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EXECUTIVE REVIEW: **Waste Management Industry**

Industry Executives Offer their Sage Opinions About the Industry & Its Future

Keys to the Temple

A Contrarian Perspective on Consolidation's Future

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Thirty-three years

Thirty-three years have passed since the roll up game burst upon the garbage scene from its humble beginnings.

A Look Back in Time

Back in 1956, Dean Buntruck married into the Dutch families that dominated Chicago trash collection. After the death of his father-in-law, he went into the business, and in 1968 linked up with the Florida operations of his wife's cousin, Wayne Huizenga. South of the Mason-Dixon, in 1967 Tommy Fatjo and his cousin Tom Deane bought a truck and began a small hauling business in a tiny Houston suburb.

The world may no longer remember Acme Disposal or American Refuse Systems, but, on those rocks – and the power of an idea – the prophets of garbage's future erected Waste Management and BFI – two colossuses, with more than $10 billion in revenues between them, that bestrided the country's mountains of trash.

Yet, although the landscape that they strode across may have chronologically inhabited the years after World War II, in the early years it actually more closely resembled the Wild West. Dominated by immigrant families operating on the margins of the burgeoning cities, trash hauling had become characterized as much by suspicious fires in packer trucks and base ball bats, as trash collected in ash cans and dumpsters.

Organized Crime

Because carters messed in society's effluvia, from its inception at the end of the 19th century, the garbage industry had been relegated by Main Street to the other side of the tracks. Then, when the Volstead Act repealed prohibition and cities moved to privatize commercial collection to save money, organized crime saw the possibilities to gussy up the trash companies as their new protection racket.

But, with so much arson and knee capping going down, white shoe bankers and Wall Street kept the garbage industry at arms length. And without access to capital, the business had remained local and fragmented.

Going Public

However, for every time there comes a season when, because of the opportunities growth offers, industries mature. On the numbers, a commanding market share turned out to be a more potent and durable pathway to fat profits than gangster hijinks. Better to impose discrete monopoly rents across an entire continent that do not raise too many eyebrows than to let hoods extort outsized collection fees in a handful of big cities like New York or Kansas City.

Essentially, the taint of mob links was locking up the larger valuations inherent in the industry. Seeing this potential, shedding their lurid past like a snake its skin, and, in 1970 and 1971, taking themselves public, were all born of that first revelation by those early visionaries. Using their freshly minted stock as collateral, they financed an unparalleled acquisition spree, to the point that, by the end of the twentieth century, almost all of the small fish and most of the mid sized ones had been snared.

Scale Efficiencies

At first, the nascent industry produced tangible rewards for investors from mergers and buyouts. The hundreds of very small haulers that the two giants acquired annually in the early years were typically inefficient, and performance was materially advanced by professional management and more efficient equipment utilization that larger size made possible. But, the Achilles heel of Buntrock and Fatjo's gamble was that the economies of scale in the trash business cap out at the metro level, and that mother lode was tapped out early on. Economically speaking – separate and distinct from whatever market power a cartel can muster – there is simply no rationale for national, nonetheless international, garbage conglomerates.

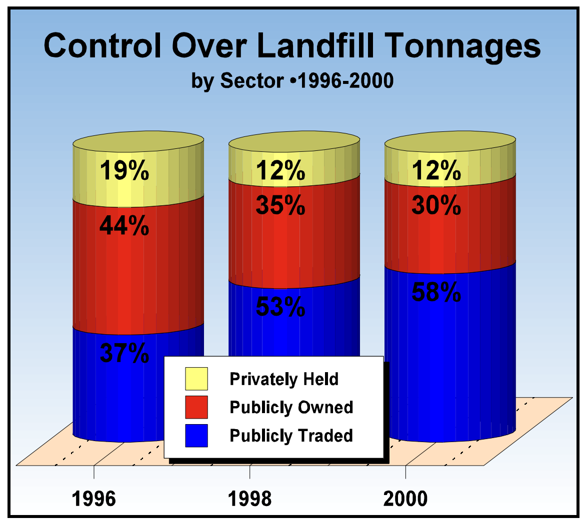
Collusion and Cooked Books

So when they weren't cooking their books to make earnings appear bigger than they were to assuage investors, they were attempting to collude on prices in order to pump up profits. But exposés in *Barons*, *Business Week* and the *Wall Street Journal* crimped creative accounting, and the crude conspiracies culminated in a crescendo of antitrust litigation, like the *Cumberland Farms* private class action lawsuit. Truculent plaintiff's lawyers who had the goods would not settle for less than $80 million, not the chump change in fines that Justice Department prosecutors settled for because they wouldn't commit the resources to litigate. And more actions and bad publicity loomed because too many people had to be "in the know" to ever keep a the cabal a secret.

