Waste Management Inc.

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Michael Feniger: Hi, everyone, I'm Michael Feniger at Bank of America Merrill Lynch. I work on the industrial team, and I lead the coverage on our environmental services or, better yet, just the waste companies. It's an honor to have today, obviously, there's been a lot of discussions over the last day or two about sustainability, recycling, and no better person to talk to than having Waste Management, the field leader in the industry right now, and the biggest player.

So we're going to have a dialog. I'll start it off with some questions and, hopefully, there will be room for Q&A as well. So kicking off, and this is Devina, very grateful to have her here and we'll, hopefully, have a good conversation and try to keep it open for everyone else involved.

Devina Rankin: Good morning, everyone.

Michael Feniger: So I think what we'll start off with is actually -- is on volume. So Waste Management has got into 2% volume after a great year of 2018. Some of your competitors are guiding more to a flat to 1%. There might be some reasons why Waste Management is seeing a stronger outlook. I was hoping you could talk about what the volume outlook kind of looks like in the US.

I think ffter the fourth quarter, some investors were thinking that, with the stronger consumer, stronger economy, maybe more of the 2% made more sense than what we're seeing in the flat economy. So is there something specific Waste Management is seeing out there on a national level or a regional level that's helping drive that stronger growth outlook?

Devina Rankin: Well, our growth outlook from volume really is a continuation of what we've seen the last couple of years in the Waste Management strong volume performance, and if you compare that to the other large players, there is a marked difference. That marked difference is coming in our most profitable parts of our business. It's commercial, industrial collection and then also in the C&D and special waste parts of landfills as well as that, kind of, steady state MSW growth that we see with population expansion and just the strong economy that you mentioned.

I think what's different about Waste Management is that we've taken a more prescriptive stance with respect to knowing the customer and particularly in the commercial line of business; levered our knowledge of the customer to expand their service offerings. We've seen service increases exceed service decreases for existing customers for six consecutive years. And that means that as their businesses grow, we're being responsive to their growing business needs by picking up more frequently, increasing the size of their containers, and that's showing real volume contributions to the business.

We are also committed to the national accounts part of our business, and that's a differentiator for Waste Management. It's one of the things that I think also creates a bit of a difference in the margins of the business structurally, and I'm guessing we'll talk about that more in a moment. But we've seen really good growth in national accounts businesses, and that's an indication of the strength of the economy as well.

Michael Feniger: And if we could talk about the volume growth in relation to the cycle. So the waste industry is always kind of viewed, or always been discussed as a later-cycle sector. I think your volume didn't turn positive until 2016. Some of that was, I think, some pricing issues you had. But, just, is there any way that you can give us a sense of where we are in the cycle compared to last cycle either in terms of landfill tons, maybe specific regions or customer bases with the commercial versus housing. Where do you think we are compared to where we were last cycle?

Devina Rankin: So, you know, at the peak on the landfill line of business, last time around we were at about 130 million tons. In 2018 we finished at 115 million tons -- ballpark. So that tells you we're still off of those peak levels. But I think there are various reasons for that. I think some of that has to do with the focus on diversion and recycling, and so more tons are going into that part of the network today than were at the last peak a decade ago.

You know, with respect to where we are in the cycle, your guess is probably as good as mine. We definitely think that the waste industry is a good barometer of the health of the US economy and the Canadian economy, and you know, we still see expansion. And we're optimistic. If you look at, for example, the housing start numbers that came out and certainly disappointed to expectations, at the end of the day, they're still creating some nice growth. And what we see there is continued growth in neighborhood construction, and that leads to additional commercial starts.

And all of that continues to be very positive in our business. It's hard to say where we are in the cycle, but we know that we are structurally different today than we were last time around, such that, one, we don't expect this next downturn to be housing-led. And then, two, we're less disproportionately exposed to that part of the market than we were in the last downturn. We're at about half the level of exposure to housing that we think we were last time around. When you combine both the temporary rolloff business and then the construction and demolition waste volumes at the landfill.

Michael Feniger: Makes sense. And when we think about on the margins, I think Waste Management is guiding EBITDA growth, kind of in line with your revenue growth for 2019. You know, after years of margin expansion in a tough pricing backdrop, we're now entering the best pricing backdrop, and we're seeing limited margin expansion this year.

