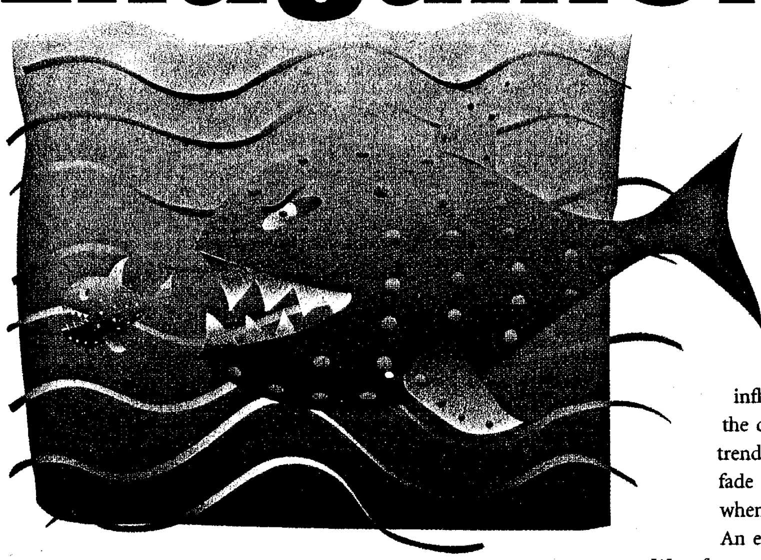
Endgame! Consolidation and Competition in the Solid Waste Industry



By Peter Anderson

Looking back from the end of the millennium to 1893, in Frederick Jackson Turner's seminal work, *The Significance of the Frontier in American History*, the noted historian called attention to the profound consequences for the American temperament that was marked by the closing of the frontier in 1890. Something on the same scale seems simmering through the waste industry today.

It all began, as legend has it, in 1959 when Dean Buntrock married into the Dutch families that dominated Chicago trash collection through which he linked up with his wife's cousin, Wayne Huizenga; and in 1967, when Tommy Fatjo began a small carting business in a tiny Houston suburb. On these rocks grew Waste Management Inc. and Browning-Ferris Industries, which merged with small hauling operators to go public in the early 1970s, used their freshly minted stock to finance an unparalleled acquisition spree, and rolled up what had before been a small, local, and fragmented industry plagued by allegations of mob tactics into a global business on a professional basis.

The Picture Today

Until May 1999, Deutsche Bank analyst Mari Bari called investors' attention to the fact that, after the 30 years of accelerating acquisitions in the waste industry that followed, "[c]onsolidation could wind down by 2001" because there are now so "few large independents left (and those are generally not acquirable [due to liabilities])." The endgame is poised to arrive with the new century.

For the remaining independents and for the municipal and commercial customers, the question is, when that happens, will it have the same seismic consequences for the trash business as the closing of the frontier had for America earlier?

The answer is that it very well may. The industry, which had begun around the end of the 19th century at the same time as Turner was examining the closing of the frontier, had passed through and left behind two earlier phases of its lives. The first dominated by allegations of mob influence and the second of white-collar cartels. Although the day might have set on its more notorious past, if the trends noted by Deutsche Bank continue, competition could fade into the sunset as the industry enters its third phase when just a few national firms survive and tacitly cooperate. An era that was once otherwise as wide open as the Wild West for new haulers tough enough to enter the waste business might be over.

Mobs and Cartels

In the early years, the solid waste industry was relegated by Main Street to the other side of the tracks because it handled garbage. Without access to capital, the trash business had remained local and fragmented. However, with its ties to criminal elements, anticompetitive activity in some of major cities could be enforced threats of physical violence that received wide notoriety.

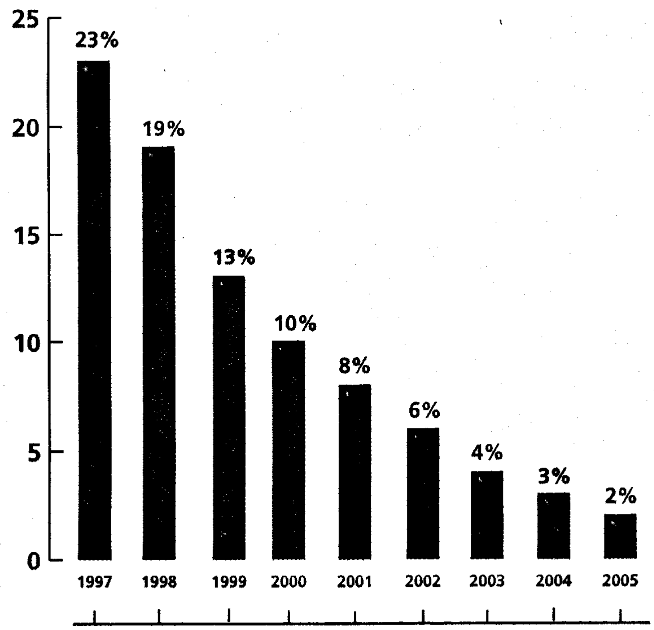
However, there comes a time when most industries mature because of the opportunities that growth offers. On the numbers, a commanding market share is a more effective and durable pathway to above-market profitability. Better to impose across an entire continent discrete monopoly rents that do not raise too many eyebrows than to let hoods extort outsized collection fees with a few small-time, five-truck fleets in a handful of big cities such as New York or Kansas City where the Mafia had influence. Essentially, the mob taint was locking up the larger valuations inherent in the industry. Seeing this potential was the genius of Buntrock, Huizenga, and Fatjo, the early pioneers of the era of consolidation.

