Republic Services: "The Worst Is Behind Us…"

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The waste industry has a number of cost levers to pull to overcome profit pressures in its residential pick-up operations and reduced volume in its commercial and industrial operations, the latter a higher margin proposition. However, economic activity seems to be picking up, and some are saying the worst may be behind us. Our favorite waste hauler is Republic Services.

By Brian Nelson, CFA

We talked a lot about the waste industry in the book *Value Trap: Theory of Universal Valuation*, explaining why the oligopolistic structure of the trash-taking space is much more attractive than the oligopolistic structure of the airline industry. For one, the former holds tremendous pricing power (consumers might be willing to pay up to get their trash taken away), while the latter suffers from extreme price transparency and fare pressure (air travel is a commodity and consumers mostly care about going point-to-point at the lowest possible price). As the airlines struggle to stay afloat in a post-COVID-19 world, the waste industry's pricing power is also being put to the test.

With consumers "cocooning" at home, residential waste volumes have been on the rise. Waste Management's (WM) CFO Devina Rankin recently noted that "the weight of residential waste has increased 15%-25% since the beginning of widespread lockdown orders in the US." While increased waste volumes seems like a good thing, residential pricing contracts tend to be a little less flexible when it comes to volumes (more residential waste tends to translate to more costs at the same price). These higher residential collection costs are happening at the same time higher-margin commercial and industrial roll-off operations are also facing pressure.

While not an ideal scenario, there may not be too much to worry about. Even if the waste industry comes up short collecting more fees from residential customers, it can still work to optimize route networks, reduce overtime hours, and eliminate non-essential costs and expenses (travel, entertainment, and consulting), while pursuing capital-spending adjustments to preserve free-cash-flow generation and dividend health. However, the group may not even need to go that far with cost levers. Recent economic data points have been encouraging. Dividend Growth Newsletter portfolio holding Republic Services (RSG), for example, had the following to say in its first-quarter report, released May 5:

> **…we are beginning to see signs of increasing economic activity.** We remain confident in our ability to quickly adjust our costs and capital expenditures to align with changes in demand. Assuming the economy continues to recover, and GDP sequentially improves in the third and fourth quarter as currently predicted by economists, we expect to generate over $1 billion of adjusted free cash flow in 2020.

On the conference call, Republic Services' CEO Donald Slager even said that "assuming these trends continue (customers re-engaging with them as businesses plan to re-open), **we believe the worst is behind us**." As states around the U.S. slowly re-open for commerce, higher-margin commercial and industrial roll-off revenue looks poised to bounce back materially, and we'd view any contractual adjustments on the residential side of the business due to higher volumes as icing on the cake (most already have embedded annual CPI-adjustments). Echoing our views on the group's solid free-cash-flow generating trends and strong business models, Waste Management had the following to say in its first-quarter 2020 press release:

> **Our business model generates strong cash flow and is resilient in any economic cycle.** In past downturns, we have demonstrated the ability to flex spending and manage capital expenditures to generate strong free cash flow and return excess cash to our shareholders. We expect to deliver on these priorities as we continue to provide essential services to our customers during this unprecedented pandemic

The third-largest waste operator in the U.S., Waste Connections' (WCN) first-quarter 2020 results, released May 6, further showcased the resiliency of the group. The company noted that, even with the "measures taken across the U.S. and Canada to limit or control the spread of COVID-19…(it) exceeded (its) first quarter outlook for adjusted EBITDA." Waste Connections' revenue in the period advanced 8.7% thanks to 'price + volume' growth of 5.2%, while the company noted that "**solid waste trends have improved sequentially late in the month (April) and into early May.**" The waste industry looks well-positioned to handle anything that COVID-19 may throw at it, while the economic backdrop starts to improve.

Concluding Thoughts

With detailed guidance for 2020 suspended by the largest players in the space, top-line and profit pressures should be expected in the near term, but we're not concerned about the resilience of the waste industry's business models or the health of their dividends. In some ways, the worst may very well be behind us, and Republic Services' dividend yield of ~2% looks as enticing as ever. We continue to be huge fans of the group.

Environmental Services Industry – CWST RSG SRCL WCN WM

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