

ROL – Q3 ‘ 23 Rollins, Inc. Earnings Call

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PRESENTATION

Operator

Greetings, and welcome to the Rollins Incorporated Third Quarter 2023 Earnings Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Mr. Ken Krause. Thank you. You may begin.

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

Good day, ladies and gentlemen. Thank you for standing by. Welcome to the Rollins third quarter 2023 earnings conference call. During today's presentation, all parties will be in a listen-only mode. Following the presentation, the conference will be opened for questions. [Operator Instructions] This conference is being recorded today, Thursday, October 26, 2023.

Good morning, everyone, and welcome to our third quarter call. This is Ken Krause. Before we begin, I'd like to take just a moment to formally introduce Lyndsey Burton. Lyndsey is our new VP of Investor Relations, joining us most recently from The Home Depot. She brings a very strong background in Investor Relations and we're excited to have her join our team at Rollins. I look forward to introducing her to many of you in Q4 as we attend several investor conferences.

Welcome, Lyndsey.

Lyndsey Burton – *Rollins, Inc. – VP, Investor Relations*

Thank you, Ken, and good morning, everyone. In addition to the earnings release that we issued yesterday, the company has also prepared a supporting slide presentation. The earnings release and presentation are available on our website at www.rollins.com.

We have included certain non-GAAP financial measures as part of our discussion this morning. The non-GAAP reconciliations are available in the appendix of today's presentation as well as in our earnings release.

The company's earnings release discusses the business outlook and contains certain forward-looking statements. These particular forward-looking statements and all other statements that have been made on this call, excluding historical facts, are subject to a number of risks and uncertainties, and actual results may differ materially from any statement we make today. Please refer to yesterday's press release and the company's SEC filings, including the Risk Factors section of our Form 10-K for the year ended December 31, 2022, and our Form 10-Q for the quarterly period ended September 30, 2023, which will be filed later today.

On the line with me today and speaking are Jerry Gahlhoff, President and Chief Executive Officer; and Ken Krause, Executive Vice President, Chief Financial Officer and Treasurer. Management will make some opening remarks and then we'll open the line for your questions.

Jerry, would you like to begin?

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

Thank you, Lyndsey. Good morning, everyone. I'm pleased to report that Rollins delivered another good quarter of growth and profitability, reflecting consistent execution of our operating strategies and continuous improvement in our business. Our financial performance for the third quarter was highlighted by an increase in revenue of over 15% to \$840 million. I'm pleased to report that we continued to see organic growth of over 8%. Further, this reflects a solid performance across all major service lines, as residential increased approximately 20%, commercial pest control rose approximately 12%, and termite was up 11% this quarter.

Revenue performance in the quarter was robust following the slower June activity that we discussed on the last quarter. We saw consistent growth in the mid-teens each month of the third quarter. We've observed continued underlying strength in the pest control markets year-to-date, particularly within North America. Additionally, our addressable markets are large, fragmented and supported by a number of key secular trends, including, but not limited to: one; a shift from DIY to do-it-for-me; two, population migration to warmer climates; three, changing weather patterns; and four, the stickiness of hybrid work schedules leading to people spending more time at home.

As we looked at our competitive position in these attractive markets, we believe we continue to benefit from several key elements of our business model. If you look back over the last 15 years or so, we've consistently grown revenues through the Great Recession in 2009 and on through the industrial slowdown in the mid-teens. We reliably grew mid-single digits, year in and year out. Revenue growth accelerated pre-COVID, and that has generally continued. We delivered high-single digit organic growth in each of the last 11 quarters.

Let me highlight four key areas that we believe have differentiated us in the market and position us well to continue outpacing a market where secular trends should support mid-single digit growth over the next several years.

First, our leading portfolio of pest control companies gives us a unique position in our markets. The combination of Orkin and our strong group of regional brands gives us multiple bites at the apple with potential customers and additional cross-sell opportunities.

Second, we use a variety of methods to acquire new residential customers and add to the depth of our relationships with existing customers. Digital marketing, cross-selling, service bundling, and door-to-door sales methods all help us reach new customers or drive further engagement with existing customers. We also have important relationships within the homebuilding and real estate market communities through brands like HomeTeam and Northwest. We're able to capitalize on this multi-channel approach to drive residential customer growth.

Third, we're investing in commercial customer acquisition, targeting key strategic verticals that are the most profitable. This is paying off with 12% growth in the quarter.

