

Industry Update

Refuse and Recycling



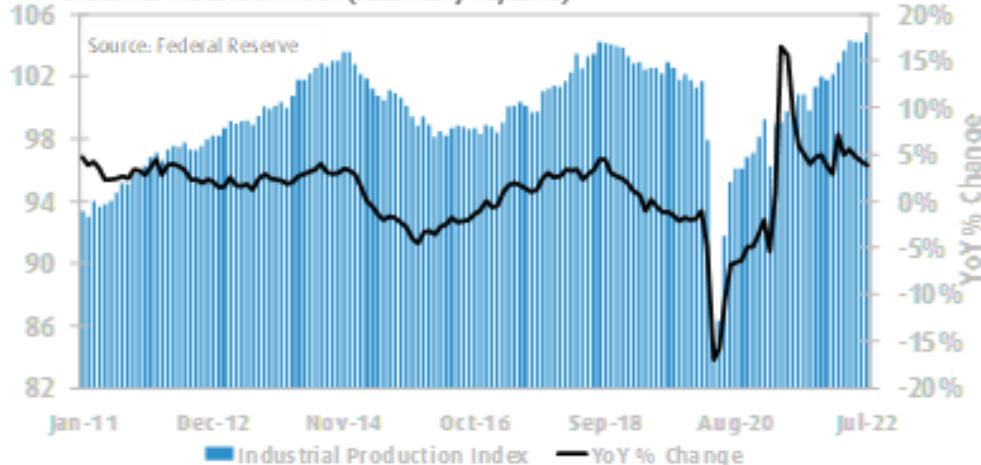
Key Developments

- According to the **Census Bureau**, household formation, a leading indicator for solid waste volumes, accelerated from 144,00 during the 1st quarter to 416,000 (+0.3%) units during the 2nd quarter and by 1.72 million units (+1.4%) compared to a year earlier.
- According to the **Bureau of Labor Statistics**, the Waste Management and Remediation Services industry, at the end of July, had regained 25,700 production jobs (+7.0%) since the low point of the pandemic while also reaching all-time high employment. Although industry labor costs continue to experience significant upward pressure, the year-over-year increase in average hourly wages during the 2nd quarter decelerated to +5.9% from +9.0% during the 1st quarter.
- Despite a growing emphasis on corporate sustainability objectives, a recent **survey of CEOs and CFOs by Gartner** revealed that in times of economic duress, investments in areas such as M&A and sustainability would be primary targets for reduction rather than those in technology or workforce spending.
- Be sure to check out the latest perspectives from BMO economists on the macro outlook (page 4).

Industry Fundamentals

The non-discretionary defensive characteristics of the waste management industry continue to exhibit impressive pricing leverage and steady free cash flow despite a decelerating macro environment. Given that CPI-linked pricing and fuel surcharges lag in both directions, and with internal inflation pressures potentially past peak, the stickiness of recent price increases should provide a tailwind for operating leverage through at least the end of the year. Still, rising interest rates and shifting consumer spending away from goods will pressure large volume-generating sectors such as construction, retail, and manufacturing. Against that volume backdrop, the industry maintains a proven cash flow preservation playbook, including reduced overtime and discretionary expenses, equipment optimization, and postponing significant capital outlays.

Industrial Production Index (Seasonally Adjusted)



U.S. industrial production jumped 0.6% in July, double the expected pace but only 3% above the pre-pandemic level of February 2020. Despite the fast start to the 3rd quarter, the year-over-year improvement slowed for the third consecutive month and is expected to continue to decelerate amid slowing consumer demand and rising interest rates.

Manufacturing, approximately 75% of industrial production, climbed 0.7% and reversed back-to-back monthly declines. Motor vehicles and parts (+6.6%) and most other durable goods posted solid growth of at least 1%. Capacity utilization during July increased by 0.4 pts to 80.3%, marking the highest since September 2018.

Business Indicators



A sample group of public refuse haulers realized record average year-over-year **pricing growth** of 6.1% during the 2nd quarter, up 80 basis points from the 1st quarter and well above the 5-year and 10-year averages of 3.5% and 2.8%, respectively. Pricing continues to be supported by steady growth in the commercial sector and advantageous negotiating leverage within the highly inflationary backdrop.

