Industry Update

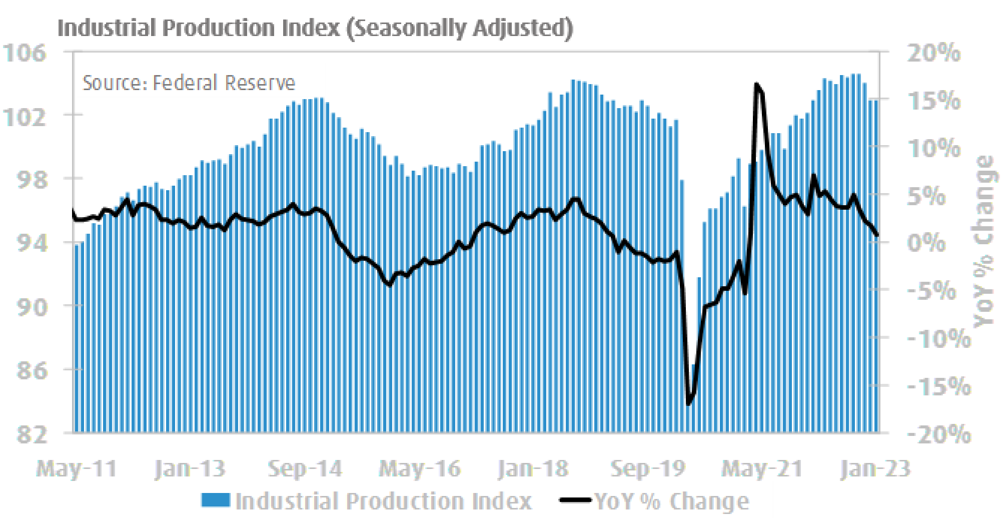
# Refuse and Recycling

## Key Developments

- According to the **Census Bureau**, household formation, a leading indicator for solid waste volumes, accelerated from 317,000 during the 3rd quarter to 1.09 million (+0.8%) units during the 4th quarter while also growing by 1.79 million units (+1.4%) from the year-earlier quarter.
- According to the **Bureau of Labor Statistics**, the Waste Management and Remediation Services industry, at the end of December, had regained 32,800 production jobs (+9.0%) since the low point of the pandemic. Although the pace of year-over-year industry wage increases had peaked during the 1st quarter (+8.6%), wage pressures re-accelerated during the 4th quarter, with average hourly wages increasing by +5.9% compared to +5.5% during the 3rd quarter, and +5.8% during the 2nd quarter.
- According to an M&A tracker maintained by Wastedive, acquisition spending by the industry's top five public solid waste companies totaled nearly $5 billion through the 3rd quarter of 2022. By comparison, collective M&A spending during all of 2021 totaled $4.29 billion.
- Be sure to check out the latest perspectives from BMO economists on the macro outlook (page 4).

## Industry Fundamentals

The carryover benefits of pricing leverage implemented throughout the 2nd half of last year and a robust M&A environment over the past couple of years will be welcome buffers against increasing challenges to the industry's ability to expand volumes and margins. Those headwinds include weak recycling commodity prices, lower CPI-linked pricing resets, stubborn internal cost inflation (mainly wages), consumer spending shifting away from goods, and macro pressures on large volume-generating sectors, including construction, retail, and manufacturing. Still, the industry maintains proven cash flow preservation levers, including reduced overtime and discretionary expenses, equipment optimization, efficiencies from prior investments in automation, and the postponement of significant capital outlays.

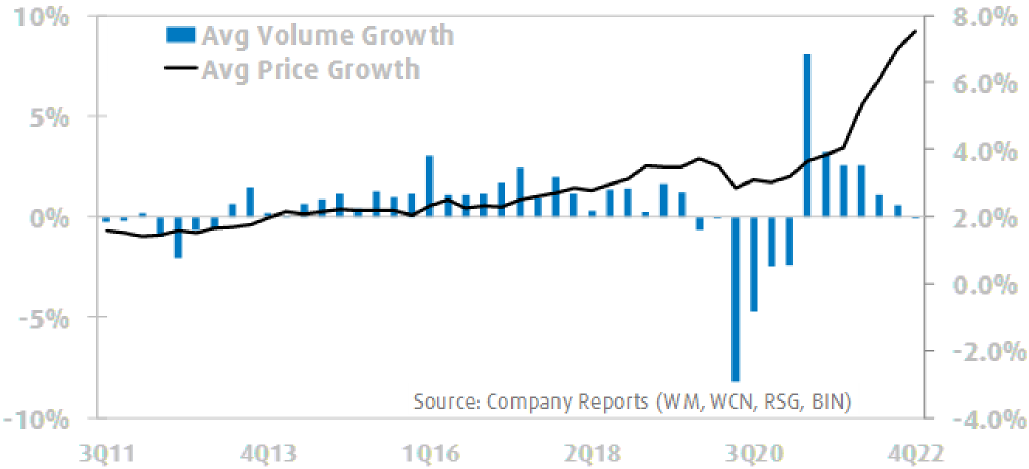



**U.S. industrial production** was unchanged in January and fell short of expectations. However, a closer look reveals the miss was entirely attributable to warm weather and a -9.9% drop in utilities. Excluding utilities, output was up by just over 1.0%.