Landfill Regulation

Just about that time when it looked like the dream might die, Dean Buntrock had his second epiphany about how to sidestep the industry's low scale efficiencies and non-existent barriers to entry that made monopoly pricing elusive. Casting about for a final endgame that would capture market power, he was one of the first with the foresight to see that – of all things – environmental regulation held the keys to the temple.

While anyone with a truck and gumption could break into the hauling side of the business, not until the mid 1990s, did environmental regulations slam the door on new entrants into landfilling. Leading up to EPA's promulgation of the Subtitle D landfill rules, probably as many as ten thousand open dumps were shuttered, and afterwards licensed landfills were whittled from 7,683 down to 3,581.



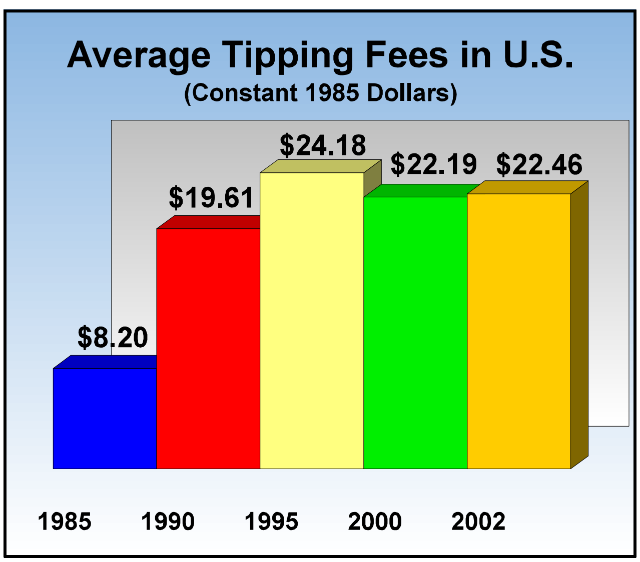
SOURCE: Deutsche Bank

At the same time, between 1996 and 2000 the publicly traded trash companies increased their share of landfill tonnages by 57 percent, from 37% to 58%, and some put recent numbers closer to 68% (see graph).

Nearly impermeable barriers to entry into the landfill market were erected as part of the Law of Unintended Consequences, and how potent a force they were. For whoever controlled those sites in a geographic market, and linked them to their trucking operations, commanded the entire waste market. Deprived of a place to fairly empty his or her trucks when they filled up, any new competitor who might challenge monopoly pricing could be price squeezed out of the market by the coming cartel with punitive tip fees or white glove treatment at the scale house. Vertical integration was what the economists called it; and hub and spoke, by the industry pundits. But to the cities and other businesses, the strategy seemed like just plain bad news.

No Pricing Power

Somewhere on the way to the bank, things didn't turn out quite the way that had been expected. In the years 1985-1995 leading up to the Subtitle D era, average national tipping fees at the gate had almost tripled from $8.20/ton to $24.18/ton (in constant 1985 dollars). Seemingly against all logic, from 1995 to 2002 in the period after the Subtitle D rules went into effect, on the other hand, the price in deflated dollars has actually gone done by more than 7%.



SOURCE: NSWMA

After 33 laborious years rolling up the once fragmented garbage business, the national consolidators have amassed control over 49% of the entire solid waste industry, and 58%-68% of landfill tonnages. Yet, prices had flat-lined at the very same time everyone expected them to ramp up. The Big Three's Herfindahl-Hirschman Index – the Justice Department's measuring rod of concentration – is probably around 1500, while the agency's *Horizontal Merger Guidelines* indicates that values between 1,000 and 1800 are moderately concentrated and typically begin to show pricing impacts in most industries. Yet the waste giants had yet to show any pricing power for all their labors over all these years.

What happened ... and where the heck did those keys go?

The Hunt for the Keys

The so-called experts have not earned their epaulets on this one. After one too many restatements and write downs that dribbled over into the nine digits, the Street lost faith in waste's old guard. In search for a solution that would put valuable assets back into productive use, new blood was called in from the bench in 1998 and 1999. Private investor pools backed number three, USA Waste, to takeover number one Waste Management, and number 4, Allied Industries, to merge with number 2 BFI.

But, white knights didn't turn out to be the solution either. One moment "New" Waste slashed administrative costs to "pull $800 million of savings out," as Mr. Rodney Proto boasted to the *Wall Street Journal*. The next, as CIBC's *Trash Talk* reflected on yet a second billion dollar wave of writedowns, restatements and charges, following the be-all-to-end-all housecleaning of the year before, "it is increasingly clear that [new] WMI was too lean." One moment WMI promises *Business Week* it will get a handle on "dysfunctional" accounting reports from the field with SAP's R/3, the next, the company writes off the $45 million of sunk installation costs and sends 1,160 outside auditors into the field to find out what's really happening. And, at the time, in an unprecedented soap opera, after firing the whole lot of them, "New" Waste winds up suing those same white knights for looting the company.

