Industry Update

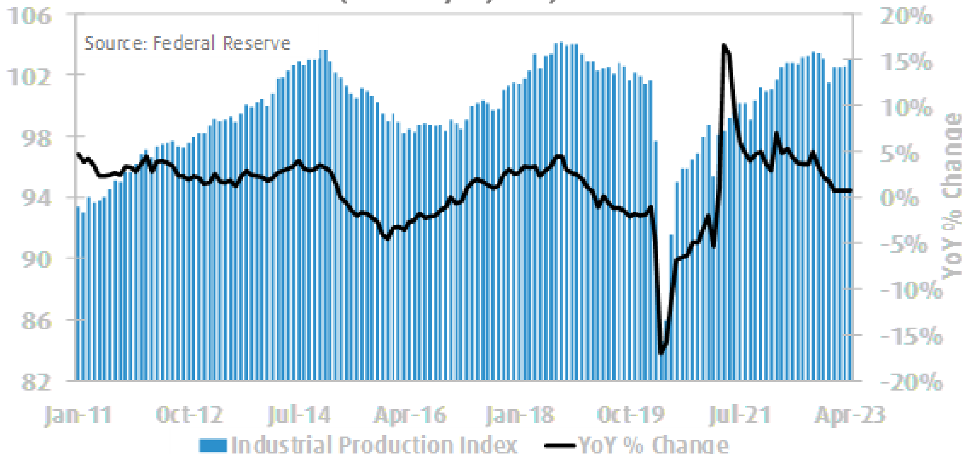
Refuse and Recycling

Key Developments

- The **California Air Resources Board (CARB)** approved the Advanced Clean Fleet (ACF) rule targeted at fleet operators. In essence, the rule will ban the purchase of new diesel trucks by some fleets beginning next year and entirely by 2036, although waste haulers received an exemption that extends the timeline six years to 2042.
- A recently introduced Senate bill, **The Resource Management Liability Protection Act**, is intended to shield some solid waste management and compost facilities from liability claims if the U.S. EPA designates certain PFAS compounds as hazardous substances.
- According to the **Bureau of Labor Statistics**, the Waste Management and Remediation Services industry, at the end of March, had lost 6,800 production jobs since the peak last November but overall regained 30,700 jobs (+8.4%) since the low point of the pandemic. Although peak wage increases are in the rearview, wage pressures are still elevated, with average hourly wages during the 1st quarter increasing by 4.0% from the 4th quarter and +6.6% from a year earlier.
- Be sure to check out the latest perspectives from BMO economists on the macro outlook (page 4).

Industry Fundamentals

Although elevated borrowing costs and tightening credit conditions have dampened macro trends, the carryover benefits from pricing leverage over the past 12 months and a robust M&A environment over the past couple of years have held those headwinds to a near stalemate. Still, weak recycling commodity prices, past-peak CPI-linked pricing resets, stubborn expense inflation, shifting consumer spending away from goods, and macro pressures on manufacturing, construction, and other large volume-generating sectors are challenging the industry's ability to expand volumes and margins. And, if conditions dictate, the sector maintains proven recession-resistant cash flow preservation levers, including discretionary expense reductions, equipment optimization, automation efficiencies, and the postponement of capital outlays.



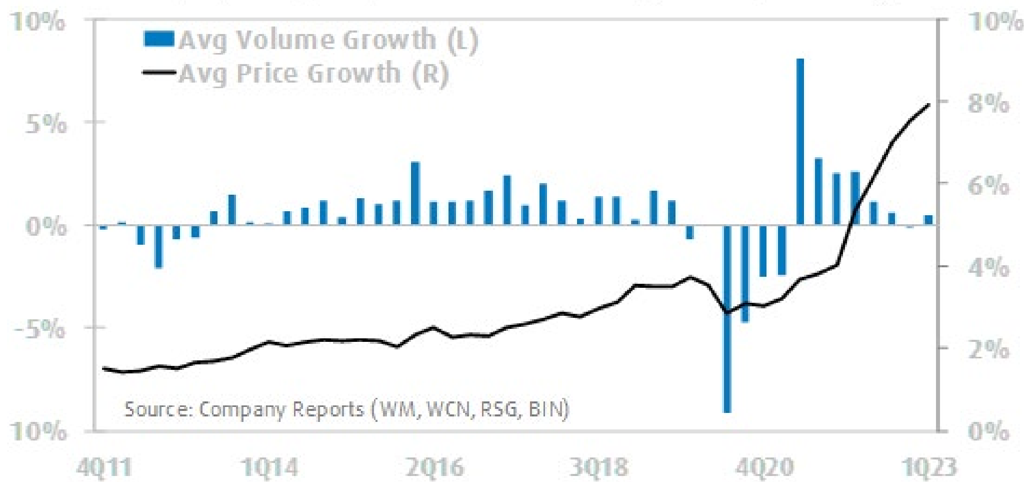
U.S. industrial production accelerated in April, rising a stronger-than-expected 0.5% month-over-month. However, the previous two months were revised lower, leaving total industrial output just 0.2% higher than last year.