Can you talk about the step up in SG&A with some of these initiatives? Give us a little granularity around what these initiatives are and, looking forward in 2020, do you see that SG&A number kind of leveling off and the operating leverage shining through by the time we get there?

Devina Rankin: So the SG&A initiatives, I think of it in terms of really incremental investment dollars. If you compare Waste Management to others in the industry, we actually have had, for some time, the lowest SG&A as a percentage of revenue in the business. And some of that is certainly our scale, right? We should have some leverage, and that leverage does shine through for us.

What I think that is different, though, is that Waste Management is viewing the SG&A dollars as similar to either an investment in a new technology, an acquisition spend, even. Because if we can do things that create customer growth organically, through technology and differentiating our service from the service that is provided by other competitors, we see that as good return investment.

And so we're thinking about $100 million of incremental SG&A in 2019. I can't say that that slows down, necessarily. We're not giving outlooks for 2020 and beyond at this point. But what I would say is, as long as we continue to see the returns on these investments, and we see technology be something that's not just a push change from Waste Management but really a pull change that is not just accepted by the customer but really expected by the customer, we'll continue to make that investment every day because we think the return profile of that is superior even to the return profile of some of the tuck-in acquisition spending that we do.

Michael Feniger: I mean, the waste industry has always kind of been viewed as a tech-light industry. Where do you think some of these improvements you guys are initiatives you're seeing that you think could gain from some tractions. Is it with the fleets, is it with customer interface? I'm just curious what you guys might think is a possibility in 2019 and 2020 that we could, kind of, roll out?

Devina Rankin: Yes and yes. So it's, you know, we think of it in the customer lifecycle and all phases of the customer journey from onboarding how we sell, how we serve, and then, ultimately, how we bill and deal with the back office parts of the customer engagement. And thinking about technology in this business, you're absolutely right. This is an industry that's been pretty far behind with respect to how we think about technology.

But at Waste Management, we've been proud to always be on the forefront of that. We've had onboard computer units on each one of our routed vehicles for a number of years now. And the margin expansion that you mentioned earlier that we've seen in the business has come from using the data that we gather about our customers, about the routes getting better efficiency in order to optimize the business.

And so we've seen technology pay off. One of the examples I like to point out most specifically is our drive cam technology that we have in all of the vehicles. And the reason I think that that's so important is, one, safety is job one for Waste Management. We recognize that serving our customers in a safe way is for the value of the community of our employees, most importantly.

But, ultimately, all of that benefits the shareholder, because we have better incident rates. You know, early on, adoption of that was actually hardest by our drivers. Our drivers were a little concerned about the Big Brother element and having a camera onboard that was rolling at all times, now they are the biggest advocates and fans for those technologies because they've actually proven them to be not at fault in a number of incidents that have occurred. Where in the past, we wouldn't have had the data to be able to support that, and it really was his or her word in an accident.

And so what we're finding is that while we've been slow as an industry to adopt technology, where we have adopted, we've seen such better leverage of our assets and our people that those returns are there, and so we can continue to make investments. It will be providing good user interface that you and I are accustomed to having in just about every part of our daily lives today, but the waste industry has been slow to create. So eventually being able to know when the trash truck is going to be servicing your location is something that we want to put in the hands of the customer. We're not there yet, but that's the journey that we're headed on.

Michael Feniger: And speaking of the journey of Waste Management, I think it's interesting you just mentioned how the industry in itself, landfill tonnage is still actually below peak yet. Waste Management is actually at the highest EBITDA margin they've had. So if you just take a step back, it kind of feels like there's been a mini-transformation occurring at Waste Management. In the last five years your revenue, I think, is up only 7%, yet your EBITDA is up over 25%, your margins have expanded 500 basis points.

You kind of touched on a few things with your last remarks, but can you help us understand what has changed at Waste Management? Is it a pricing initiative? Route optimization? A big cost takeout? What's kind of changed at Waste Management the last five years to really drive that higher profitability? I guess, going forward, you know, is there still low-hanging fruit there? Do you still see room to it? Or is it more just EBITDA will be growing in line with revenue?

