Industry Perspectives:
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Stericycle: Waste Not, Want Not

"We believe that the recent stock depreciation is a market overreaction to near-term headwinds that are hiding the true long-term potential of the underlying business."

Medical waste disposal company Stericycle presents us with a prime example of the wise adage waste not, want not, in that we should not waste an opportunity to own this unique business trading at a discount to our estimate of intrinsic value. Stericycle has a number of attributes that we value at Diamond Hill: the company holds a market-leading position in an industry with barriers to entry and operates in a growing segment of the health care industry. A significant portion of the company's revenue is recurring, it has pricing power, and management has the ability (but has not yet shown the vision) to pursue strategic alternatives. Given this opportunity set, we initiated a position in Stericycle in numerous portfolios this past year.

With the stock down roughly 70% from its peak in 2015, clearly investors have concerns about the business. In Stericycle's case, management has to take a large share of the blame. They have failed to show the ability to accurately forecast financials, and have squandered shareholders' cash and patience on some questionable acquisitions. Additionally, the company is currently working through a repricing process. After pushing pricing too far in an effort to show expansive growth, Stericycle is now in a transition period where pricing is contracting and the company is working to regain customers' trust. Compounding the issue, management is now investing in a new enterprise resource planning (ERP) system. Although the company should benefit long term from this system with increased efficiencies and better forecasting, the system will increase company spending in the near term. All of these factors have resulted in market sentiment that has become overly negative compared to the long-term potential of this solid, consistent, and growing franchise.

Investors are attracted to, and will pay a premium for, companies that generate consistent returns. Stericycle was once one of these companies. Industry fundamentals remain attractive, but mismanagement has resulted in a stock that is trading at a discount to its intrinsic value and long-term potential. Once the strength of the underlying business is apparent again to investors, the narrative around the stock will change, and we believe this should lead to attractive levels of value creation.

Medical Waste: An Attractive & Growing Industry

The domestic medical waste management market is both non-cyclical and growing, driven by increased health care utilization and an aging population. The market is highly regulated, which creates barriers to new entrants, and also requires current participants to recertify processes to keep up with changes in regulations. Historically, hospitals performed their own medical waste destruction. However, this has encouraged hospitals to increasingly outsource this costly and risky burden to focus on their core health care services. Fines for improper handling and disposal of medical waste are severe, and customers are highly motivated to avoid both the risk and expense associated with these regulations.

Scale Creates Barriers to Entry

With over 600,000 customers, Stericycle is unmatched in the collection, treatment, and disposal of medical waste. The company now owns 10 of the 16 large scale commercial incinerators licensed in the U.S., and also owns 123 autoclave processing centers. Despite their dominant market share, Stericycle is still focusing on its role as an industry consolidator, acquiring small medical waste disposal providers to enhance business and route density. Typically, these acquisitions are small, with Stericycle acquiring a new route and using its existing disposal facilities for treatment. This has the end result of enhancing utilization of costly fixed assets, which results in greater company margins. The company still has plenty of opportunity to grow this business model, with only 33% of the $3.5B domestic market consolidated, and the majority of remaining competitors being small mom and pop operations. This scale, both in terms of route density and disposal facilities, provides Stericycle with a cost advantage compared to other smaller providers.

Stericycle's business tends to be sticky, as the cost of the services it provides are relatively low compared to other expenses in the medical industry. Switching vendors exposes customers to complexity and risk, as they have to implement new provider

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processes and ensure that regulations are properly adhered to, a task which can be difficult due to the variation in regulations from state to state. As a result, Stericycle has an overall customer retention rate of over 95%. Customers also generally sign-up for three to five year contracts, providing predictable and recurring revenue that is not exposed to macroeconomic cycles.

Stericycle also provides a complete solution of related services that further enhance the stickiness of their customer relationships. The company provides in-depth training for their customers, other waste services, direct-to-patient communication, and secure document destruction. For the overburdened hospital or doctor's office administrator, having a one-stop solution simplifies their daily tasks.

While Stericycle is a dominant U.S. player, it is much less so abroad, currently deriving only 20% of revenues from international markets. However, international markets are fragmented, so it is feasible that a long-term approach, similar to its domestic strategy, may well pay off.

Leadership Team Refresh

Management has not always provided clear or consistent communication with regards to the state of the business or their strategic vision. The 2015 acquisition of the shredding company, Shred It, is a prime example. Over time, this lack of vision and adequate communication will change as new executives join the company, upgrading the quality of management. Stericycle recently hired former UPS executive Cindy J. Miller to be the new President and COO, who comes to Stericycle after a long and successful career in logistics and ERP installation. Although she has only been with the company a few months, she seems to be an upgrade compared to prior management, possessing the previous experience required to be successful in this industry. Obviously, for a logistics-based company such as Stericycle, a COO with direct and successful experience in this area is a crucial improvement. Going forward, additional management changes of this nature would help reassure investors that the company's future is in safe hands.

Improving Fundamentals

Stericycle is at the tail end of a pricing reset and we expect customer pricing to stabilize soon. Although ERP implementation is just getting started, the cost and schedule has been well communicated. Investors expect management to miss timelines and overspend, but if the process is well managed by the new COO, who has direct experience in this area, the company could exceed expectations. Any improvement in the business, such as better-than-expected pricing or less-than-expected expense for the ERP system, could result in an improved financial picture.

Conclusion

In our view, Stericycle is a strong franchise with a sticky business model that delivers recurring revenue regardless of the macroeconomic climate. The company has been fighting against several, mostly self-created, headwinds that should start to dissipate. Showing a stabilized pricing trend, ERP implementation success, and improving communication around the company's long-term vision will help investors' rediscover their confidence in the company. Indeed, Stericycle was a poster child for strong, consistent growth, which was in part fueled by tuck-in acquisitions. The fundamentals that previously made the company a success have not changed, and now there is an opportunity to reset to a more modest growth level that provides consistent gains for investors.

At Diamond Hill, we define risk as the permanent loss of capital and in the case of Stericycle, we see the current valuation as transitory. We expect a few more bumps in the road, but we believe that the recent stock depreciation is a market overreaction to near-term headwinds that are hiding the true long-term potential of the underlying business and the very favorable market conditions in the medical waste industry. Stericycle is well-positioned to take advantage of these market dynamics and its current market value is a compelling investment opportunity for the patient and disciplined investor.

As of December 31, 2018, Diamond Hill owned shares of Stericycle, Inc.