Factory output rose 1.0% as motor vehicle and parts production accelerated. Excluding motor vehicles and parts, manufacturing output rose a more modest 0.4%. The gains in manufacturing were diffuse, with both durable (+1.4%) and nondurable (0.6%) subsectors seeing improvement. Further, **manufacturing capacity utilization** increased to slightly above the long-term average, which could add some stickiness to goods prices.

Explore Financing Solutions at www.bmotf.com
© Copyright 2023 BMO Harris Bank N.A. All Rights Reserved.

Business Indicators

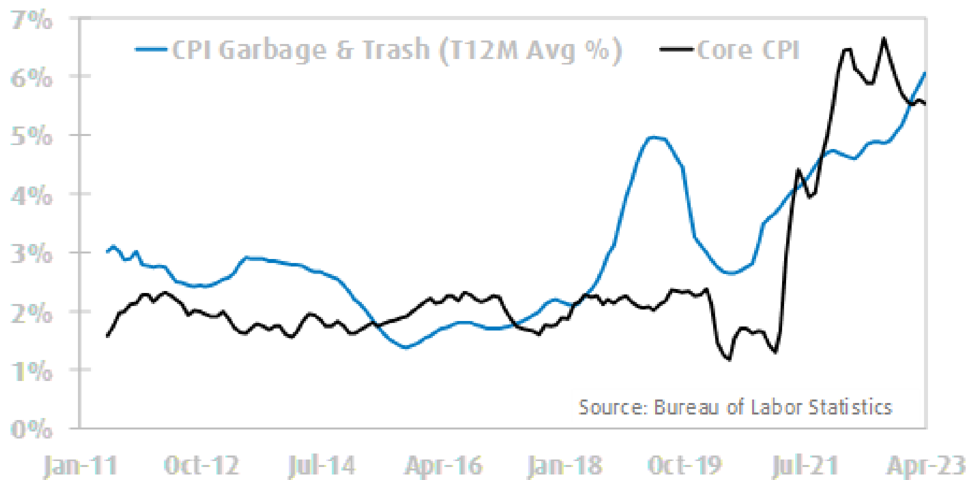
Public Company Average Reported Volume and Pricing Growth Y/Y % Change



A sample group of public refuse haulers realized record average year-over-year **pricing growth** of 7.9% during the 1st quarter, up 40 basis points from the 4th quarter and well above the 5-year and 10-year averages of 4.2% and 3.2%, respectively. Pricing continues to be supported by advantageous negotiating leverage within the inflationary backdrop.

Conversely, growth in **solid waste volumes** has decelerated significantly and, during the 1st quarter, was up just 0.5% compared to a year earlier. Yearly comparisons have stiffened while inflation and higher interest rates have taken their toll on the industrial sector and C&D activity.

