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We attempt to write readable investment letters free of *soporific jargon* but with a succinct offering of pertinent facts, letters that respect the intelligence and common sense of our clients and other discriminating audiences.

Stericycle, Inc. (NASDAQ: SRCL) Investment Letter
Experts in infection control and healthcare compliance services

The other day I was in the office of my internist, **Gordon Lantz, M.D.**, for a travel mandated immunization. Before sticking me with a needle, his nurse, **Ms. Kendra Rambo**, asked me to roll up my shirt sleeve. Then she thoughtfully warned me that I would feel a sting when she pushed down on the syringe. (Gordon Lantz is a highly respected internist with a subspecialty in endocrinology. He works for Omni, a division of the St. John Health System, based in Tulsa, Oklahoma.)

After she had given me the shot, **Kendra** placed the used needle and syringe in the sharps container fastened to the examination room's wall. The sharps container, with its biohazard warning, holds discarded needles and syringes. **Kendra** told me that a medical waste disposal company retrieves it and empties it off site, handling the container in compliance with a maze of federal, state, and local laws.

The more I thought about sharps containers, the more I realized I wanted to learn more about the waste management industry. I knew that my efforts would not go to waste.

As I began to research the industry, the name of one company came up again and again. It was **Stericycle**; I directed my energy to learning more about this company.

I looked first at the company's filings made with the United States Securities and Exchange Commission in Washington, D.C. **Stericycle, Inc.**, a Chicago-based company, I learned, is the largest regulated medical waste management company in North America. (Later, in a conversation with **Stericycle's** chief executive officer, **Mark C. Miller**, I learned that **Stericycle** is, in terms of revenues, more than ten times the size of its next competitor.)

As of December 31, 2004 the company served 317,000 customers throughout the United States, Puerto Rico, Canada, Mexico, and the United Kingdom (The customer count as of June 30, 2005 exceeded 324,000.)

With such a widely diversified business it is no surprise that no single customer accounts for more than two percent of the company's revenues, and that the top ten

customers comprise no more than nine percent of **Stericycle's** business.

As I looked at the company's annual reports and 10-K filings for the last five years ended December 31, 2004, it became apparent that the company was in the right place at the right time.

The next step was to speak with someone at the company. When it comes to a publicly traded company, the person charged with the responsibility of speaking to present or potential investors is usually called the investor contact by the standard research publications. This time **Mark C. Miller**, the company's chief executive officer, was listed as the investor contact. I picked up the phone, called **Stericycle**, and asked for him. His administrative assistant

Founded in 1989, **Stericycle** operates in a highly regulated industry. For instance, it must comply with the Occupational Safety and Health Act of 1970 (OSHA) that governs exposure to blood pathogens; lockout/tag out procedures; emergency planning, hazard communication; use of respirators and personal protective equipment, and other matters.

immediately put me through.

I identified myself and told him that I had many questions about **Stericycle's** business. I was interested in learning more about the company because I was considering investing in **Stericycle** for my clients and for myself.

He said to fire away, he had plenty of time for questions and, as it turned out, he had plenty of knowledge and energy for expansive comments. After speaking with him for just a few minutes, I knew that his knowledge about the industry was vast, even transcending much of the highly useful information available in company filings and other public sources on **Stericycle** that I had read.

My first question was this: What was the impetus for the medical waste management business? What had led to the

development of this industry, and how did government regulation and laws propel the industry's growth?

He asked me to recall what had happened in the United States in 1988. That summer large amounts of infectious medical waste, evidently dumped into the Atlantic Ocean, were ultimately washed ashore on beaches in the New York and New Jersey area.

These unsavory discoveries intensified the public's concern that the ocean and beaches in the northeast had been contaminated by pervasive, persistent, careless, and cynical treatment of medical waste.

What soon followed was [The Medical Waste Tracking Act of 1988 \(MWTA\)](#).

Legislators followed the MWTA with more regulation that specified, in demanding detail, the proper or required handling and disposal of the medical waste that the healthcare industry produces, reinforcing power of the MWTA.

[The MWTA](#) was only the beginning. More legislation followed, and each piece did two things, both in [Stericycle's](#) favor. The laws that followed the MWTA made it more compelling for large producers of waste, such as hospitals, to outsource the collection and disposal of waste, and these laws raised the barriers to entry, accelerating acquisitions in the industry, a practice in which [Stericycle](#) would become a big player.

Stericycle Selected Financial Statistics 2000-2004

	2004	2003	2002	2001	2000
Total revenue (in millions \$)	516.2	453.2	401.5	359.0	323.7
Income from operations (in millions \$)	169.0	144.0	119.0	102.0	91.4
Net income (in millions \$)	78.2	65.8	45.7	22.0	14.5
Diluted net income per share	1.69	1.43	1.01	.52	.36
Cash Flow per share	2.16	1.80	1.35	1.12	0.95
Year end share price	45.95	46.70	32.37	30.44	19.06

This act was passed, [Miller](#) went on, to ensure that medical wastes that posed environmental problems, including unsightly or ugly appearances, were delivered to disposal or treatment facilities in a manner that would minimize exposure to workers handling the waste, as well as to minimize danger to the public.