Now, it is said, the meltdown at WMI can be stanched by "switching cultures" and turning over the keys to a "seasoned operations executive" in the form of Yellow Corp's CEO Maurice Myers, instead of promoting deal-making trash guys. More power to Mr. Myers, and certainly everyone hopes that he will have more luck than Ronald LeMay who was brought on board in 1997 with the same credentials. LeMay barely lasted long enough for the ink to dry on the press release announcing his arrival when he blanched at the magnitude of the problem and fled back to Sprint.

In the end, smoother running operations is to the good, and a set of books that reflecting the true financial picture is a relief. But, it fails to answer the fundamental question about where the promised outsized profits went.

There is No Key

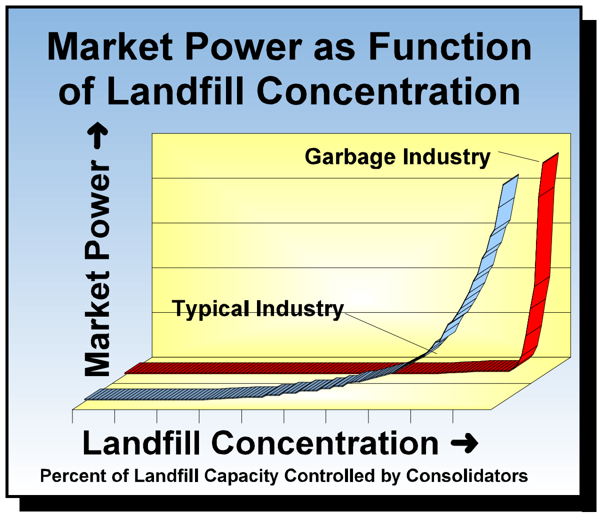
A full analysis is forthcoming from the Center for a Competitive Waste Industry in an upcoming technical industry report that this article popularizes, but suffice it to briefly note that the industry was mercilessly buffeted by cross-winds from every direction that has undercut the game plan.

New Entry. From the north, the conventional wisdom failed to grapple with the implications of the very low barriers to entry into collection, the industry's weak flank. While the Big Three busily bought out the privately held competitors and then cleverly used asset swaps to leave only one or two consolidators remaining in many major markets, when monopoly rents were imposed, the fat profits lured back in a new generation of competitors that forced prices back down.

Evidently, the Laws of Unintended Consequences ricochet unpredictably and do not, as did the Subtitle D rules, always inure to the consolidators' benefit. In order to produce the promised synergies, those same mergers that created the Big Three also threw many overlapping corporate executives over the side when companies were combined. That put back on the street experienced garbage men like Mr. Micky Flood with the know how to run the business, the respect of equity pools to attract capital, and non-competes that soon ran out.

In a seeming never ending story, until the endgame is attained, the hunt for monopoly power creates the very conditions that foster its demise. Because their reentry threatens to overturn a cartel's applecart, they have to be bought out at a premium, almost guaranteeing that they will ultimately be profitable. Then, after once more waiting out the non-compete, they can play the game all over again.

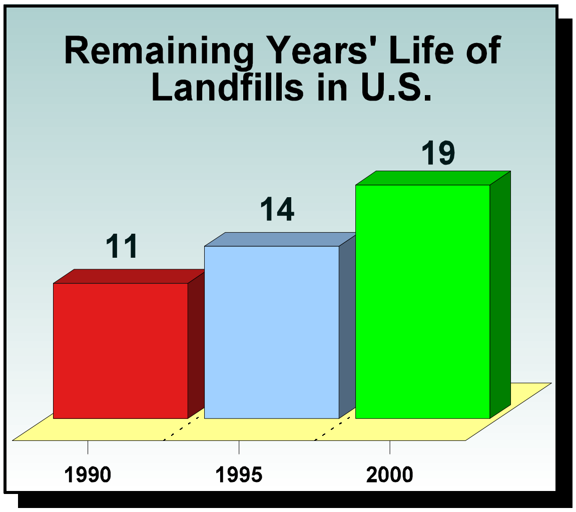
But, most critically, because of the particular way this industry is structured, until every cubic yard of available capacity in a market is moved under the Big Three's umbrella, the new competitors continue to have somewhere to offload without being gored, and, unlike most other industries, market power remains elusive until the very end, instead of steadily increasing with greater concentration (*see* graph along side).



SOURCE: Center for Competitive Waste Industry

That means doubling concentration over local landfill markets, as the consolidators have achieved, and impressive though that might sound is not enough and won't be until that last yard is locked down. Looking down the road, if the Street keeps backing this horse for another decade, the trajectory of continually increasing landfill concentration may suggest a bleak future for competition when all publicly-owned landfills close or are bought out and the reentry game is shut down. But, in many markets that is years off and has not impacted prices today, especially because landfill capacity is greater than demand.