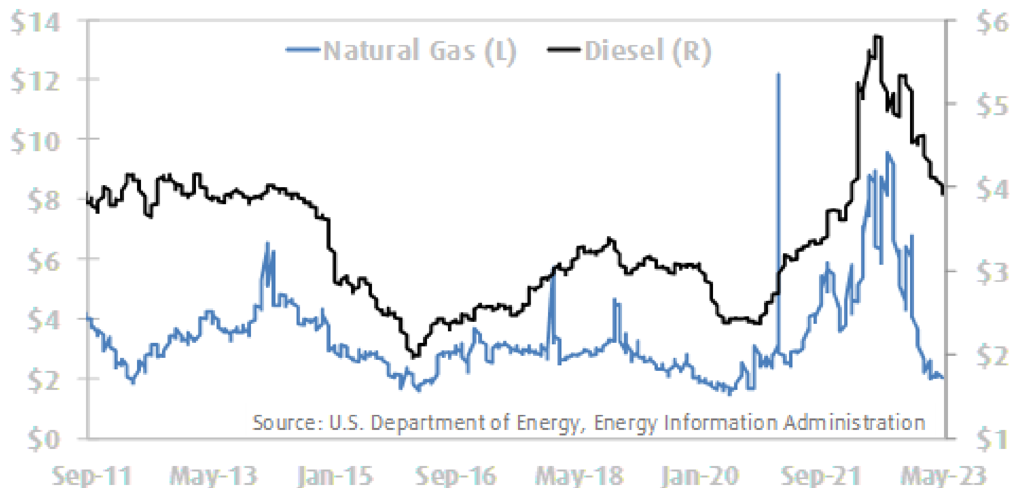
Core CPI (All Items Excl. Food & Energy) vs. CPI Garbage & Trash Collection Y/Y % Change



Slowing services inflation helped pull headline CPI inflation below 5% for the first time in two years. Prices rose 0.4% m/m for the headline and core measures, clipping their respective yearly rates a notch to 4.9% and 5.5%. While headline inflation should remain in retreat, BMO economists are still forecasting 3%+ by the end of the year before settling at the 2% target next summer.

The **CPI index explicitly related to garbage and trash collection**, which is used frequently as a benchmark for contract service pricing, has only recently shown signs of modest cooling from a multi-year high during January of 7% (6.05% trailing 12-month average).

Natural Gas Spot and On Highway Diesel Weekly Prices



Energy markets and fuel prices remain focused on the risk of slackening demand from a U.S.-led economic downturn.

Mirroring a decline in WTI crude prices, the national average weekly Diesel price of $3.90/gallon in mid-May had declined $1.91 (-33%) from an all-time high of $5.81 last June. Natural gas prices have collapsed even more spectacularly to prior cycle lows due to a mild winter, above-average inventories, and seasonal headwinds.

Despite the pullback over the past six months, the current BMO outlook suggests that WTI crude prices will rebound during the 2nd half of the year given China's gradual return to more robust growth, the latest cut in OPEC+ production, and the recognition that most major economies have thus far outperformed expectations.

BMO Transportation Finance

You can count on us.

Fueled by more than 40 years of experience, BMO Transportation Finance brings our waste management customers a locally based sales force, exceptional service and highly tailored financing solutions. Whatever your goals, we work to understand the way you work — and make it our business to know yours.

Visit bmotf.com to learn more.

BMO Transportation Finance is a brand name used by BMO Harris Bank. ©2018 BMO Harris Bank N.A. Member FDIC

"Voice of the BMO Economics Team"

With the U.S. economy generally showing surprising resilience yet still challenged by moderating but still unacceptably high inflation, potential lag effects from the year-long aggressive pace of Fed rate increases, and uncertainty around a resolution to the debt ceiling, we thought it would be helpful to check in on the BMO Economics Team's latest near-term outlook.

For more: https://economics.bmo.com/en/

Jump Start In April – Priscilla Thiagamoorthy, Senior Economist and Vice President Economics, May 2023

U.S. housing starts unexpectedly climbed 2.2% to 1.40 million annualized in April, though annual seasonal factor revisions resulted in a 4.5% decline in the prior month (previously -0.8%). While starts remain subdued, compared to last April's 16-year high of 1.80 million, the housing market appears to be stabilizing. According to the latest NAHB Housing Market Index, homebuilder sentiment continued to improve in May, climbing for a fifth straight month, with limited inventory in the resale market buoying confidence.

Volatile multi-units jumped 3.2%, while single-family homes rose up 1.6%. Starts climbed in the Midwest and West, though they fell in the South and the Northeast.

Meantime, building permits, a good gauge for future home construction, fell 1.5% to 1.42 million annualized.

Bottom Line: U.S. housing starts rebounded in April, suggesting that homebuilders are cautiously optimistic that the housing market rout may be bottoming.

