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Harsco Corp to Acquire Stericycle Inc's Environmental Solutions Business Conference Call

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CORPORATE PARTICIPANTS

David Scott Martin *Harsco Corporation - Director of IR*
F. Nicholas Grasberger *Harsco Corporation - Chairman President & CEO*
Peter Francis Minan *Harsco Corporation - Senior VP & CFO*

CONFERENCE CALL PARTICIPANTS

Huang Howe *Barrington Research Associates, Inc., Research Division - Senior Investment Analyst & Research Analyst*
Jeffrey David Hammond *KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst*

PRESENTATION

Operator

Good morning. My name is Daniel, and I will be your conference facilitator. At this time, I would like to welcome everyone to this Harsco Corporation conference call. (Operator Instructions)

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I would now like to introduce Dave Martin of Harsco Corporation. Mr. Martin, you may begin your call.

David Scott Martin ***Harsco Corporation - Director of IR***

Thank you, Daniel, and good morning, everyone. Thank you for joining us today to hear about Harsco's acquisition of Stericycle's Environmental Solutions business. I'm Dave Martin of Harsco.

With me this morning are Nick Grasberger, our Chairman and Chief Executive Officer; and Pete Minan, Harsco's Senior Vice President and Chief Financial Officer. Following our prepared remarks, we will then open the call up for questions.

The press release that we issued this morning announcing the transaction is available on our website. During the call, we will also be referring to a slide presentation about the transaction, which is also available on our website. This conference call will focus on today's announcement and transaction.

Before we begin, let me briefly cover our safe harbor statements. We will make statements today that are considered forward-looking within the meaning of the federal securities laws. These statements are based on our current knowledge and expectations and are subject to certain risks and uncertainties that may cause actual results to differ materially from those forward-looking statements. For a discussion of such risks and uncertainties, see the Risk Factors section in our most recent 10-K and our second quarter 10-Q. The company undertakes no obligation to revise or update any forward-looking statements.

Now I'll turn the call over to Nick to begin his remarks.

F. Nicholas Grasberger ***Harsco Corporation - Chairman President & CEO***

Thank you, Dave. Good morning, and thank you for joining us. Hopefully, you've had the chance to review the press release that we issued earlier this morning, and I'd like to share some additional context about our agreement to acquire Stericycle's Environmental Solutions business known as ESOL.

So let's begin on Slide 3. Last spring, we announced our new corporate strategy to transform Harsco into a single-thesis environmental solutions company with a portfolio comprised of higher-growth, less-cyclical and capital-light businesses. Ultimately, our goal is to drive more sustainable, profitable growth and enhance shareholder value creation. We've made significant progress over a short period of time. Over the past 12 months, we've acquired Clean Earth, rebranded and refocused our Harsco Environmental business and divested the 3 businesses that comprise our former Industrial segment.

The acquisition of the ESOL business is a logical and highly complementary next step in this portfolio transformation. The resulting portfolio of businesses has higher organic growth potential, is less cyclical than our previous portfolio and will require less maintenance capital. Overall, we certainly believe our new portfolio will drive better returns to shareholders.

Slide 4 outlines the benefits of the transaction in more detail. Our acquisition of Clean Earth allowed Harsco to expand into the specialty waste market, and we've been very pleased with Clean Earth's performance to date.

Upon completion of today's announced transaction, we will combine ESOL with Clean Earth, creating a national leader in hazardous waste management solutions with the scale, geographic reach, breadth of solutions and customer relationships to drive growth.

Following the ESOL acquisition, 85% of Harsco's revenue will come from environmental solutions and services, up from 60% in 2018. The combination of Clean Earth and ESOL provides Harsco with a significantly increased opportunity to make further inroads into the highly regulated hazardous waste industry. Our service offerings will increase substantially with Clean Earth's hazardous waste and contaminated soil segments and ESOL's large valuable network of hazardous materials facilities and established industrial, retail and health care business lines.

I'd also like to point out that the Clean Earth leadership team knows the ESOL business very well, having led ESOL's predecessor business when its margins were much higher. We see real and meaningful opportunities to leverage the combined talent and knowledge of these 2 businesses to drive operational improvements, cost synergies and revenue growth, which I will touch on more in a few minutes.

Turning to Slide 5. Let me outline the deal. This is a $462 million all-cash transaction, subject to post-closing adjustments and regulatory approval. We expect to finance the acquisition through a combination of borrowings under our existing revolving credit facility and new debt financing.

The transaction is expected to be accretive to cash EPS within the first year of ownership and contribute meaningfully to free cash flow and EPS accretion in the first full year after close.

In 2020, ESOL is expected to generate adjusted EBITDA of approximately $35 million on revenues of approximately $550 million.

Except for 2019, when the business had some discrete operating and management challenges, ESOL has consistently delivered $50 million plus per year in EBITDA over the past few years. And our target is to double ESOL's EBITDA to $70 million within 3 years.