Growth in **solid waste volumes** also remains above long-term averages. Still, the rate of change has moderated significantly as yearly comparisons stiffen, inflation and higher interest rates take their toll on the hospitality industry and C&D activity, and supply chain issues continue to handcuff many goods-producing sectors.

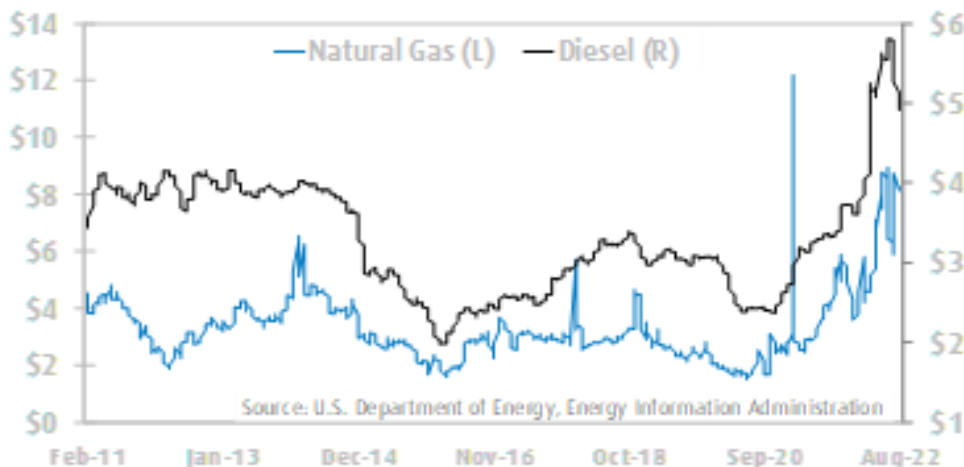
Core CPI (All Items Excl. Food & Energy) vs. CPI Garbage & Trash Collection Y/Y % Change



The **Core CPI** showed a much smaller-than-expected rise in June, up just 0.31%, which is the least in 10 months. There was no single reason for the light core print, but three travel-related areas, including airlines, hotels, and vehicle rental companies, all cut prices for a second straight month.

After retracing to a recent low of 4.0% during January, the **CPI index explicitly related to garbage and trash collection**, which is used frequently as a benchmark for contract service pricing, increased for the 5th consecutive month to a multi-year high of nearly 6%.

Natural Gas Spot and On Highway Diesel Weekly Prices



Since peaking at an all-time high in June, **Retail Diesel** fuel prices have been on an unrelenting downtrend. As of mid-August, the average weekly Diesel price of \$4.91 was down 90 cents (-16%) from the recent peak but still up 81 cents (+20%) since the invasion of Ukraine and \$1.56 cents (+46%) over the past year.

Despite the recent plunge, BMO estimates that crude and Diesel prices will remain elevated for the foreseeable future as demand for non-Russian crude and Diesel use as a natural gas substitute is only partially offset by slowing global macro growth and new supply.

The threat of supply disruptions coupled with the EU's efforts to substitute Russian supply has caused the spot price for **natural gas** to remain near multi-decade highs.



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“Voice of the BMO Economics Team”

With the post-pandemic recovery challenged by volatile commodity prices, multi-decade high inflation, rising interest rates, and persistent supply chain constraints, we thought it would be helpful to check in on the BMO Economics Team’s latest near-term outlook for the North American economy. For more: <https://economics.bmo.com/en/>

Straddling Recession – Sal Guatieri, BMO Senior Economist and Director Economics

The U.S. and Canadian economies have quickly lost steam with the former actually contracting in the first half of the year. The drag from rapidly-rising prices and interest rates has outweighed the lift from higher wages and excess savings. We reduced our 2023 growth forecast by half a percentage point to just 0.5% in the U.S. and to 1.0% in Canada, staying below consensus. Both economies will likely contract in at least one quarter near the turn of the year. Our outlook might not qualify as an official recession, but it will feel like one for many businesses and some workers.