Medical waste was increasing relentlessly as the number of people over sixty five years old grew, and as this demographic group undertook more medical procedures (often operations were euphemistically defined as procedures), with such procedures producing more concomitant waste.

It would turn out, [Miller](#) continued, that the problem, or the opportunity, of the safe disposal of medical waste was a regulator's, or a bureaucrat's dream. Medical waste was always unsightly and frequently smelly and dangerous, as well as large in scope.

In 1997 the Environmental Protection Agency (EPA) adopted regulations under the Clean Air Act Amendments of 1990 that put limits on pollutant discharge produced by medical waste incineration. Among other mandates, these 1997 regulations, [Miller](#) said, required every state to submit to the EPA for approval a plan to meet emission standards for medical waste incinerators.

The hospital managers were in shock. They knew, [Miller](#) said, that they would not want to undergo the expense and the risk of incinerating medical waste, making sure that they were always in compliance with a fast growing body of complex and confusing requirements that would make the job of medical waste disposal even more burdensome than it already was.

The hospitals, not surprisingly, sought out Stericycle.

Hospitals and small medical practices view the risks of non-compliance with state and federal medical waste

regulations as much greater in expense than the cost of hiring Stericycle or one of its competitors.

There is great potential legal liability at stake in the handling of blood borne pathogens and other infectious material, especially in relationship to employee exposure to these items, and a specialist like Stericycle can save a healthcare facility thousands of hours a year, many dollars, and reduce the risk of lawsuit, by disposing of the inevitable detritus that modern medical procedures produce.

This is not only true of the physical disposal of waste, but it is also true when it comes to the cost of legal compliance.

Smaller medical businesses, ones with five to ten doctors, also like to outsource medical waste. I was about to understand this phenomenon better when, during one of my workouts at the St. John Health Club in Tulsa, I ran into Peter Wenger, M.D., a young internist who also works for Omni, but in a different office from the one where Gordon Lantz works.

Wenger was vigorously working out on one of the club's elliptical machines. I was on the next machine. We got to talking about the latest developments in his practice and somehow the conversation moved toward the subject of medical waste disposal.

I asked him how his practice disposes of medical waste. His group of five doctors and ten nurses, he estimates, will see almost two hundred patients per day. (On the day last week that we spoke he had seen twenty eight patients.)

Many of these patients require procedures, procedures that almost always produce medical waste such as blood and blood products, used needles and syringes, and wasted disposable scalpels. Much of this waste is put in the twenty five sharps containers that are located strategically throughout the office.

He believes that the complexity and expense of safely and legally disposing of this waste is beyond the capability of his medium size practice. So Omni contracts (this is not a decision that Wenger himself makes) with a medical waste management company to do the dirty work, which

includes the education of all employees on the correct and the legally compliant methods to get rid of the waste.

In a second conversation that I had with Mark Miller of Stericycle he confirmed Wenger's observations that outsourcing of medical waste makes sense for a small medical group. Miller says that Stericycle's annual charge for the removal of medical waste produced by an office with five or six doctors will range from one thousand to two thousand dollars. This is a very small bill in view of the several million dollars in revenue that an office of that size will produce.

As I did more research on Stericycle, I found that Stericycle and its competitors touched more lives, or more correctly more disembodied parts than I had realized.

Pathologists, friends of mine, who work at the Regional Medical Laboratory on the fourth floor of the new Siegfried Tower in the St. John Health complex, tell me that they frequently have to analyze the pathology of an

The medical waste industry involves significant risks of statutory, contractual, tort and common law liability claims. Potential liability claims could involve, for example:

- Cleanup costs
- Personal injury
- Damage to the environment
- Employee matters
- Property damage
- Alleged negligence or professional errors or omissions in the planning or performance of work

amputated limb and ascertain what went wrong. After the procedure, the limb will be carted away, and destined to be collected and treated according to the dictates of the MWTA and other complex legislation.

Again, a medical waste company will do the dangerous work.

The regulated medical waste market in the United States exceeds three billion dollars on an annual basis, and that means much room for Stericycle to grow, as its 2004 revenues were about one half of one billion dollars. Medical waste is a big business, and it is getting bigger. The reasons for such optimism about the industry, I hope I have shown above, are easy to understand, making the outlook for the business and common stock of Stericycle excellent.

Best regards,



Fredric E. Russell

The writer of the Stericycle report, Fredric E. Russell, was born in New York, N.Y. on February 17, 1944. He attended public schools in New York City before attending Deerfield Academy (Deerfield, Mass.) and graduating in 1961. He then attended Swarthmore College (Swarthmore, PA) graduating in 1965. After Swarthmore he earned an M.A. (1965) and an M.B.A. (1972) at Washington University (St. Louis, MO.) He also holds a CPA certificate. He taught accounting and finance at the university level before entering the investment management profession.

He believes his love for writing and his usually correct grammar come from spending four years improving his writing skills at Deerfield and from reading everything well written he can find.

We are highly motivated to explain the basics of a company such as Stericycle in a structure that is easy to digest, that is free from soporific jargon imprisoned by stale platitudes and fatigued prose. We strive, in contrast, to write energetically with a thorough attention to detail and with a succinct offering of pertinent facts. We believe there is no reason why investment managers cannot write investment reports with simplicity and lucidity.

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