And last but not least, we have a clarity of focus and have been consistently executing our strategy in our core market for a very long time. This focus and clarity ensures we don't make unnecessary changes and enables us to continue to successfully grow our share in a very attractive pest control market.

These points of differentiation have positioned Rollins to achieve a healthy level of organic growth and are further complemented by strategic M&A. Looking at the recent acquisition of Fox Pest Control, the integration remains on track. The Fox teams are executing and doing well and we continue to be excited about the growth opportunities ahead for the Fox brand. Additionally, through the first nine months of this year, we closed 18 tuck-in deals in addition to Fox. The M&A pipeline remains healthy and we're actively evaluating acquisition opportunities both domestically and internationally.

As I've highlighted in the past, acquisitions are an important component in helping us expand our market position while also complementing efforts to accelerate recurring organic growth. We remain disciplined in evaluating M&A opportunities and are confident in our continued ability to invest in the right strategic acquisitions while delivering strong organic growth across the business.

Our dedication to continuous improvement is an important part of our strategy and culture. As you've heard us discuss previously, we're constantly looking to improve our service levels and operating efficiencies. In August, we took an important step towards increased efficiencies in our Atlanta Support Center to accelerate our growth goals. For the first time in about 20 years, we executed a restructuring program that was designed to support our modernization efforts and flatten our overhead structure. We plan to reinvest cost savings in initiatives that further enable our growth priorities and allow us to serve our frontline operations more efficiently. We continue to see opportunities for margin expansion as we move forward and execute our strategy. Ken will provide more detail and address the margins in the quarter shortly.

Operationally, we're committed to developing great talent and investing in our teams. Hiring has been healthy and we've put a lot of energy into onboarding the right people in both support functions and the customer-facing side of our business. Effective sales and service staffing

helped us capitalize on continued strength in demand and to achieve high levels of organic growth both in the quarter as well as year-to-date.

We remain focused on safety, and I'm pleased to report that we have seen our average Mentor driver safety score increase over 25% since the beginning of the year. You'll recall that this driving score is derived from an app that we have implemented to monitor driving behaviors when our vehicles are in motion.

Improving a safety culture isn't something that's done overnight, but we are making strides and we're encouraged that our claims activity had less of a negative impact to our financial results versus a year ago. We're working hard in the field to increase safety awareness and training, while recognizing and rewarding those that are the safest. We believe these efforts will keep our people safe and mitigate negative financial impacts to our business.

We continue to focus on creating value and returning capital to our shareholders. We're pleased to be in a position to increase our dividend by 15%, and we remain committed to a growing and sustainable dividend. Additionally, in the third quarter, we completed \$300 million in share repurchases. The moves we made earlier this year in modernizing our capital structure by refinancing and expanding our revolver gave us the flexibility to be opportunistic and participate in a repurchase at a very attractive price. Ken will share some additional details on this in a moment.

Our modernization efforts continue to progress well, but we're not done yet. And we look forward to sharing additional developments on this front over the coming quarters. In closing, before I turn the call over to Ken, we're excited about where our business stands today, we're very well positioned for the remainder of the year, and remain focused on robust organic growth, delivering healthy incremental margins, and continuing to attract, hire and retain top talent across the business.

I'll now turn the call over to Ken.

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

Thanks, Jerry, and good morning, everyone. The third quarter reflects continued strong execution by the Rollins team. Let me begin with a few highlights.

First, we delivered robust revenue growth of over 15% year-over-year. We saw good growth across each of our service offerings. Organic revenue was up over 8%. Acquisitions drove the other 7% of the total revenue growth.

Second, our gross margins were healthy, approaching 54% this quarter. We continue to be positive on the price/cost equation and saw good performance across several key cost categories. Adjusted EBITDA margin of 24.8% was strong, improving 150 basis points, driven by leverage across the P&L.

Our GAAP earnings were \$0.26 per share and excluding certain expenses related to the Fox acquisition and severance costs for the restructuring that Jerry just mentioned, adjusted earnings per share were up 27% to \$0.28 per share.

And last but not least, we delivered operating cash flow of \$127 million and free cash flow of \$121 million, both up slightly versus last year. Cash flows were impacted by the timing of certain payables, the payment of payables at quarter end.

Let's look at the quarterly results in a little bit more detail. Quarterly revenue was \$840 million, up 15% on a reported basis. Currencies reduced revenue growth by 10 basis points. Organic revenue growth was very healthy at about 8% this quarter, improving from the second quarter levels. We continue to see good demand for our services and our acquisitions, most notably Fox, continued to deliver value in the third quarter.

