ALPINE WASTE & RECYCLING: COMMITTED TO INNOVATION

CNG: TAKING AN ACTIVE ROLE IN CNG FUEL TANK SPECIFICATION

Download on the App Store

GET it FOR FREE AVAILABLE NOW!
Private Equity Spotlight: How Private Equity Views the Waste and Recycling Industry

When exploring the sale of a company, business owners need to understand the motivations and investment philosophies of the various types of buyers.

By Brad Page

Over the past several months in this column, we have discussed several of the most important aspects of mergers and acquisitions in the waste and recycling industry. The topics we’ve covered include how valuation is determined, the steps involved in selling a company, the team of advisors in a sale process and the value drivers in a sale to a strategic acquirer.

This month, we focus on one of the most important players in the M&A ecosystem in the waste and recycling industry: private equity firms. Specifically, we discuss the factors influencing private equity’s interest in the industry as a whole and what characteristics investors are looking for when evaluating an individual company. For context, activity of private equity firms in the waste and recycling industry has increased in six of the past seven years, according to Dealogic. Figure 1 details the annual transaction volume by private equity firms in the sector dating to 2009. In addition, we examine the role that infrastructure funds play as investors and long-term partners of waste and recycling companies.

Private equity firms (also referred to as financial sponsors) look to partner with management teams to invest in and grow businesses. Firms will partner with management to purchase a business (generally a majority stake), with capital for the purchase typically split between debt and equity. The private equity firm’s targeted investment horizon usually is around five years, but that can vary depending on several factors such as the success of the investment. Private equity generates investment returns through a combination of three fundamental ways: improving profitability, paying down debt or selling the business at a valuation multiple greater than the purchase multiple. A firm will generally commit resources, including introductions to outside advisors or added capital, to support the investment along its development plan.

Factors Shaping Private Equity’s View of Waste and Recycling

The waste and recycling industry offers a balance of characteristics that represent both opportunities and challenges in the eyes of private equity firms. The industry generates a high degree of recurring revenue that is comparatively well insulated from any fluctuations or downturns in the broader economy. Like

<table>
<thead>
<tr>
<th>Private Equity M&amp;A Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>M&amp;A Market Volume(1)</td>
</tr>
<tr>
<td>(# of transactions)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>YTD 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value</td>
<td>11</td>
<td>19</td>
<td>24</td>
<td>16</td>
<td>22</td>
<td>28</td>
<td>29</td>
</tr>
</tbody>
</table>

Note: Information based on publicly available sources. YTD 2015 as of November.
Source: Dealogic.
(1) Represents transactions of U.S. environmental services firms sold to private equity buyers.

Figure 1
anything else, volumes are affected during a recession, but trash is generated and needs to be collected in both good and bad markets. Private equity firms are cautious of investments that run the risk of losing a significant amount of the firm’s capital. The adage “zeros don’t average” is true for investment returns, which is why the relative predictability of waste collection is seen as a positive. In addition, while the pricing environment is challenged, the public’s interest in recycling is a macro trend that is here to stay. Pricing will rationalize, and demand will continue fueling expectations for attractive long-term cash flows. Overall, the stability of the waste and recycling industry essentially lowers the investment risk and gives a potential buyer increased visibility into what the company’s revenue streams will look like in the future.

Along with these highly attractive characteristics, the waste and recycling industry also features some elements that are challenges for private equity firms. In particular, the industry is capital-intensive, is open to risk from environmental liability from landfills or transfer stations, and has seen a gradual decline of solid waste volumes driven by continued landfill diversion. This presents challenges for private equity firms, but currently these considerations are largely priced into the industry. Private equity firms understand these risks and have largely developed a coherent thesis on the industry’s long-term outlook.

**Value Drivers for Private Equity Buyers**

There are several characteristics of waste and recycling companies that are particularly attractive to investors. We have outlined the key focus areas that private equity firms look for when understanding and valuing a business in the sector:

- **Differentiated or scarce assets:** Private equity firms are looking for unique elements that allow a business to protect its market share and profitability from competing businesses or industry pressures. A scarce asset may be in the form of a transfer station or landfill that other companies are not able to replicate because of permitting requirements or geographic constraints. These unique assets allow the company to “build a moat” around its business and insulate itself from factors that could negatively affect revenue or profitability.

- **Long-term contracts or contracts in franchise markets:** Long-term established or franchise contracts are attractive because they enable enhanced operating efficiency and visibility into future cash flows with 10-year life spans. The same could be said for a business that is strong in a particular niche, such as a real estate development or a homeowners’ association where a single contract can help ensure a consistent waste stream and predictable base of cash flow for the future owners.

- **Vertical integration across the waste stream:** Control of the waste stream from collection through final disposal can be an attractive characteristic to private equity, particularly in densely populated markets or those with tight regulatory hurdles. Control of the waste stream can lead to added revenue or the removal of a disposal expense, both of which translate into higher margins. Instances of exceptionally high operating costs or potential exposure to environmental liability, however, could detract from interest in the disposal assets.

- **Focus on sustainability:** From an M&A perspective, sustainability is a tangible quality that is generating real value in the waste industry. Whether mandated by legislation or driven by consumer demands, recycling and other environmentally friendly practices will be an increasingly important part of the waste industry. Companies that are able to successfully deploy technologies related to single-stream recycling and other aspects of sustainability are more attractive acquisition targets than companies that have not had the same focus.

- **Modernization:** Increased environmental regulation is a reality in the industry as cities and towns across the country continue to enact tighter regulations. For example, several areas have passed laws requiring waste companies to operate fuel-efficient trucks or maintain a more modernized fleet. Fleet upgrades or retrofits can be expensive, and private equity firms will be hesitant to partner with a company requiring a significant capital investment in the near term. Conversely, companies that employ tools such as route optimization software or have a modern, fuel-efficient fleet represent a lower future capital expenditure, and this translates into a higher current value for the business.

**Infrastructure Funds’ Interest in Waste and Recycling**

Infrastructure funds are investment vehicles created to support the construction and maintenance of tangible assets such as airports, toll roads, water and waste plants, railroads and other real assets.

Investors backed by infrastructure funds are generally in search of investments with a moderate amount of growth combined with stability and a hedge against inflation. Infrastructure investors are not put off by businesses or industries that require growth capital and typically have investment horizons that are longer than the average private equity investor discussed earlier. The waste and recycling industry’s growth and capital profile aligns well with an infrastructure fund’s risk/return appetite. Private equity firms typically are looking for investments that generate returns approaching 20 percent; by comparison, an infrastructure fund will be targeting a return in the mid-teens. The lower return requirements provide flexibility for an infrastructure investor to deploy capital for growth and development of the business. Given their high degree of recurring revenue and noncyclical nature, waste and recycling companies often are good investment opportunities for infrastructure funds.

When exploring the sale of a company, business owners need to understand the motivations and investment philosophies of the various types of buyers. Sale processes in the waste and recycling industry should expect to generate interest from private equity funds, infrastructure funds and strategic acquirers alike. Thus, it is important to tailor your sales presentation to the unique needs and motivations of the different types of buyers.

**Brad Page** is a member of William Blair’s investment banking team and is the head of its environmental and industrial services practice in Chicago, IL. William Blair works closely with public companies, private companies, business owners, and private equity investors on transactions related to M&A, equity capital and debt capital. Brad can be reached at (312) 364-8969 or via e-mail at bpage@williamblair.com.