In terms of margins, ESOL's current EBITDA margin of 6% compares to Clean Earth's margins of about 20%. So while our 3-year EBITDA target implies a margin of 11% to 12%, we believe we can do better, achieving margins approaching those of Clean Earth over time.

We anticipate that our net leverage ratio will approximate 3.5x. While this ratio was higher than our target leverage, we believe it is a very manageable figure given our -- the term of our debt, our expected future cash flow and other factors. We remain committed to a long-term average of 2.5x or less and expect to be back to this level over the next couple of years.

Turning to Slide 6. These are 2 very complementary businesses that will be made even stronger together, enabling them to better leverage skills, expertise and scale. ESOL operates a valuable network of 13 federally permitted transfer, storage and disposal facilities, or TSDFs for short, and nearly 50 10-day transfer facilities.

In addition to scale, the acquisition will also increase our geographic reach. ESOL's portfolio, concentrated in the Midwestern and Western states, is a natural complement to Clean Earth's existing coverage across 16 states, primarily in the Northeast. With larger capacity across an expanded nationwide network, the combined business will be able to leverage its scale to achieve greater efficiencies.

Slide 7 outlines ESOL's served markets and key customer relationships. ESOL brings a blue-chip industrial and health care customer base and has a significant presence in the retail space, serving more than 33,000 customers at 90,000 locations. ESOL also operates a sizable truck fleet, adding an important element to Clean Earth's business model.

We spoke with several major ESOL customers during the diligence process, and we were quite pleased to hear their high degree of respect for and confidence in the ESOL team.

Turning to Slide 8. The combined business is expected to generate approximately $15 million of annual synergy improvements on a run rate basis in Harsco's third year of ownership. These synergies will be centered around back-office consolidation and operational, logistical and final disposal optimization. We are constructing a substantive and detailed plan to capture these and other performance improvement opportunities to boost ESOL's margins as noted earlier. And again, we believe that the combination will yield incremental growth opportunities as a result of the expanded customer base, scale advantages and cross-selling.

So in short, as we show on Slide 9, we believe this acquisition will provide compelling benefits to all stakeholders. For customers, the application of the Harsco business system and the insights of the Clean Earth team, combined with the benefits of added scale and geographic reach, should provide a meaningful opportunity to significantly enhance ESOL'S value proposition.

For investors, Harsco's financial profile should continue to improve with higher growth rates, margins and returns on capital invested while being less exposed to economic volatility.

And for the 2,000 or so employees of ESOL, I'm confident they will embrace our values-based culture and our commitment to their business as a core part of Harsco's future.

So this is an exciting day for Harsco and for ESOL. I'll take questions you might have in a minute. But before I do, I'd like to offer some perspective on our fourth quarter.

I think it goes without saying that I was and certainly am deeply disappointed with our Q4 performance, in particular since it's the first time in my 7-year tenure that we have missed guidance. As noted in our press release from a few weeks ago, this result was largely driven by customer shipment delays at our Rail division that pushed deliveries beyond year-end; and secondly, further unexpected declines in steel production affecting Harsco Environmental. The Rail operational surprise was the result of a suboptimal execution of our planned manufacturing consolidation during a time of record customer demand. We are committed to addressing this situation, and our entire leadership team is keenly focused on fixing the issues within our Columbia, South Carolina plant. I've already taken a more active role in the operations of our Rail business, and I will continue to do so.

As of now, our detailed action plan is already underway, and we've stabilized operations and hired a new operations leadership team.

I'm confident that Rail will be operating at its full potential later this year, and I'm particularly optimistic about the increasing customer demand.

Based on our backlog, our new product introductions and expanded geographic reach, I continue to believe that Rail can generate $100 million of annual EBITDA in the next 3 years.

As far as Harsco Environmental is concerned, the earnings shortfall was likely not a surprise to many of you who follow the steel industry. While we certainly hope to have a better 2019 in Environmental, our revenues and profits were largely unchanged, despite serving an industry that suffered a material decline in profitability. In effect, the growth from our new contracts offset volume declines. I'm also quite pleased that we've been able to maintain double-digit operating margins in Harsco Environmental.

Many of you may recall the state of the HE business 4 to 5 years ago when 1/3 of our contracts were underperforming and profit margins and returns on capital were less than half of what they are today. We've made significant strides since that time, and I firmly believe that the foundation of HE is very strong today.

So ultimately, today's announcement is grounded in confidence, confidence in our strategy and confidence in our organization's ability to execute at a high level across the business segments and our functional teams. I have no doubt that our strategy to move towards a single-thesis portfolio built around environmental solutions is the best path forward for all of our stakeholders. I also have no doubt that our organization is more talented, capable and dedicated than ever in the past. So it's that combination of our strategy and our people that gets me excited about the next few years at our company.