When the great roll-up began, the new consolidators knew that they had to professionalize the business in order to sever the link with the industry's past crime-sullied reputation. White-shoe investment houses whose capital they needed to make the acquisitions did not, after all, want to be associated with an industry whose members get reported in the media.

Threats to torch trucks became inexpedient in an era when consolidators banked on capital to grow and on investors' favor to bid their stock up to high-flying valuations. For when investors saw great potential for profitability in the waste industry, they bid up the stock's price/earnings ratio above the market average, and that made financing acquisitions with their own stock as currency much cheaper than going to a bank.

Illustration: Tom Stanley

Privately Held Haulers As a Percent of the US Solid Waste Market



But there was a problem with that strategy because roll-ups never had any fundamental logic for the garbage business. It is true that within a local market, higher route densities from consolidation is more efficient, but because of a host of confounding factors, market share needs to exceed 75% before the cost savings will rise above 10%. It is also true that some local consolidation can spread overheads over more sales to reduce unit costs. But that is not what national-scale waste firms are about.

Trash collection simply has no economies of scale above that found on the regional level that could offset the premiums that had to be paid to close on all those acquisitions and the administrative costs combining and then running dispersed operations from a corporate headquarters in a business that is fundamentally about local markets.

The obvious implication—that there is no underlying rationale for waste-industry consolidation—was not widely appreciated by investors. Until they became so big in the late 1980s and early 1990s that the "law of large numbers" overcame the effect, this underlying reality had been hidden by the way roll-ups are legitimately booked, which recognizes their revenue immediately but masks or spreads out over decades the costly premiums that had been paid through pooling of interest or purchase accounting. At some point, though, their size becomes so large—the law of large numbers—that acquisitions are too small as a fraction of the whole to impact the bottom line any longer. The difficulty in unraveling the core profitability from the accounting chimera is why, periodically, Wall Street spooks about roll-up industries in general.

The problem facing the industry became how to meet investors' earnings expectations when the core business did not make that possible and the law of large numbers began to reveal that the emperor had no clothes. With the industry's antecedents, it didn't take much to figure out how to take advantage of the fact that consolidation had progressed to the point where an oligopoly would economically dominate many markets. By operating across multiple markets and with their deep pockets, they could afford to temporarily bid below their costs just to put a competitor out of business in cutthroat markets and absorb those losses in highly concentrated markets where they were earning above-market returns.

Later prosecutions revealed that cartels had formed in many cities during the 1970s and '80s and that they now used the threat of economic retaliation, which their market power made possible, instead of physical violence to enforce price-fixing arrangements.

But the weak link with this new tactic was that it involved meetings to split up territory. And, eventually from inside these sprawling companies that required legions of foot soldiers to operate, someone with a conscience or just a functioning superego would pick up what was going on when they mistakenly tried to win business and make commissions by taking away a customer from a competitor who was a member of the cartel.

For a while, a string of convictions and settlements over price fixing in Wisconsin, Georgia, Ohio, Florida, and California were typically settled with antitrust regulators for less than $100,000—chump change relative to the profits earned from the illegal practices. But then in 1988, a nationwide class-action suit for damages, brought by the hungrier plaintiffs' bar, cost them more than $50 million to settle. A new strategy was urgently needed to provide a means to enforce market power.

New Landfill Regulations and Market Power

Dovetailing with heightened industry consolidation, as an outgrowth of the 1986 Resource Conservation Recovery Act Amendments pushed by the environmental movement, EPA promulgated new rules in 1991. These set forth enforceable national standards for landfill design, operation, and closure that, because of the cost of compliance, wound up shuttering more than half the unregulated local dumps—from 7,683 down to 3,581—and also increasing the capital at risk during prolonged permit hearings to the tens of millions of dollars and stretching that review period often more than five years, and sometimes longer than 10 years.