Devina Rankin: So there's definitely more room, I think that's the headline, right? At the end of the day, that growth that we've created in EBITDA dollars is something we expect to continue, and Jim said on the call, right, when you look at 2018's results, the headline number really should be for a waste industry company, waste industry leader. So a mature business, we grew EBITDA at double the rate of the growth in the economy, and that's impressive. And most of that was organic. We did have some help from small tuck-in acquisitions but, far and away, the majority of that EBITDA expansion was organic growth in both revenue and earnings.

The room that continues is from technology and investment in technology. It's from knowing the customer better. It's from differentiating Waste Management from small local haulers. The technology investments that we're making, we expect our largest competitors to make as well. They may not make them as quickly as we do because we tend to find ourselves as a leader in a lot of ways. But we expect that they'll be fast followers, but the differentiator will be that the small local haulers won't have that service offering. And, really, in some ways, it may become very, very difficult for them to catch up because those technology investments won't be as readily accessible to them as they are to us.

What's changed in that transformation I really think is it's something that Waste Management's done, but I think it's something that the industry, as a whole, has done. One of the beautiful things about this industry is the cash flow that it generates through cycles. You know, we generated over $2 billion of free cash flow this year, and it really is an incredible indication of our EBITDA conversion to free cash flow. And that can be a blessing and a curse.

It's a blessing because day in and day out, through any economic cycle, you know that you're going to be generating strong earnings and strong cash. The curse is, in some ways, particularly historically, it could create a level of complacency in the largest service providers in the industry. That level of complacency has exited the building at Waste Management. We do things very differently today than we did five years ago.

We're more disciplined from an SG&A spending perspective, from a capital expenditure, M&A perspective. Each and every part of our process is about ensuring that we're allocating our human capital and our financial capital to the highest return parts of our business.

Michael Feniger: And on what you just mentioned, I think, on the M&A side, if we could touch on that for a brief second. It feels like when we think of M&A for Waste Management in 2019, I think your leverage is the lowest it's been in the company history. I would argue it's a little too strong, your balance sheet.

So when we come into 2019, should we be thinking it's a similar story to 2018 in the sense of a lot of tuck-in acquisitions that you know, consolidated fragmented industry, raising the dividend I think was 9% to 10%, or could we see something different, something bigger? Waste Management entering a new vertical perhaps? What is Waste Management at this point considering strategic? Is it more evolution, non-revolution? Or could we see a step change in 2019 or 2020 with how you approach M&A?

Devina Rankin: That's a lot of questions.

Michael Feniger: A lot of questions I there, I know.

Devina Rankin: So I'm going to start with the balance sheet dividend and share buyback. You know, your comments about the balance sheet being possibly too strong. What I can tell you, as a former treasurer at this company, when we had a very weak balance sheet from a lot of different perspectives, we had a weak enough balance sheet that people questioned our ability to continue the dividend. People questioned our ability to do any strategic M&A. We weren't positioned to be able to do anything of size or scale.

And to be where we are today it's not because we paid down debt. It's because we locked down on those core fundamental things that I mentioned earlier and really had shown EBITDA growth that has outpaced even our own expectations five years ago. And even last year, we increased our debt balances by $500 million.

So you can think of that in terms of allocating free cash flow first to the dividend of number-one priority, right? And we grew that 10.2% for 2019. It's the largest single-year increase that we've ever provided, and it shows you the confidence that our Board has and that management has in the continued growth of free cash flow over the long term.

Last year we allocated about 90% of our free cash flow to the shareholder in a combination of dividends and share buyback. And on top of that had the biggest acquisition year that we'd had in a while.

And so when you think about what we'll do in 2019 on those priorities, it's going to be more of the same, and I think that's a good thing. Share buyback we guided at $800 million, which is a slight decline from what we did in 2018, but it's actually ahead of what we guided to in 2018. So we've got authorization for $1.5 billion. So there's some room there, and we'll use that room as we see fit based on our own valuation and how we view our valuation versus the opportunities that are out there for tuck-in acquisitions and strategic M&A.