So I appreciate your support, and Pete and I are happy to entertain any questions you may have.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Jeff Hammond with KeyBanc Capital Markets.

Jeffrey David Hammond ***KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst***

So just on the split of the business, you gave kind of the end markets, but just help us understand how much is the hazardous, how much is the transportation. And within all that, clearly, a big difference in the margins between ESOL and Clean Earth, and I just want to understand better what -- maybe what the margins were and what's the opportunity operational versus maybe structurally, the margins would be lower.

F. Nicholas Grasberger ***Harsco Corporation - Chairman President & CEO***

Okay. Thanks. So first for the mix. I think the combined business of ESOL and Clean Earth will be 85% or so hazardous waste, with the remaining being contaminated soil and dredge material. Within ESOL today, looking at the -- its exposure to different end markets, about 40% would be in kind of the manufacturing and industrial space. Another 40% or so would be in retail, and the balance would be in health care.

The transportation piece is just a part of the business model, right? Clean Earth today does not have that front-end. They do not have the collection and the on-site services at customers that ESOL has. So that will be brought to Clean Earth by ESOL.

So in terms of the upside that we see, we talked about doubling EBITDA in the next 3 years and then, ultimately, getting the ESOL margins up to the Clean Earth margins of 20% or so.

We did extensive diligence on the business. I think we have a very good understanding for why the ESOL margins are where they are and what needs to be done to get the margins up to the Clean Earth level. And it's across many components of the business, as you might imagine. So clearly, there are synergies that will be realized by putting them together, and we talked about that. But the greater upside here really is going to come from the fundamental operational and commercial changes that will be made by the ESOL team and the Clean Earth team. Because this is a carve-out from Stericycle, there's a lot of work we need to do to stand up the organization. And we're doing that work now, but we're very confident that we're going to have a first-rate organization. We are soon, I believe, to announce a new president of the combined business. I'm very excited about that.

And again, I'll just highlight that the Clean Earth team knows this business very, very well. And they are -- they really could not be more excited about the opportunity to integrate this business into Clean Earth and to boost the margins up to their level.

Jeffrey David Hammond ***KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst***

Okay. And then, Nick, can you talk about -- I think you said this business was kind of averaging $50 million EBITDA, and then there were some discrete items in '19, and I think you're just looking for $35 million in '20. So what were the discrete items? What, if any, really go away in 2020? And just -- I want to understand how easy those are to really get back.

F. Nicholas Grasberger ***Harsco Corporation - Chairman President & CEO***

Yes. Well, the revenue did not change much year-to-year. The issue was really on the cost side. The facilities, the TSDFs, had really lost visibility to their own business. It was really being run effectively at the Stericycle level. So pricing and the ability to pass along annual cost increases is fundamental to this business model and simply wasn't done by ESOL in 2019. So we think that while we can't get back to the $50 million or $55 million in 1 year, we think there are some very basic and executable things that we can do quickly to get it up to the $35 million level or so this year.

Jeffrey David Hammond ***KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst***

Okay. And then last thing. It looks like if you look at the Stericycle numbers, maybe not totally clean, but their business has been kind of flat to down, and you guys have been growing Clean Earth at 7%. And I just want to understand the disconnect there as well.

F. Nicholas Grasberger ***Harsco Corporation - Chairman President & CEO***

Yes. Well, keep in mind that part of the Clean Earth growth has been driven by bolt-on M&A. But you're right. The organic growth in Clean Earth has been 6%, 7%. And I really can't comment on why. Obviously, within Clean Earth, they've done a very good job executing on finding new waste streams and boosting volumes through their TSDFs. And also on the soils business, they've seen some nice growth. So I really can't comment on why the Stericycle business -- the ESOL business has been flat.

Operator

And our next question comes from Chris Howe with Barrington Research.

Huang Howe ***Barrington Research Associates, Inc., Research Division - Senior Investment Analyst & Research Analyst***

Following up on some of the previous questions, as we look at the mix of their business between industrial, retail and health care, can you talk about -- more about the value that you saw within each of the segments as we consider your movement towards growing EBITDA moving forward?

F. Nicholas Grasberger ***Harsco Corporation - Chairman President & CEO***

Well, I think there's growth in each segment, across medical, industrial as well as retail. Competing businesses have seen that growth. We've seen that growth in Clean Earth. These are scarce assets, as you know, these federally permitted facilities. And so there's been an ability to capture price in addition to volume gains. So as I mentioned earlier, it's also a business that does not require a lot of capital investments every year, and it's growing above GDP. So it's -- the financial profile of the business, similar to that of Clean Earth, is really very compelling.

Huang Howe ***Barrington Research Associates, Inc., Research Division - Senior Investment Analyst & Research Analyst***

Okay, okay. What I was trying to get at is I'm sure the margin profile differs when you compare health care versus industrial. I was just kind of parsing out the potential that you see within each of those segments.

