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Deal us out

If QE made investors complacent, tapering may make them anxious. If so—barring a Federal Reserve about-face to un-tapering or a spontaneous resumption of the 2013 festivities — the short-selling trade may have its day in the sun. Now under way is a bearish analysis of a company that, under the spell of monetary ease and a rising stock market, has gotten more hall passes than a high school quarterback.

To give our target its due, Clean Harbors (CLH on the New York Stock Exchange) is an American success story. Under the leadership of the founder, current chairman and CEO, Alan S. McKim, the company has grown from a four-man tank-cleaning business to the top hazardous-waste-disposal company in North America. At the end of 2000, the stock changed hands for the split-adjusted price of $1. Today, it fetches $54. McKim himself owns 4.6 million of the 60.7 million shares outstanding. The burden of proof is plainly on any who would bet against this exemplary capitalist.

Growth through acquisitions is McKim's grand design. Our thesis is that recent deal making has carried the company far from its lucrative roots. While the Street wasn't looking, Clean Harbors became more cyclical, more leveraged and less deserving of its fancy valuation.

McKim dealt himself into a position of strategic dominance starting in the late 1990s. When others wanted out of the hazardous-waste cleanup business, he was happy to buy their incinerators and environmental treatment plants. "The one deal that stands out occurred in 2002 when McKim borrowed $280 million to buy Safety-Kleen's Chemical Services Division," relates colleague David Peligal. "The acquisition gave Clean Harbors the majority of the disposal assets it holds today, including the valuable Deer Park, Texas, incineration plant. It was a leveraged bet and a contrary one, but McKim bet the company on what he knew. To judge by the course of the share price, he knew a lot."

The beating heart of Clean Harbors is what the company calls its Technical Services segment—essentially, the $1 billion in revenue per annum legacy waste-disposal business. NIMBY is McKim's silent partner. Because not one new hazardous-waste landfill or incinerator has been permitted in over 15 years, Clean Harbors is sitting in the North American catbird's seat. Thanks to the aforementioned acquisitions, the company accounts for 66% of hazardous incinerator capacity, 24%

Clean Harbors Inc.
(in $ millions, except per-share data)

	12 mos. to 9/30/2013	2012	2011	2010	2009	2008
Revenues	$3,189.2	$2,187.9	$1,984.1	$1,731.2	$1,074.2	$1,030.7
Cost of revenues	2,297.2	1,540.6	1,380.0	1,210.7	753.5	707.8
SG&A expenses	441.2	273.5	254.1	205.8	163.2	159.7
Depreciation and amortization	241.7	161.6	122.7	92.5	64.9	44.5
Income from operations	197.3	202.2	217.7	211.9	82.1	108.0
Interest expense, net	(72.3)	(47.3)	(39.4)	(27.9)	(16.0)	(8.4)
(Benefit) provision for inc. taxes	(3.2)	(1.9)	57.4	56.8	26.2	36.5
Net income	130.7	129.7	127.3	130.5	36.7	57.5
Diluted earnings per share	2.26	2.40	2.39	2.47	0.74	1.26
Diluted shares out. (in millions)	60.7	54.1	53.3	52.9	49.9	45.7
Adjusted EBITDA*	$464.4	$373.8	$350.0	$314.7	$157.6	$163.2
Adjusted EBITDA margin	14.6%	17.1%	17.6%	18.2%	14.7%	15.8%
Capital expenditures	$(274.7)	$(195.8)	$(148.5)	$(116.4)	$(62.2)	$(57.5)
Free cash flow	124.4	156.5	42.0	102.3	50.5	53.1
Interest coverage ratio	2.7x	4.3x	5.5x	7.6x	5.1x	12.9x
Goodwill	$590.2	$593.8	$122.4	$60.3	$56.1	$24.6
Total assets	3,956.9	3,825.8	2,085.8	1,602.5	1,401.1	898.3
Long-term obligations (inc. current portion)	1,402.0	1,408.0	538.9	278.8	301.3	53.6
Total stockholders' equity	1,476.1	1,432.1	901.0	780.8	613.8	429.0

*net income plus accretion of environmental liabilities, depreciation and amortization, net interest expense, and provision for income taxes
source: company filings

of hazardous landfill volume market share and 35% of permitted treatment, storage and disposal facilities.

"To underscore the point," Peligal notes, "Clean Harbors owns eight commercial hazardous waste incinerators, including three in Deer Park, two in El Dorado, Ark., one in Kimball, Neb., and one in Aragonite, Utah. If you wanted to build the Deer Park facility today—if you could secure a permit, which seems an awfully big 'if'—it would probably cost around $300 million. By extension, to replicate all of Clean Harbors' permitted facilities would probably run to a few billion dollars. Yes, the assets are valuable. They are also expensive to operate. The key to running them profitably is to have the waste (at an economic cost) to feed them."

McKim succinctly described the Clean Harbors M.O. at the Needham Growth Conference on Jan. 14. "When you think about our business model," said the founder, "it's really about gathering waste from our customers, transporting that material and bringing it back to some of our treatment and disposal facilities. For those materials that we can get value from, if we can recycle and reuse, whether it be solvents or metals or other types of materials, we'll sell those products as recycled products. For those materials that need to be ultimately disposed of, we will use incinerators, wastewater treatment plants and other landfills, and that really makes us quite unique."