We did announce as part of the first quarter call that we have an acquisition we expect to close in Q1 in the Permian Basin for some disposal assets. That is going to take us to the high end of that tuck-in M&A guidance that we provided of $200 million to $400 million pretty quickly. It wasn't specifically contemplated in our guidance, but we were confident that we were getting close to getting the deal done. So that was certainly one of the things that we were thinking about in terms of how we framed the year ahead.

You know, for us oilfield services disposal is core. That's not something that we see as tangential. We focus on positioning ourselves in the markets that we think are going to provide outpaced growth in the economy over the next five to 10 years. And when we look at that part of the US economy, we see the Permian as the place to be to participate in the growth that we'll see in environmental solutions for that line of business.

We are a good, solid environmental solutions provider across a number of aspects and verticals. And so the focus is on the customer and thinking about what the customer is demanding and where the customer is growing. M&A will continue to be a part of that. If we see markets where maybe we're a number two or a number three service provider, and we have opportunity to expand market share in a growth market, we'll look for those opportunities.

But we're going to do so with the same discipline that has created the best return on invested capital in the industry. You know, we won't pay more than our multiple for businesses. We remain disciplined, and, you know, that's a requirement, I think, of shareholders. I am a shareholder. If I were a shareholder in other businesses in our industry, I think I'd be really focused on their ability to continue to generate returns that mean that there's more value to the shareholder of that M&A dollar than there is to a shareholder return directly either through dividend or share buyback.

Michael Feniger: That makes sense. And to your point about being a full service provider, we have to talk about recycling. Recycling is a big theme here, and it was a tough year last year with where recycle (inaudible) prices were down 60% based on China's policy, and it kind of hit the industry hard last year. I think going into 2019 there was a view that prices have kind of stabilized at low levels and I think you guys were -- investors were expecting maybe a (inaudible) $50 million EBITDA uplift in 2019 just if prices kind of stay flat with some of the pricing mechanisms and contamination fees you guys were charging.

So we came into this year, in February we saw another drop in prices. So I guess from where you're sitting, internally, are you hearing that, one, prices have stabilized after that drop in February? And, two, how are you guys thinking about recycling in 2019 and, kind of, even going forward?

Devina Rankin: So we got out of the business a long time ago of trying to predict where recycling commodity prices would go. We've built in an expectation that on a basket basis, our average rate per ton would be $70 a ton for 2019. We've actually seen the year start meaningfully lower than that expectation. But we're still optimistic that with some of the normal cyclicality in recycling, particularly demand in the summer months for cardboard, preparing for the Christmas season as an example. If there is an opportunity for the full year to remain at that level.

But with the $70 rate, that was about a $20 million to $30 million help on a year-over-year basis to the recycling line of business. That's certainly still off of the peak levels of earnings contribution from recycling, which is why we have to change the way that this business is built. If you look at that $70 a ton on the commodity price that we can sell and compare it to the average processing cost per ton for recycling, there's an out-of-balance there that means that the business is not sustainable economically.

We want recycling to be sustainable both because we think that there is environmental utility. We know that it's what our customers and our communities want. We think it's the right thing for the environment. Big picture and long term, we've made investments and continue to make investments in the recycling line of business. We're building a new, more automated MRF in Chicago and expect that to come online later in 2019. We know that recycling is good for the environment. It has to be economically sustainable as well.

Michael Feniger: So we have a lot of European investors here. And the question I get from time to time is when you look at Europe, they have a lot more stringent policies, recycling rates are higher. I mean, how does Waste Management look at, you know, when you see Europe versus the US, what are the big differences? You know, are you planning in five to 10 years that that landfill number will actually continue to decline, and we continue to go into more recycling? What has to change there to make it any different than the more you see in Europe? Or do you see the market is very different?

Devina Rankin: The markets are dramatically different, and it really starts with taxation. In Europe landfills are taxed to a point where they're just not economically competitive. And that model is dramatically different here. I think what's not different is the desire for us to be mindful of the responsibility we all have to protect and preserve our natural resources and be good stewards of the environment.

And so when we think about what's happening in the US and how it can change over time, we're investing in communities that have demonstrated that it's important to them. There's a social responsibility that a lot of communities have stepped forth and said this is important enough that the effective taxation of our community is appropriate. And we're going to do that.