Banking Strains Will Stress Economy - Sal Guatieri, Senior Economist and Director Economics, May 2023

United States

With the risks of additional bank failures fading, a sense of calm has returned to financial markets. This follows the failure of three sizable U.S. banks, the latest being First Republic. The banking stress has eased with the initial sharp drop in deposits and lending now stabilizing, leaving the financial system still flush with liquidity. The Fed's emergency support to banks has also ebbed. However, higher deposit rates have increased bank funding costs and pressured loan margins, reducing the incentive to lend. Consequently, lending standards, which were tightening before this year, have become more restrictive, according to the Fed's latest survey of bank loan officers. Small businesses are feeling the pinch, as loan availability fell to the lowest level in at least five years, finds the NFIB. Tougher lending conditions will only compound the lagged effect of the most aggressive rate increases in four decades, testing the economy's resilience. We still look for a mild, two-quarter recession that lifts the unemployment rate by more than one percentage point to 4.8% at year-end.

The U.S. economy slowed to an annual rate of 1.1% in Q1 from 2.6% in Q4, as weakness in business spending, inventory investment and residential construction largely offset robust gains in household and government spending. While consumer spending accelerated 3.7%, much of the gain stemmed from warmer weather and higher Social Security payouts in January. Consumers have downshifted more recently, and the economy itself has lost steam and looks poised to contract slightly in Q2. The weight of higher borrowing costs and tighter lending conditions should counter the lift from excess savings and pent-up demand for services and autos. For besieged office properties already facing rapidly rising vacancy rates, the mild recession will compel companies to reduce headcounts and space, aggravating the secular challenge arising from the adoption of hybrid work.

Banking Strains Will Stress The Economy (Cont.)

A recession is the timeworn cure for high inflation. While the annual CPI rate has fallen from four-decade highs of 9.1% last summer to 4.9% in April, the core rate is proving much stickier, down just over one percentage point to 5.5% and still running at 5.1% annualized in the past three months. Cheaper gasoline and some recent moderation in food inflation explain the faster decline in the headline rate. Helping the cause, global supply chain pressures have normalized after three years of disruptions and delays, according to the New York Fed. Still, minimal slowing in wage growth suggests prices in the labor-heavy service sector will continue to run hot. We still see a 3-handle on inflation at year-end.

With banking stress calming and core inflation stubbornly high, the Fed raised rates by 25 bps on May 3. However, it signaled a potential pause in the rate cycle to assess the impact of 500 bps of cumulative increases on the economy and inflation. The shift reflects concern that further tightening could lead to a harder landing for the economy and the financial system. While investors expect policymakers to reverse gears later this year, we suspect that worries about reigniting inflation will delay rate cuts until early next year. The Fed should then slowly guide rates back to more neutral levels of around 2.6% in 2025. The current 10-year Treasury rate of 3.5% should then drift down to around 3.0% in that year.

Canada

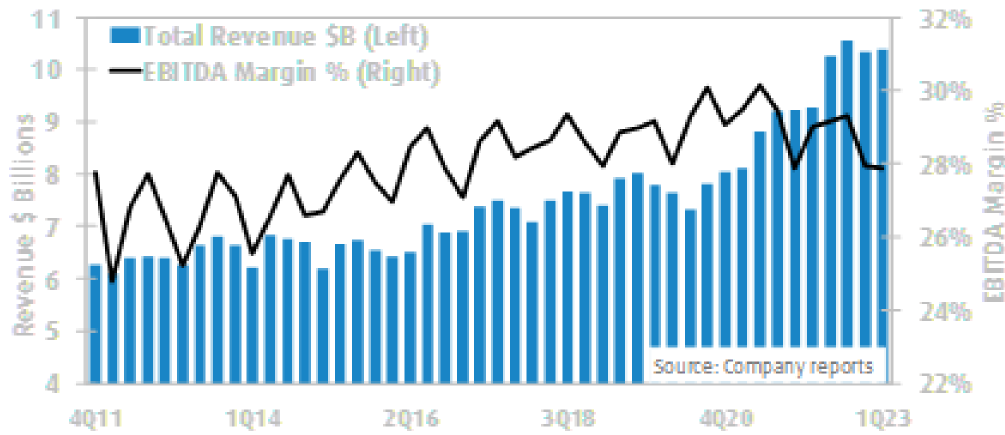
Canada's economy also bolted out of the gate this year, but has since shifted to a slower gait. Juiced by unusually mild weather in January, real GDP rose the most in ten months (0.6%), before slowing sharply in February and contracting slightly in March according to Statistics Canada's initial read. While growth likely rebounded to 2.5% annualized in Q1, the weak handoff, together with some hit from the federal public sector workers' strike (now settled), points to a modest contraction in Q2. The slump should take some steam out of the labor market after employment rose the most on record (outside the pandemic) in January, before moderating to a still-solid pace in the following three months. Meantime, the year-long correction in the housing market appears to have ended. Existing home sales rose in the past three months to April, as lower prices and the central bank's rate 'pause' pulled prospective buyers off the fence. After sliding 16% since early 2022, benchmark prices have risen the past two months.

