itself is another sticking point. In its first-quarter press release, Rollins began disclosing revenue growth minus "significant" acquisitions. What does "significant" mean? "This is the same way that we've measured it every quarter, probably for the past 15 years…when we acquire a small tuck-in acquisition," Chief Operating Officer Jerry Gahlhoff told the earnings-call audience on April 28. He meant that a small acquiree counts as organic.

On the one hand, this helps explain why Rollins's organic growth, as reported, has been so steady, narrowly ranging between 3.8% and 5.6% per year in the decade ended 2020. On the other hand, it doesn't answer the question of what underlying growth actually is, an important datum for a highly valued growth stock. In response to criticism from the Street, Rollins issued "very clean organic" growth numbers, as it styled them, in the third quarter. However, at the same time, it ceased to break out organic growth by business line and refused to provide historical "clean organic" growth figures.

An SEC investigation stemming from complaints by a Rollins whistleblower is another item of note. The inquiry, the existence of which management disclosed last year, relates to how the company "established accruals and reserves" beginning in 2015. This was the year when Paul E. Northen became chief financial officer. In the course of its own internal investigation, Rollins discovered and cured an internal controls deficiency. According to the latest 10-Q report, any errors found along the way were "in the aggregate immaterial."

The SEC's investigation continues, however, and the Rollins front office has reacted as if something were not, in fact, quite right. In 2019, the board of directors consisted of eight long-serving individuals (the median director had joined the board in 1983), of whom three were named Rollins. Now there are 11 directors, of whom eight joined in 2020 and 2021, while family members number two. And two of the new directors are former partners of Ernst & Young, LLP. On July 27, one day before Rollins announced its second-quarter results, Northen assumed a new post, senior vice president focused on sustainability, and Julie Bimmerman, the former VP of finance and investor relations, took over as interim CFO.

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Grant's is not predicting that Rollins's organic growth, whatever it is, will slow, although next year will face tough comparisons with 2021. Nor are we predicting that competition will lead to a collapse in margins, although cost pressures nicked adjusted Ebitda margins in the third quarter (23.2% versus 23.8% in the like period of 2020).

What we observe is the hotting up of competition for American pest-control acquisitions. U.K.-based Rentokil posted turbocharged revenue growth in North America in 2015–20, to $1.6 billion from $623 million, fueled by a steady diet of acquisitions and organic growth. (In the third quarter, Rentokil's organic growth of 10.1% in the North American pest-control business topped Rollins's "clean" organic growth of 9.2%.) Swedish competitor Anticimex is moving into the U.S. market, and Terminix used its latest earnings call to promise a step up in M&A activity. Besides the incumbents, "we're seeing private equity on the hunt for smaller regional platforms

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to pursue a roll-up strategy," Chris Hunt, head of M&A for Rentokil, said at a Sept. 28 investor confab.

Acquisitions in the pest-control business "used to go for 1.0 to 1.5 times sales," Jay Van Sciver, who rates ROL a sell for Hedgeye Risk Management, LLC, tells me. "As Rentokil entered the market, multiples went up to 3 times. It's harder to make a high-valuation acquisition work." You can see evidence of the rise in purchase multiples on Rollins's balance sheet. From year-end 2015 through Sept. 30, goodwill compounded at an 18.6% rate, more than double the rate in revenue growth. Those costly acquisitions lowered returns on invested capital to 19.5% in 2020 from 29.2% as recently as 2015.

Rollins, Inc. at a glance

all figures in USD millions except per share data

	TTM**	2020	2019	2018	2017
revenue	$2,360.2	$2,161.2	$2,015.5	$1,821.6	$1,674.0
pretax profit	467.8	354.7	261.2	310.7	294.5
net income	348.0	260.8	203.3	231.7	179.1
diluted shares	492.1	491.6	491.2	490.2	490.9
earnings per share	0.71	0.53	0.41	0.47	0.37
cash	117.7	98.5	94.3	115.5	107.1
debt	68.0	203.0	291.5	0	0
goodwill	665.6	653.2	572.8	368.5	346.5
total assets	1,904.8	1,845.9	1,744.4	1,094.1	1,033.7

* The 12 months ended Sept. 30, 2021.

source: company reports

Once Rollins stops including bolt-on acquisitions in its figures, Van Sciver points out, "you are going to find out that organic growth is lower. Then you are left with the roll-up part of the long thesis, and, if acquisitions are too expensive to make the returns work, that also undermines the bull thesis."

Longer-term, family control may lead to a stock overhang. From 2010 through 2019, third-generation Rollinses sued for more control over the family trusts, which action ended in a sealed legal settlement. Along the way, Gary Rollins fired his son Glen, who had served as COO of the Orkin subsidiary and as a vice president of the parent organization. So it's not inconceivable that the grandchildren of John W. and O. Wayne Rollins may choose to diversify the family's 51.5% stake in ROL when they have full disposition of the shares.

It will be said that poor disclosure, an inquisitive SEC and the hotter competitive environment notwithstanding, pest control has much in common with the consumer-staples sector. Very true. However, the 32 companies that comprise the staples component of the S&P 500 trade at an average of 22.3 times trailing earnings. That's less than half the multiple that investors have optimistically hung on Rollins.

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