Manufacturing was behind most of the strength with the biggest monthly gain (+1.0%) since February 2022 and was broad-based, with non-durables (+1.1%), durables (+0.8%), and other manufacturing (+2.2%) all recording gains. Further, **manufacturing capacity utilization** jumped 0.6 percentage points to 77.7%, which could blunt the deflationary trend in goods prices.

## Business Indicators

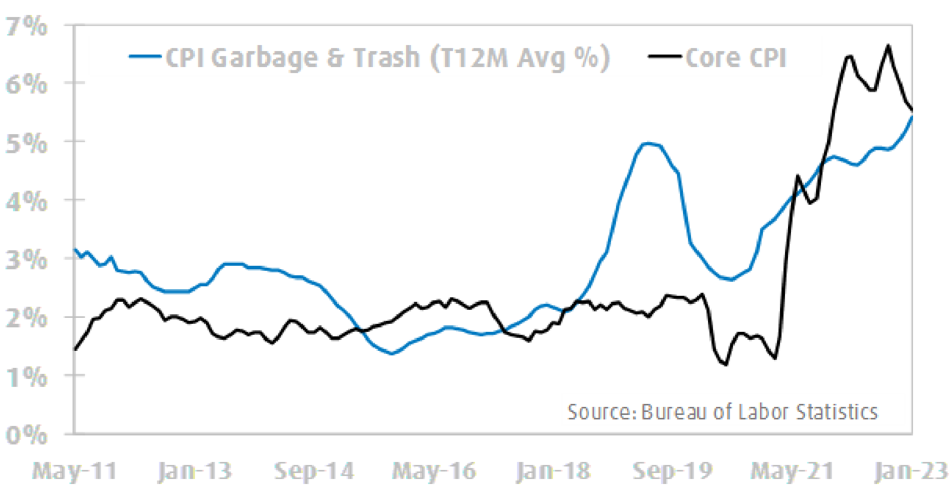
**Public Company Average Reported Volume and Pricing Growth Y/Y % Change**




A sample group of public refuse haulers realized record average year-over-year **pricing growth** of 7.5% during the 4th quarter, up 50 basis points from the 3rd quarter and well above the 5-year and 10-year averages of 3.7% and 2.9%, respectively. Pricing continues to be supported by advantageous negotiating leverage within the highly inflationary backdrop.

Conversely, growth in **solid waste volumes** has decelerated significantly and, during the 4th quarter, was effectively flat compared to a year earlier. Yearly comparisons have stiffened while inflation and higher interest rates have taken their toll on the hospitality industry and C&D activity. And although supply chain constraints have eased, output in many goods-producing sectors also decelerated during the quarter.

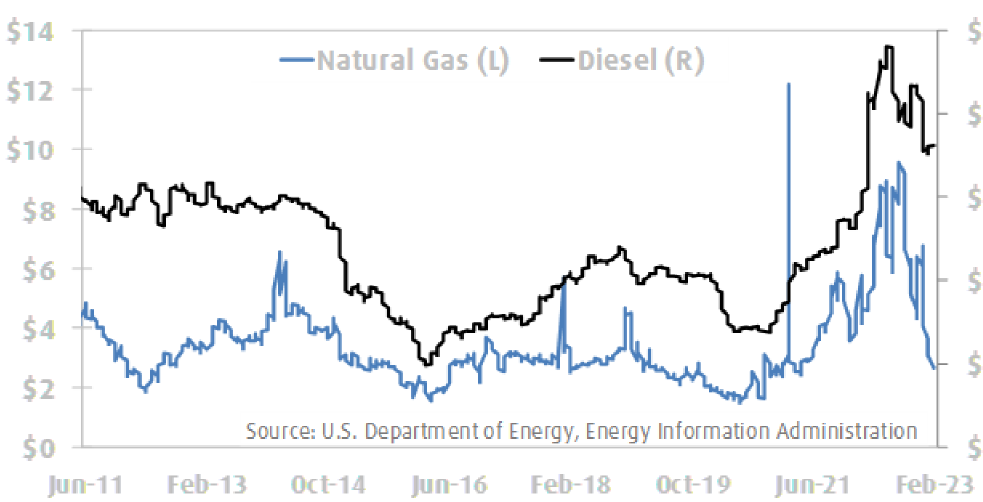
**Core CPI (All Items Excl. Food & Energy) vs. CPI Garbage & Trash Collection Y/Y % Change**




Core prices during January rose an expected 0.4% compared to December. Nonetheless, the year-over-year rate was shaved by a tenth to 5.6%, which is down from the cycle high of 6.6% in September. The 3-month annualized core rate of 4.6% is up three tenths from December's pace, though it's down from 7.1% in June. Some stickiness was found in core goods prices which rose (albeit slightly) for the first time in four months.