As a result, one of the great unintended consequences to the public of those so-called Subtitle D set of regulations—coupled with the roiling local hostility to the siting of new disposal facilities—has been the erection of near-insurmountable barriers to new entry in collection as well as disposal.

Even though purchasing a few garbage trucks to start up will cost just a couple hundred-thousand dollars, if all the disposal sites in an area fall under the control of an oligopoly, it becomes impossible for a new hauler to break in and compete against the major consolidators that, seeing this coming, were vertically integrated with their own landfills. When it comes time to off-load as his packing trucks top out, the erstwhile competitor will have to queue at one of the cartel's landfills. There he will be susceptible to price squeezes by being overcharged, sent for a very long wait at the scale house or have his loads given a "white glove" inspection, and turned away for containing proscribed material.

For the first time, a strategy appeared that did not necessitate meetings among members of a cartel, which is something squarely unlawful under the Sherman Act that contains criminal and treble damage penalties when two or more companies talk about fixing prices or output. Once all of the landfills in an area fell within the control of a manageable number of like-minded companies, it would only be necessary to obliquely signal each other of an intent to pursue higher profit margins instead of market share. But if problems arose before the endgame arrived, the entire apple cart could be overturned.

Speed Bumps

There are so many centrifugal forces at work in a free market that cartels, especially ones built on tacit signaling, are damnably difficult to sustain. As the 1990s unfurled, speed bumps cropped up along the way, canceling out, for awhile, those unintended opportunities that had been created by Subtitle D. The major consolidators' financial results went south and suddenly it became unclear whether Wall Street would pull the plug on financing the final acquisitions to consummate the endgame, just short of the end zone.

For one thing, the industry proceeded to wildly overbuild landfills, far larger than the one before, when the Flying Dutchman–like epic of the Mobro garbage barge in 1988 was interpreted as a metaphor for a wider garbage crisis. The overhanging overcapacity created enormous downward pressure on pricing for much of the '90s. For another, their hubris that led them to massively diversify into hazardous waste imploded when the manufacturing sector decided it was cheaper to reduce or internalize their waste discharges than risk tort liability and sky fees for Cadillac disposal from the giant waste companies. And their expansion into Europe unraveled when they found themselves ill-equipped to compete in a different culture and regulatory environment. Their stocks went into a slump in 1992 from which they have yet to recover, and that forced a series of write downs, reorganizations, and asset sales.

Things might never have gotten back on track to later set the stage for monopoly pricing had it not been for the ironic fact that the continuing confrontations over antitrust suits wound up in an ill-fated effort to marry an incompatible odd couple that was followed by what became a very portentous divorce.

Retuning the Image

The antitrust suits were slowly drawing a noose around the industry, and a string of environmental lawsuits for polluting weren't helping anything. The industry's image problems became part of the reason for the depressed state of its stock.

It was time to shed its skin once again. Waste Management Inc., which had been elected to *Rolling Stone* magazine's 1989 Hall of Shame for its environmental record, contented itself with hiring a director of the Environmental Defense Fund to take charge of its new environmental affairs office. Dean Buntrock joined the board of the National Wildlife Fund. The company championed the new environmental *cause celebre*—recycling. But at BFI, the attacks had become more personal.

Consequently, BFI's attempt at a makeover was more serious and not limited to a cosmetic facial. In 1988, "Mr. Clean," former EPA Administrator Bill Ruckelshaus, rode in on a white horse to take the top job, becoming the new CEO to clean house at BFI. But when the rubber hit the road, the polished attorney quickly clashed with the company's inbred culture.

Then–BFI President John Drury, who had

started driving his dad's garbage truck when he was 14 years old and was a BFI lifer, remembered, "Bill truly thought that the future of disposal would be recycling. I was always opposing it. I wouldn't accept it." In the end, Ruckelshaus called Drury "a dinosaur" and, as Drury later recounted the episode, "Bill asked me to move along." Omitted from his recollections of those days was the fact that the class-action suit also reminded the company about things it wanted to forget.

The Phoenix

Shown the door after a lifetime with the company, Drury went on to work for Houston-based Sanders Morris Mundy, a regional investment banker that put together financing pools in the environmental field. It was at SMM that the seeds were laid to raise, phoenix-like, the garbage industry from the ashes.

Drury's detour into money management put a new generation of ambitious and still-hungry trashmen in direct contact with the managers of private pools of capital. Like Soros Fund Management, Lens Inc., and the Bass Brothers, the institutional bottom fishers who had bought Waste Management and BFI stock at distress prices, the smart money was said at the same time to be looking for a new horse to back and to take over the mismanaged, but otherwise perfectly good, waste-hauling assets. "We have become convinced that the only way the inherent shareholder value in the company can be realized is with a change in the current top management," warned Soros Fund manager Stanley Druckenmiller.