The best example is in Oakland, California, where we've invested over $100 million in capital in more advanced technologies in recycling and organics. And when communities demonstrate that this is important to them and important enough that the community is willing to pay for it, we're prepared to make that investment. The expectation that that mindset will shift to middle America is really hard to imagine because the land constraints that you see on the coasts and in Europe don't exist in Texas, as an example, where there is a lot of wide open spaces.

So to convince people that, you know, where we can process landfill tons at more, like, in the $20 to $30 a ton range, and you're talking about taking something to more $100-plus a ton in order for it to be economically viable, and make that capital investment worthwhile. You know, that's something that communities and neighborhoods have to decide whether they're prepared to step up for. It's not something that we will do without there being a good environmental and economic solution.

Michael Feniger: That makes sense. I think economics, at the end of the day, has to kind of drive it. We touched on this cycle versus last cycle. You mentioned there is some diversion. Housing isn't as robust as it was last cycle. Those are some differences. I'm just curious on your customer base. I mean, obviously, e-commerce is something that's kind of changed the game this cycle versus last cycle. How is Waste Management looking at their consumer or their commercial business? Are you agnostic to, you know, a Sears versus Whole Foods? And are you seeing any changes with e-commerce with more waste generation maybe at the home versus at the store? I'm just curious if you're seeing any switches in the mix over the last cycle because of some of these factors?

Devina Rankin: I'm guessing you get more cardboard at your house than you did a decade ago. I know I certainly do. And there are a lot of changes. I'm also -- what's the app -- Door Dash. I'm a Door Dash user, which means that instead of going to a restaurant, I'm having food delivered to my home, and so that means the waste is shifting in part.

Now, there's still waste in booth steams, right? So the restaurant is still producing the food, and that means that they're still going to have some level of service. But there are changes, and what we have noticed most, I think, is in the shopping mall part of the business. That's one of those that we've seen a dramatic shift in the last five years. We acquired a shopping mall business with our Oakleaf acquisition almost a decade ago, and the business profile for the shopping mall part of that national accounts business has fallen dramatically.

Aside from that, the small commercial business is performing very, very well. And that really is our best return customer in the collection part of our business. And so continuing to see strength there is what's important from an overall return profile and mix of business profile. The residential business is something that we've struggled with, and I think the industry struggles with it. It's extremely capital intensive. Most of our workers' compensation issues happen in the residential part of the business because it's less automated than other parts of the business.

As someone who is in the industry, I get very frustrated with my neighbors when I see the large, heavy bulky items that they put on the side of the road and expect that our drivers are just going to be able to somehow launch a couch into the back of the hopper. You know, so that part of the business needs to evolve as well. And we're placing more of an emphasize on automation. You see that in the picture, right, using automated side loaders in place of the more traditional backend loaders is important.

But really getting people to recognize -- you know, it's interesting because if you think about what you pay for your garbage service, I'm guessing -- I can tell you that I don't even see it at my house because it's blended into my utility rate that I pay. But I would pay 10x what I pay today for the service because I don't like the alternative. The alternative is me having to proactively manage or engage with my waste, and that's not something I want to do. I want it to be as simple and convenient as possible.

And so we've got to partner with communities in order to get better pricing leverage for the capital investment, the human capital investment that we make in that part of the business.

Michael Feniger: That makes sense. And I just would like to open it up if anyone has any questions they'd like to ask. All right, well -- oh, yes, of course.

Unidentified Audience Member: Hi. I just had a question regarding some of the -- you mentioned you're expanding to Permian Basin. Obviously, there's a lot of waste being generated there. How do we think about the potential risks that you may incur? I mean, obviously, many of the old companies could face, at some point in the future, risks from some of the weights they are creating. How does that impact you? And if you want to expand beyond just the Permian to other potential environmental risks that you may face in the future? Thank you.

Devina Rankin: So from an environmental risk perspective, I would tell you our view there is that we're the leader in building, constructing, operating, and closing landfills. And we take our environmental responsibility associated with the disposal of the waste that's generated from that part of the business as seriously as we do normal household waste.