The growth downgrade reflects recent weaker data and tighter monetary policy. U.S. real GDP contracted 0.9% annualized in Q2 following a larger decline in the prior quarter. Weaker consumer spending, a surprising decline in business investment, and a cooling housing market indicated an even softer underbelly than in the first quarter, when the contraction was concentrated in inventories and exports.

Given strong job growth, **the U.S. economy is probably not in recession.** Over half a million payrolls were added in July, on top of 2.8 million in the first half of the year. The surge in hiring, despite recession talk and worker shortages, fully erased the 22 million jobs that were lost at the start of the pandemic. It also lowered the unemployment rate to 3.5%, matching the 53-year low set before the pandemic. Still, job prospects are beginning to dim and will only worsen as the jobless rate heads toward 4.6% by late next year.

Canada's economy is seemingly holding up better than the U.S. due to a later reopening bounce and support from still-elevated commodity prices. Real GDP growth likely strengthened to 4.5% annualized in Q2 from 3.1% in the prior quarter. However, recent data suggest activity has weakened due to the same headwinds swirling south of the border. Most notably, employment has fallen this summer, reflecting softer demand and the challenge of finding new workers in a drum-tight labor market—the 4.9% unemployment rate is the lowest in five decades—and amid an aging workforce. We expect real GDP to grow just 1.0% in the current quarter and to contract early next year, before resuming modest growth.

In both countries, the earlier mania gripping **housing markets** has quickly fizzled, as the rapid rise in mortgage rates worsened already poor levels of affordability. Sales have plunged to below pre-pandemic levels and look to stay soft this year. **Prices have fallen for several months in Canada and are expected to tumble 20% by next spring**, marking the biggest correction on record. The decline should take prices back to levels of spring 2021 and affordability to moderately above long-run norms from the worst levels since the 1989 bubble. By next summer, prices will likely resume rising amid record immigration and a tight rental market. **U.S. resale prices rose through the spring** due to low listings, pushing affordability to the worst levels since 2006. However, timelier data from Redfin suggests prices are softening (as per new home prices), and we expect a 10% correction in the year ahead.

Central banks will need to press a little harder on the brake than we thought previously to suppress inflation. We added 25 bps to our call on peak policy rates, with the **Bank of Canada** expected to stop at 3.5% and the **Fed** at around 3.6% by year-end. These levels are sufficiently above neutral levels of roughly 2.5% to chill inflation while not putting the economy on ice. Following the Bank's jumbo 100-bp hike last month and the Fed's second straight 75-bp punch, both central banks are expected to scale back to smaller 50-bp moves in September due to the weaker economy. Following two additional moves later this year, both are expected to pause in 2023 as the economy stalls and inflation falls. While markets are starting to price in rate cuts in 2023, we suspect that a greater fear of inflation than recession will delay such until early 2024. Even if the economy slips into a mild downturn, the need to reestablish (badly tarnished) inflation-fighting credentials will likely delay the cavalry's ride to the rescue until inflation is headed convincingly back to the 2% target.

“Voice of the BMO Economics Team”

Straddling Recession (Cont.) – Sal Guatieri, BMO Senior Economist and Director Economics

It all comes down to inflation, of course. For a change, not all the news has been bad. Commodity prices have reversed meaningfully, led by base metals, lumber, and crops. The Commodity Research Bureau's spot index is down 10% from April's high, nearly reversing the past year's gain. Oil prices have slid below \$90 a barrel, though scorching temperatures have cranked up air conditioning and natural gas prices. Supply chain bottlenecks have eased a little amid shorter delivery times, fewer order backlogs, and less clogged ports. While scant inventories are still propelling car prices at double-digit rates in the U.S. and Canada, automakers aim to boost production as more microchips become available. Large retailers are now cutting prices to clear out unsold inventory, such as exercise bikes. Perhaps the best news is that most measures of long-term inflation expectations have eased a bit, giving central banks some breathing room. In addition, there is anecdotal evidence that U.S. companies are having a slightly easier time finding and retaining workers, possibly due to recession fears.