By the mid-1990s, the founding oligarchy in the waste industry was hemmed in from two directions. On one side, Justice Department regulators seemed to be breathing down its neck with a notice of a national investigation. Waste Management perceived that any attempt to pick up the pace of acquisitions, previously limited to the slow process of buying small private haulers, by ramping up to merge with other large publicly traded companies would be dead on arrival at the agency's antitrust division. On the other side, Wall Street had lost confidence in the giant trash firms, pummeled their stock, and called for management's blood, demanding that further costly acquisitions be shut down until things were back on track.

Based on what later transpired, from his office at SMM, Drury presumably convinced the investors that the problem in the industry was that Waste Management and BFI "got diverted, and they took their eyes off their really significant assets, and we're not going to do that. Our philosophy is keeping it simple and really focusing on collection and transfer and disposal, which is our power ally." "Power ally" was a great turn of phrase. He had learned well the art of the deal.

Rebirth and Revival

Drury reemerged into the solid waste industry in 1994. Long-time industry maven Donald Moorehead, who bought control of a three-year-old small Dallas-based start-up, USA Waste Services, in 1990 when it was just a $2.6-million business, had asked Drury to take over the reins of the company. There Drury was given a chance to prove himself to investors.

At USA Waste, Drury's breathtaking list of trophies that he tacked onto his wall immediately after taking over made clear that he had adopted a new strategy from anything that had gone on before to get to the top fast. While the colossus that became Waste Management had actually been created by the aggregation of 3,000 small, family-owned haulers over 20 long years, he had the support of investors to implement the idea of merging with other regional consolidators to race to the finish line in record time. He may also have had the insight that a seemingly innocuous upstart could slip under the Justice Department's raider screen, while Waste Management or BFI might have felt that they risked being hung out to dry by the Justice Department acting under its merger review authority.

In less than the four years that followed, that $3-million company went on a buying binge, spending over $6 billion in an unprecedented merger-and-acquisition spree with Chambers Development, Western Waste, Sanifill, Allied Waste's Canadian operations, United Waste Systems, TransAmerican, City Management, and American Waste. This incredible ramp up graphically illustrated what winning investors' confidence could wrought.

As a company that had not yet run into the law of large numbers or become so dominant as to elicit regulatory concern, Drury was able to do all this and show the kind of earnings growth that Waste Management and BFI had not shown in years. Also, he was not seriously impeded by objections from the Department of Justice, which only nicked the company in ordering minor divestitures in merger markets with overlapping assets.

While it was impressive, the USA Waste run-up still left too many players in each market to avert competition. To really improve profitability, competition had to be dampened, and Wall Street signaled that it expected the industry to concentrate on improving margins instead of gaining market share if the flow of capital was to continue.

With the confidence of investors reinvigorated in a new road-tested generation of waste executives, and with a relatively benign regulatory climate from the Justice Department, the penultimate next step was broached. That involved leveraging the beefed-up regional powerhouses that had made USA Waste and Allied Waste into new number-three and number-four players on the national stage, to take over the executive suites at Waste Management and BFI and combine with the number-one and number-two waste companies in the country, which were twice and triple their size.

Tacit Signaling

Never before had the solid waste industry been so close to its endgame. It immediately set to work signaling its intentions directly or through the mouths of the investor analysts for the waste sector that landfill prices would be going up, not down, notwithstanding the overcapacity problem.

But the mere fact that they are signaling an intent to increase profits does not, by itself, mean that they will either honor their representations or that the new generation of consolidators will not threaten their hold on the market.

Not by itself, it may not, but in conjunction with the nature of the industry, it does. The very act of being a consolidator means that the industry has become totally dependent on a continuing infusion of capital to survive. Without that sustenance, the consolidator simply unravels—the stock price crashes, institutional investors rattle the cage and a revolving door of new CEOs parade through, the talented executives flee for the lifeboats, assets are sold off to preserve enough cash flow to pay the bills and meet coverage requirements and customers fall away until the sale price falls to a point where someone who has capital feels that they can money with the remains. And Wall Street, which provided the crucial financing that made it possible for two minnow-eats-whale–style megamergers, has shown that it intends to ensure that its investments bear fruit to salvage its wasting assets. This began with the selection of the new management that it had selected for the ailing giants. And it extended to effectively auditing the waste firms books to make sure that no one dropped rates to pick up share. Clearly, Wall Street is leaving nothing to chance.