You know, I think what's interesting in the more industrial disposal and the waste that's created is the evolution that's happening like in coal ash as an example where some of the large companies are being required to line effectively and move the waste that's been placed in some of their disposal facilities in past years to better, more constructed landfills. That's something that we've taken seriously for decades that other industries haven't necessarily kept pace with. And so we think we're very well positioned to be a partner for those large customers who are generating that waste in order to provide the solution that they need to be environmentally responsible. Does that answer your question?

Unidentified Audience Member: Partially. So what kind of waste has been generated in the Permian Basin. And, obviously, production of hydrocarbons there has skyrocketed. There's tons of activity there. It's probably the fastest-growing county or region in the US possibly. I mean, across all parts of the country. So is it all kinds of waste that you're managing there?

Devina Rankin: We're looking at focusing on the solid waste that's produced. We're not managing the liquid waste.

Michael Feniger: If I could ask a question on cost. I mean, inflation is, you know, CPI inflation is actually baked into a certain amount of your contracts. So inflation going up, the data going up, is actually good for the price in your contract. But the flip side of that is a cost dynamic, right? We're in a low unemployment rate environment. Where are you seeing the pressure there? You guys have called out kind of earlier than some of your competitors that there were some transportation costs playing out. Where are you seeing labor and that cost dynamic moving in 2019? How are you finding ways to ease that? Are you able to price above that to be able expand your margins, the underlying business, as you enter 2020?

Devina Rankin: So in 20018, we saw about 3.8% increase in the average wage rate for the driver, and that compares to our long-term historical norms of more to 2% to 2.5%. So it's a pretty dramatic increase there. And then when you consider that we paid a special bonus to our employees as well, you really saw the labor line have a more dramatic increase in year-over-year cost growth than what has been typical for us.

You'll see some normalization because of the absence of the special bonus in 2019. But we do expect, and are planning for a continuation of about that 3.8% wage increase. What we're also seeing, though, is the third party transport is dramatically increasing. That's in the double digits at this point from a percentage increase on a year-over-year basis, and we can't overlook that. And that means that transfer and disposal pricing has got to be a focus area for us, and it will be -- it will continue to be. Our core price and just as a line of business was in excess of 3% last year, and so the focus will be on continuing to keep pace there to cover the incremental costs that we're not just seeing on the operating side but, frankly, on the capital side.

In 2018, the solid waste business, in spite of those cost headwinds, created 50 basis points of margin expansion, and that comes from the value of volume growth, which can't be understated. That incremental volume, that incremental ton comes on at a better contribution margin than the existing ton in most cases.

And so the incremental margin efficiency, rad (ph) optimization, all of those things are what we're doing to create incremental margin expansion in the year ahead in spite of a really significant increase in the inflationary cost pressures in our business.

Michael Feniger: Makes sense. And just, lastly, you know, there's a lot of small mom-and-pop collection garbage companies. But not everyone owns a landfill. And over the last, I think it's in Subtitle D, so the last two decades the number of landfills has declined rapidly. Why don't we see more pricing power? Is that something, an issue that Waste Management would want to drive? It seems like at the high barriers-to-entry type business, it costs a lot money to run these landfills appropriately and need regulations. What do you see on the pricing dynamic on the landfill side?

Devina Rankin: So, you know, our commercial and industrial pricing success in the collection line of business really came when we centralized some of the decision-making powers associated with those behaviors. And we're doing the same thing in our landfill part of our business. The reason, I think, for Waste Management specifically, I can't really speak to the others, that we don't see better pricing leverage at the landfill is a lot of those volumes are contracted, for one.

And then, at the same time, for your gate rate customers, the risk of losing a customer to an alternate site is relatively high. So a single collection customer, if you made a bad pricing decision there, losing that one customer doesn't have as significant an impact on the earnings of the business as losing a disposal customer. And I really do think that's the difference.

But if we provide better insight to our teams about the optimal market position of our sites and insight into the labor and cost pressure that others are seeing, that means that they really are going to prefer the Waste Management landfill because in 16 of the 20 largest markets in North America, Waste Management has either the best position landfill, or we're tied for the best position landfill. And we have got to price those assets accordingly, because there're real value to our customers associated with that strategic and beneficial position in the marketplace.

Michael Feniger: Perfect. And on that I think we're wrap it up. Thank you so much, Devina.

Devina Rankin: Thank you.

Michael Feniger: Thanks, everybody.