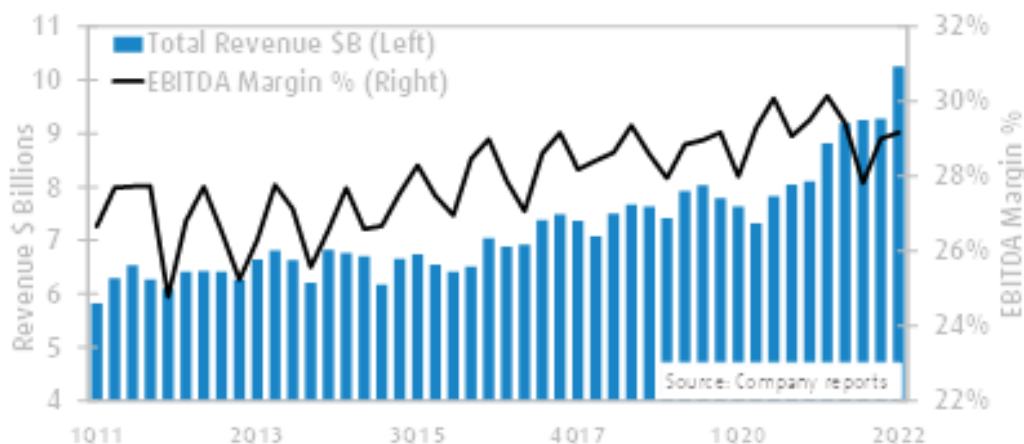
But inflation that stops rising is one thing; how quickly it retreats from four-decade highs is another. Here, prospects are less sanguine. Rising wages and rents due to tight labor and rental markets flag persistence. Faster increases in services prices are offsetting the benefit of slower goods prices. Consequently, current CPI rates of 8.5% in the U.S. and 7.6% in Canada will likely still hover near 5% by the middle of next year and around 3% in late 2023. The latter is still well above the 2% inflation targets, meaning central bankers will need to bite their lip to avoid sending the economy into a tailspin.

A key question is: **how much weakness in demand is required to restore price stability?** In our view, and assuming some further retreat in commodities and lessening of supply chain pressures, it will take enough weakness to lift the jobless rate sufficiently to cool wages. The Fed believes the so-called neutral rate of unemployment is around 4.0%, though Powell suspects it may have risen due to a shift away from customer-facing jobs. In any case, the current jobless rate must exceed the neutral rate to slow wage growth and ease inflation pressure. While a recession is not a necessary condition for this to occur, a period of sustained soft demand is, as per our outlook.

Stubborn inflation continues to pose the **single biggest threat to the economy**. Inflation may not fall according to plan, let alone as fast as the consensus view, which is a full percentage point lower than our call in 2023. In this event, policy rates would need to be much more restrictive, somewhere in the 4%-to-5% range. If so, there won't be much debate about whether the economy can avoid a deep downturn. As well, along with the potential for the war in Ukraine to escalate, heightened tensions between the U.S. and China over Taiwan are a growing concern.

Business Indicators

Waste Management Public Company Total Revenue and EBITDA Margin



Core pricing strength combined with increased surcharges and solid volume growth resulted in **total revenue** for a sample group of public waste management companies reaching an 8th consecutive quarterly high. Revenue during the 2nd quarter jumped more than 10% from the seasonally sluggish 1st quarter and an eye-catching +16.3% compared to the year-ago 2nd quarter.

In a "normal" environment, **EBITDA margin** typically follows revenue trends with the benefit of operating leverage. But in the current climate of rapidly rising costs, mainly labor and fuel, the industry's ability to respond with higher pricing and surcharges continues to lag. As a result, despite significantly higher revenue, EBITDA margin of 29.2% during the 2nd quarter fell 90 basis points from the year-ago quarter while increasing only 20 basis points from the 1st quarter.

2022 Outlook for Waste Management Public Companies

Company	Revenue Y/Y %	Adj. EPS Y/Y %	EBITDA Y/Y %
Waste Management	+10.2%	+18.2%	+10.6%
Republic Services	+18.7%	+14.4%	+15.7%
Waste Connections	+16.5%	+17.1%	+14.9%

Refuse Financing Inquiries

Jim Roberts
Jim.roberts@bmo.com
 972-819-2616

Industry Research Contact

Michael Zimm, CFA
Michael.zimm@bmo.com

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