Turning to profitability, we realized a 150-basis point improvement in gross profit margin, as pricing more than offset inflationary pressures. While Fox was accretive to gross margins by about 30 basis points, we saw 120 basis points of improvement in organic margins in the quarter. Setting aside improvements associated with a more favorable claims experience and the contribution of Fox, we saw 50 basis points of improvement in gross margin, as leverage from people cost as well as materials and supplies more than offset pressure from fleet due to lower gains on the sales of leased vehicles versus a year ago. We are pleased with our ability to leverage our cost of services provided, as we continue to benefit from a more consistent pricing discipline across all of our brands this year.

SG&A cost as a percentage of revenue decreased by 20 basis points in the quarter. Excluding the earnout adjustment for the Fox acquisition, SG&A cost as a percentage of revenue decreased by 30 basis points in the quarter. Peeling back the SG&A layers a bit more, people costs, advertising and selling costs, along with insurance and claims, make up the bulk of our SG&A spend. Margins benefited year-over-year associated with improved claims experience and we saw leverage on our people costs, but were negatively impacted by increased advertising and selling expenses as we invested to drive growth in our business.

As Jerry mentioned, for the first time in 20 years, we executed a restructuring program at our Atlanta Support Center to further support our modernization efforts. Roughly 15% of our back-office employee population was impacted, and we intend to reinvest associated cost savings in both people and systems that can drive further change and increase productivity as we work to become a better, more efficient provider of shared services for our frontline operations.

As I mentioned earlier, we had non-GAAP adjustments this quarter for restructuring costs and for Fox acquisition-related items. These totaled approximately \$10 million on a pre-tax basis and were related primarily to the Atlanta Support Center severance cost along with purchase accounting amortization and the fair value of contingent consideration on the Fox acquisition.

GAAP operating income was \$177 million, up 22% year-over-year. Adjusted operating income was \$187 million, up approximately 29% versus the prior year on 15% total revenue growth.

EBITDA was \$202 million, up 19% year-over-year, and EBITDA margin was a healthy 24.1%. Our adjusted EBITDA was \$208 million, up over 22%, and representing a 24.8% margin. Margins were up 150 basis points versus a year ago, primarily related to the improvements in gross margin discussed previously.

Fox was neutral to EBITDA margins in the quarter. Year-to-date, our adjusted EBITDA margins improved 90 basis points versus a year ago, with 20 basis points of that improvement coming from the Fox acquisition. Excluding this, 70 basis points was driven across the remainder of the business.

As we have consistently indicated, we like to look at the business using incremental margins or meaning what percentage of every additional dollar of revenue growth is converted to EBITDA. On an as-reported basis, we generated incremental margins of over 29% and excluding the restructuring cost and the additional costs associated with the earnout on our recent acquisition, incremental margins were almost 35%.

Year-to-date, we generated incremental margins on an as-reported basis of over 27%, and on an adjusted basis, incremental margins were almost 30%.

Quarterly GAAP net income was \$127 million or \$0.26 per share, increasing from \$0.22 per share in the same period a year ago. Adjusted net income was \$136 million or \$0.28 per share.

The effective tax rate was approximately 26% in the quarter and for the first nine months, the ETR was 26% as well, up over 100 basis points compared with 2022, driven by higher foreign income taxes.

Turning to cash flow and the balance sheet, quarterly free cash flow remained healthy. We generated \$121 million of free cash flow in the quarter versus \$119 million a year ago. As previously discussed, quarterly free cash flow was impacted by the timing of certain payables, primarily related to our door-to-door sales.

Year-to-date, free cash flow was \$354 million, an increase of 11% versus last year. During the quarter, we made acquisitions totaling \$21 million, we paid \$64 million in dividends, and we completed a share repurchase of \$300 million at below \$35 a share. We repurchased 8.7 million shares and used our revolver to fund this purchase. We expect this to be less than 1% dilutive to results in the first year and minimally accretive in the second year. Debt remains negligible and debt-to-EBITDA is below 1 times on a gross and net level.

Our strong cash flow profile has enabled us to execute a very balanced capital allocation strategy this year. Year-to-date, we have invested approximately \$350 million in acquisitions, repurchased \$300 million of our shares, and paid \$192 million in dividends, a 30% increase year-to-date.

Additionally, we just announced another 15% increase to our dividend earlier this week. This marks over two decades of consecutive increases in annual cash dividend payments.

We remain active in pursuing additional acquisitions. And looking at multiples, we remain very disciplined. Year-to-date, we have invested approximately \$350 million in acquisitions and the market remains highly fragmented, and we continue to be an acquirer of choice and a very active participant in our markets.

