

**Stericycle Inc** SRCL | ★★★★★

PDF Report

## Stericycle continues to add ancillary services to its wide-moat business.



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### Analyst Note 02/04/2016

We reiterate our fair value estimate of \$127 per share after Stericycle's fourth-quarter earnings report and believe that shares are modestly undervalued at present. Slower-than-average sales growth continued for Stericycle in the quarter, mainly driven by weak project-based industrial hazardous waste volumes in Stericycle's newly formed Environmental Solutions group; while this negative impact crimped domestic year-over-year organic revenue growth to an atypically low 4%, the international segment outperformed, reporting an 8% year-over-year increase in organic sales. In total, consolidated revenue reached \$888.3 million in the quarter, up 5% year over year when excluding the impact of foreign exchange, and over 31.2% when including the impact of Shred-It and 10 other smaller-scale acquisitions in the quarter. Adjusted operating margins contracted 380 basis points year over year, reflecting the impact of the Shred-It acquisition along with stronger sales growth in the lower-margin international segment; however, Shred-It is about halfway through the initial synergy targets it set for its earlier integration with Cintas, putting it on track to begin its integration within the Stericycle organization by the back half of 2016.

We continue to caution that Stericycle's expanded platform does add a greater element of cyclicity to Stericycle's business, as was evident in weaker industrial waste volumes and recycled paper prices in the quarter. That said, approximately two thirds of Stericycle's business remains in regulated medical waste, which we believe is the main anchor of the company's wide economic moat. We remain intrigued by the cross-selling opportunities materializing with the addition of Shred-It and the expansion of hazardous waste capability, and believe these services have the potential to generate higher-margin incremental revenues going forward within the core medical waste business.

### Investment Thesis 04/24/2015

Stericycle is well positioned to profit from a changing health-care landscape, and we believe its competitive advantages will sustain strong shareholder returns as the company continues its growth-by-acquisition strategy. Rising costs have created a permanent need for health-care practitioners to closely manage operational overhead, which has led to an industry appetite for outsourcing. The U.S. Environmental Protection Agency estimates that the financial burden of medical waste compliance is increasingly compelling hospitals and other large-quantity, or LQ, waste generators to discontinue on-site incineration programs in favor of outsourced disposal.

An aging U.S. population will be the primary driver of growth in Stericycle's small-quantity segment, as service delivery and frequency shifts from larger and more costly hospital operations to smaller acute-care or ambulatory clinics. U.S. health-care reform may present additional opportunity, as the industry adapts to serve

### Morningstar's Take SRCL

<b>Analyst</b>		
<b>Price</b> 02-08-2016	<b>Fair Value Estimate</b>	<b>Uncertainty</b>
105.99 USD	127 USD	Medium
<b>Consider Buy</b>	<b>Consider Sell</b>	<b>Economic Moat</b>
88.9 USD	171.45 USD	Wide

**Stewardship Rating**   
 Standard

#### Bulls Say

- Stericycle has ample opportunity to expand both the top and bottom lines by upselling ancillary services, effectively increasing revenue per customer and increasing customer reliance on its suite of services.
- As health-care services delivery shifts from hospitals to ambulatory care clinics, Stericycle has the potential to shift its customer mix from lower to higher margin, both domestically and internationally.
- Medical waste regulations will continue to protect customer demand for Stericycle's services.

#### Bears Say

- International market dynamics might make it difficult for Stericycle to amass higher-margin SQ customers.
- More than 20 years of aggressive acquisition activity may mean that there are fewer quality acquisition candidates left for Stericycle to pursue domestically.
- The PSC Environmental acquisition depressed margins considerably, and Stericycle will need to realize strong synergies to improve them.

### Competitors SRCL

More...

