Investment And Financing In The Waste Management Industry

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EXECUTIVE SUMMARY

The European waste management industry has been subject to spectacular and rapid change over the last decade. Increasingly tighter regulations, resulting in higher environmental standards and the rising importance of secondary raw materials, have created a vibrant growth market generating approximately €54bn in sales by private European companies. Other sources even estimate industry revenues of €40bn and 250,000 workplaces in Germany alone. This fact together with the necessity of a sustainable and environmentally-friendly use of raw materials have turned the waste management sector into one of the 6 European lead sectors.

Over the past 15 years the German secondary raw material and recycling industry has had an average annual growth rate of 14%. This evolution in Germany and similarly in Europe has been accompanied by some prominent investment, privatisation and merger and acquisitions (M&A) activity. M&A activity in Europe has generated 1,906 deals with a combined value of €146bn (sum of disclosed deal values only) over the past 10 years - today approximately 50% of globally all waste management and recycling businesses are in Europe.

We expect to see more investment activity, not only due to the increased internationalisation of the waste management sector and the different consolidation and recycling standards of the European national markets. We see particularly room for further consolidation among small and medium-sized players on a regional, national and international scope. Looking at the current post-financial crisis market conditions, equity and debt capital markets seem increasingly set to support such investment and growth trends again.

INTRODUCTION

General Economic Outlook And Post Financial Crisis Equity Markets

The global economic recovery has continued into the first half of 2010. As for 2010, world output is expected to rise by about 4.5% (2011 by about 4.25%), following a 0.5% contraction in 2009. Economies in developing and emerging countries, particularly in Asia, have demonstrated great dynamism. Production increases in industrialised countries have
also developed more favourably than anticipated. Germany’s economy experienced a strong recovery in the first half year, which was supported by the significant upswing in the global economy, as well as the depreciation of the euro against the dollar. All this will have had the positive impact on business sentiment now also shown by the August two-year-high of the IFO business climate survey and the current DAX-Index figures (second year of recovery) displayed below.

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<tr>
<th>IFO Business Climate Index</th>
<th>DAX Index</th>
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<td><img src="image1" alt="IFO Business Climate Index Chart" /></td>
<td><img src="image2" alt="DAX Index Chart" /></td>
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Underlining the above, the performance of European stock markets as per the end of the second quarter this year shows a clear move of investment away from more conservative, defensive sectors to cyclical ones (i.e. Industrials up 9% and Technology up 7%), which goes hand in hand with full order books and rising production. Consumption and the will to invest are up again.

**Valuation Of Waste Management Companies**

Waste management sector stocks, while naturally also having suffered from the financial crises and temporary raw material price decline, have shown relative stability during the last 24 months, which explains the valuation premium observed during these months and even today.

**Waste Management Companies EU (excl. Technology)**

![Waste Management Companies EU Chart](image3)

When looking at the multiples of these companies, even a rise of EBITDA and EBIT multiples in recent months can be observed. This certainly correlates with an improved
average second quarter 2010 of the sector mainly due to a strong rebound in demand for and prices of recycled raw materials, an improvement in industrial collection volumes – however in parts still fragile and uneven – and internal cost and services optimisation. But it is true more than ever, waste management company is not waste management company or in other words business models have to be viewed differentiated.

Specialisation, inclusion of secondary raw material marketing and demand oriented strategies are key to a successful business model. Contrarily, e.g. overcapacities of incineration plants in Germany depress margins and can currently not be compensated by cross-border volumes. On the other hand, secondary raw materials will drive the market growth even more in the future, making private households one primary source of raw materials with Yellow Bins (“Wertstofftonne”) and obligatory bio-waste collection thereby withdrawing further input volumes of incineration.

Interestingly enough, revenue based multiples have slightly declined, suggesting that investors attribute extra premiums to effective optimisation programmes that companies had implemented during the crisis.

As a final remark on multiples, recycling technology has also seen a good multiple up-turn since December 2009 (EBITDA up 7% to 4.7x and EBIT up 15% to 8.5x). Against the whole waste management sector recycling technology might still seem to be valued below average. However, against the manufacturing sector in general, with an EBIT Multiple range of 5.0x to 8.0x the picture looks somewhat gloomy.

**Financing Future Growth**

According to a recent Deloitte study amongst European CFOs and company owners, equity and bond issues, if at all, have been selectively available for financing in recent months. However, bank borrowing is now resurfacing as a source of corporate funding again but at a very limited scope.

This reflects slight improvements in bank borrowing conditions such as lengthening loan tenors, pricing and fee conditions of corporate credit.

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<th>EMEA Average Corporate Credit Spread (bps)</th>
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<td><img src="image.png" alt="Graph of EMEA Average Corporate Credit Spread" /></td>
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Monthly declining spreads have led to a calming of the credit market. Thus, current and future financing costs and growing market liquidity are thought to lend new opportunities to companies for investing in future growth.

As for the leveraged buyout (LBO) market, financing conditions have been unwound to the 2002/03 period with some room for improvement. For mid-sized buy-outs 3.0-3.8x EBITDA senior and 4.0-5.0x total debt is the norm in the current market. Banks require an average
equity contribution of at least 40-50% in new transactions. The upside is that there appears to be the re-emergence of mezzanine finance.

Looking at the equity side of M&A, the PE community is currently under pressure to deploy over $445bn of un-invested capital, since deal volume in recent history has been at the lowest in years.

On the other hand, although re-municipalisation seems to be on top of the agenda, public household deficits together with decades of neglected infrastructure investment throughout Europe will make it unavoidable to find innovative solutions for private investment to support public infrastructure thereby bridging public interest and investors’ required return on investment.

CONCLUSION

1. Albeit with some uncertainties in relation to the period “after the stimulus packages” attached, the global economic recovery has led to a positive business sentiment in general and consequently also to a brighter outlook amongst European waste management industry leaders.
2. Waste management multiples have been relatively stable during the economic crisis as companies in general proved able to cope with difficult market conditions. Furthermore, in some cases management has been able to improve operating structures and strategic set-ups leading to noticeably good H1 2010 results. Current industry valuation multiples show, that such performance is now rewarded with an upward trend in profitability based multiples.
3. On the debt side improving borrowing conditions result in an increase of market liquidity - banks selectively appear to be returning as a partner for financing future growth in the industry. On the equity side high cash reserves, few closed deals and the scarcity in attractive targets lead to a high pressure on PE’s to deploy their funds.
4. We expect further consolidation investment in mature markets (in particular among small and medium-sized regional companies) and geographical expansion of Western European industry players will significantly increase M&A activity in the short to mid-term. Current industry rumours include the possible trade-sale of the Irish waste manager Greenstar, the process around London-listed Shanks Group and a possible deal involving French waste management operations of ISS.
5. Differentiated business models and their respective future outlook will require profound due diligence of assets, contractual and process structures from both investors and banks.

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