After dipping to a recent low of 4.6% during August, the **CPI index explicitly related to garbage and trash collection**, which is used frequently as a benchmark for contract service pricing, reached a multi-year high during January of 7% (5.42% trailing 12-month average).

**Natural Gas Spot and On Highway Diesel Weekly Prices**




Energy prices have diverged as natural gas has been pressured by an exceptionally mild winter and may continue to suffer with storage at full capacity. In contrast, WTI appears to have bottomed due to expectations of greater Chinese demand and tighter OPEC+ supply.

As such, BMO economists are holding to their forecast for WTI to average $90/barrel in 2023. However, the average natural gas spot price projection for 2023 has been trimmed to $3.50/mm btu from $5.00.

Since the invasion of Ukraine, **Retail Diesel** fuel prices have been on a high-altitude roller-coaster. More recently, however, mirroring a decline in WTI, the average weekly Diesel price of $4.44/gallon during mid-February had declined $1.37 (-24%) from an all-time high last June.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## "Voice of the BMO Economics Team"

With the U.S. economy generally showing surprising resilience yet still challenged by volatile energy prices, moderating but still unacceptably high inflation, rising interest rates, and cracks in the housing market, 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/

**Softer Landing – Sal Guatieri, BMO Senior Economist and Director Economics**

The U.S. economy has shown **surprising resilience** in weathering a blizzard of Fed rate hikes. Real GDP grew 2.9% annualized in Q4, hardly slowing from the prior quarter's pace, though half of the increase stemmed from a large inventory build that will weigh on future quarters. Nonfarm payrolls soared over half a million in January, even topping the strong average pace of last year, while retail sales shot up by 3%. The resilience largely reflects three factors. **First**, the lagged effect of policy changes suggests the full force of earlier rate increases won't be felt until later this year. **Second**, consumers still have some pent-up demand for travel, in-person events and motor vehicles. **Third**, households are tapping a reservoir of savings to mask the sting of high inflation. An estimated draw down of around $800 billion in the past year is equivalent to 4% of after-tax income. The remaining firepower could last a year and will go a long way to allaying headwinds. Companies also built-up large cash buffers that they are using to buy machinery and automation as a substitute for scarce workers.

Still, the economy has lost some stamina and will **likely face a mild slump this year** due to tighter financial conditions. A downturn would validate the often reliable signal from a sharply inverted yield curve and a lengthy decline in the leading indicators index. Revenge spending will fade over time, causing hiring to slow and layoffs to mount. The correction in house prices will continue, with a 15% decline likely required to restore affordability from the worst levels in a generation. However, the recent sharp drop in mortgage rates should put a floor under home sales soon. A divided Congress limits the prospect of expansionary fiscal policy, notwithstanding some bipartisan support for modest spending measures. **We expect real GDP to contract modestly in the spring and summer, while registering 0.7% growth for the full year.** The downturn should lift the jobless rate to 4.8% by year-end from the current 54-year low of 3.4%.

Barring a resurgence in resource prices (and oil in particular), **inflation has peaked**. Goods prices are trending lower as retailers discount items to clear excess stock and cost-conscious consumers push back against price hikes. Supply chain pressures have eased amid lower shipping rates, less congested ports, and improved delivery times. Increased automation has lessened the strain of worker shortages. However, steady (albeit easing) wage pressure is keeping services inflation elevated. For this reason, **we see the CPI rate hovering around 3% y/y at year-end**. This would mark a big step back from last June's four-decade high of 9.1% and the latest 6.4% rate, but would still be uncomfortably above the 2% target.

The **Fed continues to signal a need for further rate increases**. The median forecast (as of December) of the FOMC members called for policy rates to rise 75 bps this year to just above 5%, the highest since 2007. After raising rates 25 bps on February 1, the committee appears to be sticking with this earlier call, with the press statement claiming that "ongoing increases" are still appropriate and Chair Powell saying that we are "not yet at a sufficiently restrictive level on rates". Following the strong jobs report, **we now concur with the FOMC's view of two more rate hikes**, likely in March and May. L ong-term rates have fallen this year in anticipation of an eventual policy reversal, but we judge the Fed will hold tight until early next year to limit the risk of overshooting its inflation goal. We expect a modest, temporary backup in long-term rates in the months ahead.