Name	Price	% Chg	TTM Sales \$ mil
<b>Stericycle Inc</b>	<b>\$105.99</b>	<b>-4.62 ↓</b>	<b>2,775</b>
Veolia Environnement SA	\$23.00	-5.35 ↓	26,610
Veolia Environnement SA ADR	\$23.20	-2.11 ↓	26,610
Waste Management Inc	\$52.70	0.25 ↑	13,152
Republic Services Inc Class A	\$43.42	-0.37 ↓	9,039
Waste Connections Inc	\$57.09	-1.91 ↓	2,112

greater numbers of people through outpatient facilities in lieu of emergency room visits. As industry operating budgets adjust in response to these secular trends, Stericycle's bundled services portfolio may gain traction. These higher-margin services, such as SteriSafe OSHA training, ultimately reduce the customer's overhead and risk. Stericycle also offers ancillary services such as patient communications, transport, and recently added hazardous waste management through the PSC Environmental acquisition in 2014. PSC came to Stericycle with much lower margins; however, integration efforts have uncovered synergies that should lead to stronger profitability in time.

Stericycle's international revenue has grown about 20% year over year on average during the past five years, and we expect this trajectory to continue as the company attempts to replicate its domestic acquisition strategy. Given that Stericycle chose to enter markets with similar medical waste regulations to the U.S., we believe comparable margin performance is reasonable to expect. However, it remains to be seen whether these areas have enough customer density to match the U.S. in route efficiency.

#### **Economic Moat** 04/24/2015

We believe Stericycle has the widest economic moat of all the integrated waste haulers we cover. Its unmatched scale in medical waste disposal was built over time through a series of acquisitions, which secured valuable intangible assets in the forms of medical waste disposal permits and customer relationships much faster than organic development would have allowed. This dense network of collection routes and processing facilities navigates a complicated maze of local, state, and federal EPA regulations that is difficult for competitors to replicate at a similar level of operational and financial efficiency. Since improper handling of medical waste presents an even greater public health risk than municipal solid waste, health-care institutions face steep financial penalties when out of compliance. As costly permit requirements discourage new entrants from entering the market, the necessity of reliable service leaves health-care institutions with a limited pool of vendors from which to choose, no viable substitutes for medical waste processing, and little bargaining power. In our opinion, Stericycle's capacity for efficiently handling the entire medical waste stream--from collection to sterilization and incineration--also acts as an element of risk management for its customers by fulfilling the need for fail-proof service. We believe this leads to customer retention in Stericycle's core business, as customers would need an extremely compelling reason to switch from a trusted incumbent in light of the regulatory risks. Furthermore, given that it takes considerable capital for medical waste processors to operate in compliance, we believe Stericycle's efficient scale in this niche industry lessens the likelihood of irrational price behavior from fragmented competitors, as the fight for market share could quickly cause industry returns to eventually fall below the cost of capital. We expect these dynamics will allow Stericycle to continue producing outsize ROICs for an extended period.

#### **Valuation** 09/11/2015

We are raising our fair value estimate to \$127 per share after incorporating Stericycle's recently announced mandatory convertible preferred share offering, which will be used to partially finance the Shred-it deal. Both the time value of money since our last update and our expectation that equity will be raised at a price per share above our estimate of Stericycle's intrinsic value contributed to the increase. Our forecast incorporates our expectations that Shred-it will represent nearly \$900 million of additional revenue for Stericycle by 2019. In addition, the execution of nearly \$80 million in operating cost synergies (approximately \$50 million remaining from Shred-it's ongoing integration of Cintas' document management operations, combined with \$20 million in cost synergies from Shred-it's future integration with Stericycle), will culminate in an EBITDA margin of 32.8% for Shred-it by the end of our forecast. We assume that the combined operations will surpass \$5 billion by 2019, with Stericycle's international medical waste operations representing about 35% of the overall company. This would reflect a compound annual growth rate of about 16% for the period. In Stericycle's domestic