Even if credit conditions in Canada tighten less than stateside, the economy is unlikely to avoid a mild, two-quarter recession. The global financial stress will have knock-on effects for domestic businesses. While interest rates haven't risen as much as in the U.S., households are more sensitive due to larger debts and shorter mortgage terms. With policy rates now the highest since 2007, many younger mortgage holders have never faced high borrowing costs and will be compelled to cut back on discretionary spending. Consequently, real GDP growth is expected to decelerate to 1.0% in 2023 from 3.4% last year, before expanding 1.3% in 2024. Some modest net fiscal stimulus announced in the federal budget will provide support. The unemployment rate could rise from 5.0% in April to 5.8% by year-end, a modest increase compared with past recessions.

Inflation continues to fall. After poking its head above 8% last summer, the annual CPI rate is down to 4.4% in April. However, the core measures indicate stickiness, suggesting further progress in reducing inflation could be more challenging in the face of tight labor markets. Assuming the economy weakens further, we expect inflation to ease to around 3% at year-end, before making a more concerted move toward the 2% target next year.

The Bank of Canada held policy rates steady at 4.5% in April, sticking with its earlier guidance to pause and assess the impact of past actions on the economy and inflation. However, the Bank underscored the conditional nature of its decision, warning that either stronger growth or stickier inflation could pull it off the sidelines. We still see no further policy changes this year, with rate cuts likely to begin by early 2024. Ultimately, policy rates are expected to gravitate toward less restrictive levels of around 2.5% in 2025.

Business Indicators



Total revenue for a sample group of public waste management companies saw an atypical uptick during the usually seasonally weak 1st quarter. The 0.4% sequential increase from the 4th quarter was well ahead of the average 2.6% seasonal pullback over the past eleven years. Nonetheless, despite pressure on volumes due to slowing manufacturing and construction activity, core pricing strength combined with contributions from M&A still resulted in the second-highest quarterly revenue total on record and year-over-year growth of nearly 12%.

In a "normal" environment, **EBITDA margin** typically follows the direction of revenue due to increasing or decreasing asset utilization and operating leverage. But in the current climate, the industry's substantial pricing leverage is diluted by unusually high and sticky internal cost inflation (labor, insurance, maintenance, etc.), acquisition integration inefficiencies, and deflationary recycling commodity prices. As a result, EBITDA margin of 27.9% during the 1st quarter was flat compared to the 4th quarter of 2022 but down 110 basis points from the year-ago quarter despite robust revenue growth.

Refuse Financing Inquiries

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

Industry Research Contact

Michael Zimm, CFA
Michael.zimm@bmo.com

IMPORTANT DISCLAIMER: This newsletter provides general information and should not be used or taken as legal, regulatory, business, financial, tax, accounting or other advice, or relied upon in substitution for the exercise of your independent judgment or legal advice. For your specific situation or where otherwise required, expert advice should be sought. Although BMO Harris Bank N.A. believes that the information contained in this newsletter has been obtained from and is based upon sources BMO Harris Bank N.A. believes to be reliable, BMO Harris Bank N.A does not guarantee its accuracy and it may be incomplete or condensed. BMO Harris Bank N.A makes no representation or warranties of any kind whatsoever in respect of such information. BMO Harris Bank N.A accepts no liability of any kind for loss arising from the use of the material presented in this newsletter.

bmotf.com

Copyright © 2023 BMO Harris Bank N.A. All rights reserved. You may reprint or forward this presentation to others provided that it is reproduced or distributed in its entirety, including this disclaimer.