Overcapacity. From the west, in the quest for greater share, the waste giants massively overbuilt capacity, leading to a disposal market glut hanging out there for years to come. As an indicator of that, the aggregate remaining life at landfills has reportedly increased from 11 years before Subtitle D was promulgated to 19 years a decade later (see graph along side). The Big Three, incidently, have reported even longer remaining lives in their own portfolios: Waste, 33 years, Allied, 38 and Republic 34. With typical lateral expansion permits taking five years, anything much beyond that in a market suggests excess that overhangs the market.



SOURCE: NSWMA

High Fixed Costs. From the east, although there are no real scale efficiencies in collection until unattainable 75% concentration ratios are achieved, there are at the landfill. But, to achieve those impressive scale economies that do exist in landfills, mega sites incur 50% greater fixed costs than their predecessors. That is no problem when thousands of tons come through the gate each day, but, when too much capacity overhangs the market, it makes landfill owners, desperate to cover debt payments, all too anxious to drop prices to fill the gap.

Regulatory Threats. And from the west, the liner based engineering systems that are mandated by the EPA rules, and that create the barriers to entry, turn out to be fundamentally flawed for their intended environmental purpose.

Encasing the waste load in a giant diaper may seem fine in the short term, but eventually, as EPA tech staff have long warned, the barriers will "ultimately fail." Then, rainfall will reenter the site, and decomposition will resume, reigniting a whole second wave of uncontrolled hazardous leachate and landfill gas emissions.

This has been the landfill industry's dirty little secret for over a decade, as they sought sucker the public into inadequate financial assurance regs so that, after a seemingly reassuring post-closure period, they can walk away. They hope to be allowed to pocket all the profits and leave the orphaned sites and the billions of dollars in Superfund clean up costs with the States and the taxpayers, not to mention the Fortune 500 companies, which only tangentially used the sites for non-process wastes.

Many of America's largest companies may have thought they had evaded the joint-and-severally briar patch by moving their industrial hazardous wastes to their own controlled sites. But, so far they have failed to recognize that, even though they themselves are no longer landfilling hazardous wastes at MSW sites, small generators are, and eventually, that will result in the States having to run costly clean up projects and on the prowl for deep pockets.

At one time when Subtitle D rules were adopted, that seemed so far off in time, none of these nasty complications entered into the political calculus. But today, too many landfills are reaching the end of their lives, and the chickens are about to come home to roost. Even landfill leaders from within the citadel, like SWANA Executive Director, John Skinner, have recently warned public officials that "the responsibility of responding to long-term problems at dry-tomb landfills will fall on future generations, and the funding requirements could quite likely fall on state and local governments."

The States are beginning to become restive, because they are seeing that the liability from orphaned landfills is likely to fall on their backs with billions of dollars of bail out costs that they can ill-afford to fund. Now that the time is running out and the warning flags have been raised, we can expect push back as they seek to insure that the waste industry is really held responsible and they don't wind up holding the bag. Some Superfund cleanups have cost $50 million at a site. There are almost 2,500 operating MSW landfills in the U.S. today: Waste Management alone has 288 of them. Do the math and then try to imagine writing the press release for that earnings restatement.

Wall Street may think it doesn't have a dog in that fight. But, there are major consequences to investors from this environmental dust up. Any number of possible reforms could wind up turning the industry's much heralded cash flow into negative territory as well as ratcheting up the cost of landfilling to the point that discarding garbage in the ground is no longer competitive with the other alternatives from composting to waste-to-energy. That's not to mention the possibility that more than half of their waste flows could wind up being diverted elsewhere. Think downward Death Spiral.

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One thing is clear. After three decades, Messrs. Buntruck and Fatjo's dream has become tattered. Landfill regulations had been the last White Hope, and certainly, there is a chance that the Big Three may dodge the bullet once again and live to bring the industry into the promised land. But, right now, the odds do not look all that favorable.

When that reality sinks in, Waste Management, Allied and Republic – which look like behemoths today – could wind up the target of sharks tomorrow. Taking things full circle, the shrewdest bottom fishers may presciently see that there is greater value in breaking them up, lopping off the dead weight of corporate overhead, and leave them leaner and nimbler, in their regional components.

And, the analysts' attempts to ballyhoo the sector's recent recatagorization from growth stocks into a cash flow play is not a good thing that makes them an astute buy. Rather, it suggests that investors believe that they can make more money having the free cash flow distributed as dividends to diversify their own portfolios than seeing the trash haulers plow it back into growing the business.

It has been 33 years now, and the search for those keys to the temple is looking more and more like the pursuit of the Holy Grail. The future implications for the tottering national trash companies are not likely to be lost on the smart money for much longer. ❏

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