medical waste segment, we expect that secular trends toward outsourcing in health care will help sustain average internal revenue growth rates of more than 8% for the small-quantity segment and just over 5% for the large-quantity segment. We believe that domestic growth will partially hinge on increased penetration of ancillary services, such as Shred-it's document destruction solutions, and that offering this new service to Stericycle's vast customer base will allow Shred-it to increase its year-over-year sales growth rate from its historical mid-single-digit range to about 7%. Internationally, we expect Stericycle to achieve average internal revenue growth rates just under 7%, reflecting an improvement over the most recent five-year average. As the international business mix shifts toward small-quantity customers over time, we expect internal growth rates will start to approach those seen in the domestic SQ segment. We forecast operating margins to average about 23.8% across our forecast period, assuming margin improvement as synergies from the Shred-it transaction are realized and increased penetration of ancillary services across the customer base enhances overall profitability. These assumptions support an average ROIC of 11% across our forecast horizon.

#### **Risk** 04/24/2015

Our uncertainty rating for Stericycle is medium. The necessity of Stericycle's medical waste services support a reliable stream of recurring revenue, which mitigates the overall risk of cyclicity in this business. Continued global economic uncertainty has the potential to slow Stericycle's international expansion plans; however, as its base of business continues to achieve density in these new markets, the international business should exhibit organic growth characteristics that mirror the domestic market.

While we like Stericycle's plans to enhance its product portfolio with higher-margin services, there is no guarantee that these investments will add value over time. For example, Stericycle's recent acquisition of NotifyMD--a patient communications system--strays considerably from its core competency of route-based medical waste management platforms. Furthermore, the addition of PSC Environmental to Stericycle's portfolio depressed gross margins considerably. Thus, Stericycle's acquisitive strategy can make it difficult to accurately forecast margin progression.

#### **Management** 04/24/2015

In 2013, CEO Charlie Alutto, the former president of Stericycle USA, succeeded longtime CEO Mark Miller, who had led the company since 1992. Under Miller's watch, Stericycle diversified its customer base from mainly large customers to hundreds of thousands of very profitable small customers, laid the foundation for its international segment, and reached \$1 billion in revenue for the first time.

Alutto has held several executive leadership roles since joining Stericycle in 1997, including managing director of Stericycle's European business. Given that Stericycle's growth strategy hinges on European expansion, we expect that his experience is suited to focus on driving outside ROIC growth in the segment as it gains traction.

Executive salaries are quite modest compared with industry averages, with compensation weighted heavily toward stock option grants. While we normally would expect that such a compensation structure would give management incentive to favor earnings per share gains over profitability enhancement, Stericycle's historical performance leads us to believe that this is not necessarily the case. The company has proved itself to be adept at extracting value from acquisitions, which has led to an impressive record of shareholder returns. As such, acquisitions receive capital allocation priority, with remaining excess capital typically returned to shareholders via stock buybacks. However, this heavy reliance on acquisition growth prevents cash from building up on the balance sheet, which lessens the likelihood that Stericycle will pay a dividend anytime soon. We expect that Alutto will continue to deploy capital toward building Stericycle's international presence with the intent of replicating the highly profitable U.S. business.

That said, over the past 10 years, average ROIC has been ticking down as the company invests more internationally. Furthermore, adding PSC Environmental to the mix caused ROICs including goodwill to fall slightly below 10% for the first time in a decade. While returns remain above our weighted average cost of capital of 8.4%, we find this trajectory worrisome and expect to see that trend improve as the international business builds route density and PSC Environmental improves. However, until we see sustainable evidence of a negative trend reversal, we'll assign Stericycle a Standard Stewardship Rating.

## Overview

### Profile:

Stericycle is the largest domestic provider of regulated medical waste management to large-quantity generators (such as hospitals and pharmaceutical companies) and small-quantity generators (such as medical and dental offices). The company's international operations include Latin America, Europe, South Korea, Ireland, and Japan, which combined represent nearly 30% of total revenue. The company also provides risk management platforms, such as returns and recalls management, as well as compliance training.

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