Barriers to entry abound. Asset value, if not quarter-to-quarter profitability, seems assured. Still, Clean Harbors continues to buy businesses that don't obviously fit the original, lucrative mold. Two cases in point: The $400 million acquisition of Eveready Inc. in 2009 and the C$200 million purchase of Peak Energy Services Ltd. in 2011. Together, they constitute a new Clean Harbors' corporate division, the Oil and Gas Field Services unit, which, in revenue size—$400 million a year—amounts to not quite half of the original, basic and profitable NIMBY-protected clean-up line.

Eveready is part trucking business—hauling fluids from well site to waste facilities, pipelines, etc.—and part lodging services; oil-field workers lay down their heads in Eveready-provided man camps. Peak is an energy-services vendor. It will rent you 4,000 different pieces of equipment germane to oil and gas extraction. It operates 14 service centers situated in western Canada and the United States. Whatever the merits of these business segments, just about anyone can enter them. None is regulated so heavily as the hazardous-waste disposal business. Suffice it to say that, in the first nine months of 2013, adjusted EBITDA (earnings before interest, taxes, depreciation and amortization) of the oil and gas segment fell by 15.9% from the first nine months in 2012.

A much bigger—and, to date—more disappointing acquisition is Clean Harbors' $1.3 billion purchase of Safety-Kleen in December 2012. You will recall the 2002 purchase of Safety-Kleen's Chemical Services Division; this was one of the acquisitions that put Clean Harbors on the North American hazardous-waste map. Not content with that one strategic coup, McKim decided to buy the rest of Safety-Kleen, a leader in, among other things, the business of collecting and re-refining used oil into base oil, an essential ingredient in the manufacture of lubricants such as motor oils. In 2010, Clean Harbors entered a bid for $716 million; the quarry declined. A price of $1.3 billion did the trick in 2012, which McKim financed with a combination of cash, an equity offering and $600 million of debt.

Not too much to pay for the "largest collector, recycler and servicer of parts-cleaning equipment and used solvents in North America," Clean Harbors assured its stockholders. "Through its two major facilities—one in the U.S. and one in Canada—Safety-Kleen has more base oil re-refining capacity than any other company in North America," the acquirer pointed out.

But no sooner did Clean Harbors reel in Safety-Kleen than the base oil market fell apart; since October 2012, a gallon of the Group II type has fallen to $3.37 from $4.13. One might imagine that base oil prices would usually track crude oil prices, and one would be correct. They usually do, though not over the past 18 months. Each has gone its separate way.

"Perhaps demand for base oil is lower because people are driving less (about 2% fewer vehicle miles in 2013 than in 2007, according to the U.S. Department of Transportation), or because they are changing their oil less frequently (every 5,000 miles will do it for newer vehicles, according to the AAA, compared to the every 3,000-mile routine that was formerly standard)," Peligal writes. "Or perhaps what's wrong with base-oil prices is a prospective supply-demand imbalance. A new, $1.4 billion Chevron refinery in Pascagoula, Miss., slated to open later this year, is expected to boost annual American production by 18%. One has to wonder how Clean Harbors will keep up. For Chevron, the re-refining business is a rounding error. For Clean Harbors, it represents 17% of consolidated revenue."

The 2012 acquisition by Nuverra Environmental Solutions of Thermo Fluids Inc. illustrates the risks in the Clean Harbor diversification drive. Thermo Fluids does some of what Safety-Kleen does: It recycles used oil, antifreeze, oily water and oily absorbents. It will haul away as little as one 55-gallon drum of toxic waste, and it will roll up its sleeves to remediate great big toxic industrial messes. The price tag was $245 million. Perhaps it was the wrong price rather than the wrong business, but Nuverra (formerly Heckmann Corp.) in November took a goodwill impairment charge, wrote down the value of Thermo Fluids to $145 million and announced that it was putting the division up for sale.

Has the sell side noticed the signs that, at McKim's corporate creation, things are not as they were? No indication yet. "Even though Clean Harbors cut financial guidance more than once in 2013, the majority of analysts (11 out of the 14 on the case, according to Bloomberg) continue to rate the shares a 'buy,'" Peligal reports. "Preliminary guidance for 2014 is as follows: $3.7 billion to $3.8 billion in revenues; $610 million to $640 million in adjusted EBITDA (see the accompanying table for a definition) and $200 million in free cash flow. Unguided are analysts to the fact that the new, overly diversified Clean Harbors is more volatile and more capital intensive than before. Thus, in 2008, depreciation and amortization charges amounted to 27% of EBITDA; this year, D&A is expected to come in at 44% of EBITDA. Though EBITDA has been growing, the quality of EBITDA has been fading.

"Other aspects of the Clean Harbors story seem to have escaped the Street's attention," Peligal winds up. "For instance, the leveraged balance sheet that now has $1.4 billion of long-term debt. For another, CFO Robert E. Gagnon resigned from the company on Feb. 4, 2013, after the Safety-Kleen acquisition was completed but before the 10-K was filed; his tenure was all of six months. And not least, the company, which pays no dividend, trades at 20.5 times the projected 2014 earnings estimate of $2.64 a share—after likely earning less than $2 a share in 2013. It trades at 7.2 times the projected EBITDA estimate of $616 million—after likely generating $525 million of EBITDA in 2013. Some of the scales may fall from the sell side's eyes when the company reports results later this month. Then, again, the Street being the Street—and Clean Harbors being the valued M&A client it undoubtedly is—the scales just might remain in place, even as that elevated multiple drifts down to earth."

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