**Softer Landing (Cont.) Sal Guatieri, BMO Senior Economist and Director Economics**

**The risks to our outlook are two-sided**. Stubborn inflation could require even more restrictive policy, leading to a much harder landing. We attach roughly 15% odds on this scenario. However, there's likely a greater chance (35% odds) of avoiding a downturn all together if inflation falls more rapidly, paving the way for an earlier policy reversal and easier financial conditions. A possible escalation of the Russia-Ukraine war poses an ongoing threat to the global economy. Another potential landmine is if Congress fails to address the debt ceiling before the Treasury Department exhausts so-called extraordinary measures, at which time—early June according to Treasury Secretary Yellen—the government will risk default. While Congress will probably act at the last minute to prevent such an unprecedented event, credit-rating agencies could still move to reduce the nation's credit rating, as per S&P in 2011. Its downgrade sent equity markets tumbling at a time when the economy was on an upswing from the Great Recession; a setback this time could strike when the economy is on its back heels.

**U.S. Housing Starts Unable To Heat Up - Priscilla Thiagamoorthy, Senior Economist and Vice President Economics**

Despite milder January weather, **U.S. housing starts** dropped 4.5% to 1.31 million annualized. That marks the fifth straight monthly drop and the lowest level since June 2020. The housing market continues to be weighed by labor constraints and still-high inflation that's eroding affordability. Construction of **single-family** homes fell 4.3% to the lowest level in two months, while volatile **multi-units** dropped 4.9%. Starts plunged in the **Northeast** and the **Midwest**, while the **South** and the **West** rebounded.

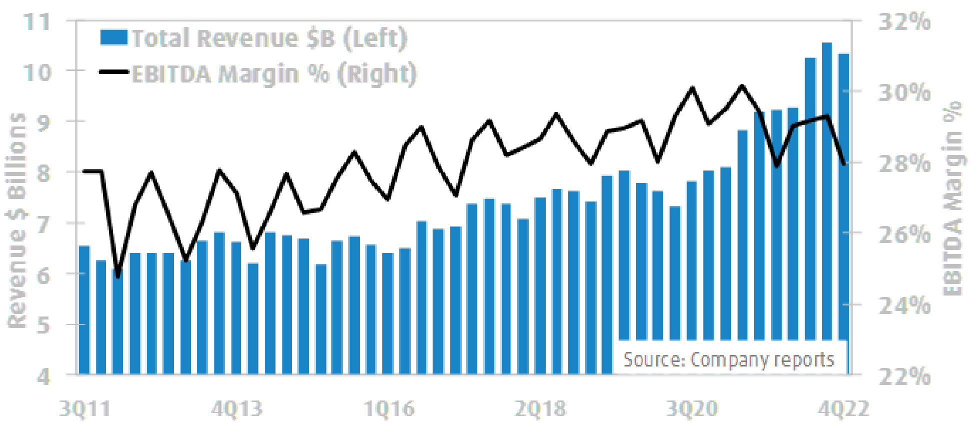
Meantime, **building permits**, a good gauge for future home construction, eked out a 0.1% gain to 1.34 million annualized. While permits for condo construction jumped, those for single-family units faltered yet again, extending declines for the 11th straight month, despite improved homebuilder confidence. According to the latest NAHB Housing Market Index, **homebuilder sentiment** surged 7 pts to 42 in February. Aside from the pandemic swings, that's the biggest monthly jump in a decade. Milder weather likely helped lift confidence after sagging through all of last year. Even so, the gauge is well below 81, where it stood last February, before rates started to climb.

A separate report showed **initial jobless claims** edged down 1k to 194k in the February 11 week. That adds to a string of data suggesting remarkable labor market tightness. Meantime, **producer prices** came in hotter than expected in January, up 0.7% m/m, the fastest pace since last June. The combination of a tight job market and persistent inflationary pressures will keep the Fed on track to hike rates at least two more times this year.

**Bottom Line:** Although milder temps kept most of the economy from softening in January, that wasn't the case for U.S. housing starts, which fell more than expected. Home builders continue to face a raft of headwinds including worker shortages and fading housing demand. And, with rates likely to stay high for some time, homebuilders are not out of the woods… yet.

## Business Indicators

Waste Management Public Company Total Revenue and EBITDA Margin




**Total revenue** for a sample group of public waste management companies saw a typical seasonal downtick during the 4th quarter. However, the 2.1% sequential decline from the record 3rd quarter was slightly more than the average 1.3% seasonal pullback over the past ten years. Nonetheless, despite decelerating 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 either 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 inflation (labor, insurance, fuel, etc.), acquisition integration inefficiencies, and deflationary recycling commodity prices. As a result, EBITDA margin of 27.9% during the 4th quarter was flat from the year-ago quarter despite robust revenue growth while also decreasing 140 basis points from the 3rd quarter.

## Refuse Financing Inquiries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