But moving to my follow-up question, you mentioned the front-end side of this business. As we consider the size of this acquisition and your current leverage ratio, how would you characterize your appetite for further tuck-in acquisitions, whether it be on the front-end side or in other areas of the business? Are we going to place that on hold for a while given the size of this acquisition?

F. Nicholas Grasberger ***Harsco Corporation - Chairman President & CEO***

I think if you simply consider the human resource that needs to be applied to everything we're doing now within the company, both in Rail and Harsco Environmental as well as very heavy lift that's going to be required here to carve this out of Stericycle and integrate it into Clean Earth and boost its performance. So I really don't see us being active in M&A for a while. We -- our plate is quite full.

Huang Howe ***Barrington Research Associates, Inc., Research Division - Senior Investment Analyst & Research Analyst***

Okay. And one last question, if I may. If you could comment on -- just to add some more color on the timing of this deal, why you felt now is the right time as opposed to waiting. And I'm sure there were other smaller tuck-in acquisitions available with sites. If you could comment on that.

F. Nicholas Grasberger ***Harsco Corporation - Chairman President & CEO***

Yes. It's a good question. Certainly, this was available. And it's a very rare asset because of its scale and the number of permitted facilities that it has. Also, I mentioned that the familiarity of the Clean Earth team with this business, having run it in the past when it performed much better, gave us confidence that we can fix this business. And we were anxious to get the scale as well. We're anxious to rotate the portfolio. We've -- we're really very happy with what we've done in the last 10 months or so. And so really, as I said in my remarks earlier, it came down to confidence, confidence that we can execute this.

Operator

(Operator Instructions) Our next question is a follow-up from Jeff Hammond with KeyBanc Capital Markets.

Jeffrey David Hammond ***KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst***

So maybe you can just talk about just on the free cash flow side and then leverage one. Any thoughts on how you're thinking about capital deployment any differently in terms of like growth CapEx for Environmental kind of given this bigger deal? If we kind of exclude any divestitures and just given what you think free cash flow looks like, when do you think you can get back to that 2.5x leverage target?

Peter Francis Minan ***Harsco Corporation - Senior VP & CFO***

Jeff, it's Pete. Yes. As we -- as Nick mentioned earlier, the pro forma leverage after this transaction is going to be about 3.5x. And then when you consider where we are in terms of transaction cost, integration cost and so on, by the end of 2020, we'll be lower than that, but we'll still be slightly above 3x, based on where we see things going, based on our current expectation on cash flow. So we're really getting closer to zeroing in on our 2.5x target ratio starting in 2021 and should be there within a short period after that.

In terms of capital allocation, really, it's the same. Bear in mind Nick's comments just a second ago with respect to our capacity for M&A, but it starts with kind of the organic growth capital to a reasonable amount with respect to Harsco Environmental. We're going to try to keep those levels more or less consistent with the prior year.

And then we're talking about looking at opportunities to get our delevering done to reduce debt. So there's really -- it's not a big change from where we were before, with the exception of kind of taking future, at least in the near term, some of the M&A activity kind of off the table for a period of time.

Jeffrey David Hammond ***KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst***

Okay. And then I know you guys have talked in the past about Rail as kind of getting to single thesis and Rail being maybe a divestiture candidate. And do some of the operational hiccups you have had there kind of pushed that out meaningfully? And when do you think is a reasonable time to maybe look to divest that business to help with the leverage from this deal?

F. Nicholas Grasberger ***Harsco Corporation - Chairman President & CEO***

Well, all I'll say, Jeff, is that we are entirely focused on fixing the operational challenges in Rail to meet what's a very, very attractive outlook and backlog of existing business for that -- for Harsco Rail. As I said earlier, even though achieving $100 million of EBITDA, which I'm confident we can do, is maybe pushed out a bit. That's the focus.

Jeffrey David Hammond ***KeyBanc Capital Markets Inc., Research Division - MD & Equity Research Analyst***

Okay. And then just a couple of housekeeping items. Can you talk about what the incremental amortization expense is going to be associated with the deal? What you think the interest cost is associated with the debt you'll take on? And if you can talk about what the current D&A component is of the ESOL business, that would be great.

Peter Francis Minan ***Harsco Corporation - Senior VP & CFO***

Yes, Jeff. This is Pete. We'll get back to you on that, if that's okay. We can get you all the specifics a little bit later today.

Operator

Thank you. Ladies and gentlemen, this concludes today's question-and-answer session. I would now like to turn the call back over to Dave Martin for any closing remarks.

David Scott Martin ***Harsco Corporation - Director of IR***

Again, thanks for joining this call. We appreciate your interest in Harsco and look forward to speaking with you in the near future. Have a great day. Take care.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.