In closing, our performance this quarter continues to demonstrate the strength of our business model and the engagement level of our team. Our family of brands are driving profitable growth and we are focused on continuous improvement across the business. We remain focused on providing our customers with the best customer experience and driving growth both organically and through disciplined acquisitions.

With that, I'll turn the call back over to Jerry.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

Thank you, Ken. We're happy to take any questions at this time.

Operator

Thank you. [Operator Instructions] Our first question comes from the line of Anish Sabadra with RBC Capital Markets. Please proceed with your question.

Ashish Sabadra – *RBC Capital Markets*

Thanks for taking my question. It's good to see the strong momentum in the business. Just wanted to better understand, can you – you obviously talked about multiple different avenues to attract new customers and – but I was just wondering if you could comment on the underlying demand environment, have you seen any slowdown in the demand environment. And you, obviously, talked about month-to-month being consistently strong, but have you seen a better focus on certain selling strategies versus another? Thanks a lot.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

This is Jerry. Thanks for the question. I think some people think the entire market demand is driven by whatever someone's seeing in digital. And that's not always the case, especially for our business. When you look at the digital side, it was relatively flat or maybe even slightly down on the digital side. And that's really where our strategy to have lots of approaches for how we acquire customers – it plays a differentiating factor for us. So, while the digital segment was

certainly, I think, on the flattish to slightly down side, our diversified strategy is really what's paying off for us.

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

Yeah. The only thing I would add there, just two points. One, the growth across the business is quite impressive. When I look at the business in the quarter, we saw broad-based growth not only on a quarterly basis, we saw consistent growth, but broad-based growth across all of our family of brands. So, that was really good to see, first. And second, as we exited the quarter and went into October, we continued to see a really healthy demand level. And if you might recall, a year ago, we saw a lot of business from really tough hurricane season in September get pushed into October. So, to see good momentum into October also gives us a bit of optimism as we think about the future.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

And I think it's also important to mention that what we've seen across, say, the US and Canada, in particular across North America, is that all of our businesses are doing well. And geographically, not only – but from a brand – individual brand strategy, but also from a geographic strategy, they're really all doing quite well.

Ashish Sabadra – *RBC Capital Markets*

That's great color. And just maybe on my follow-up, I wanted to talk about the solid incremental margins that we've seen of 35%. As we think about the modernization efforts that you've worked on, how should we think about the incremental margins going forward? Is that 30% to 40% sustainable going forward? Thanks.

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

Yeah. It's a great question, Ashish, and thank you for that question. What I would say is our focus is to continue to deliver a very healthy incremental margin profile. This quarter, you're correct in saying that we were at 35%. We continue to see an opportunity to deliver 30% incremental margins, upwards of 35% to 40%, depending on a multitude of factors. But we certainly continue to have a confidence level in our ability to deliver the 30% incremental margin and continue to see EBITDA margins lift as we go into the future. It's a great business, it's an essential service, it's got pricing and we're focused on continuous improvement in our – across our business, not just in our back office. So, with all those points, we continue to focus on delivering a very healthy incremental margin profile.

Ashish Sabadra – *RBC Capital Markets*

That's great color, and congrats on the solid quarter.

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

Thank you.

Operator

Thank you. Our next question comes from the line of Vicky Liu with Bank of America. Please proceed with your question.

Vicky Liu – *Bank of America*

Hi. Good morning, and thank you for taking my question. This is Vicky on for Jason Haas. To start off, I'm just curious, have you seen any pushback from the 4% price increase or is it more business as usual as we see?

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

Price increase has been – it's been a very healthy environment as what we've seen from a standpoint of price increase. You may see certain Zip codes that you might see challenges in, but you see other Zip codes where you don't see much challenge at all. But overall, we see as a very healthy environment for our essential services.

Vicky Liu – *Bank of America*

Yeah. Thank you. And then to follow up, do you think your customers can take another price increase on a similar scale in 2024?

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

This is Jerry. We're going to evaluate that we're – and here in the fourth quarter is when we start really taking a look at our price increase data, the results from the last 9 or 10 months and say what happened, what did we learn and create our strategies for next year. And I guess my best advice to you would be to stay tuned. We'll probably update you on that at some point in the first quarter.

Vicky Liu – *Bank of America*

Yeah. Thank you so much.

Operator

Thank you. Our next question comes from the line of Tim Mulrooney with William Blair. Please proceed with your question.

Tim Mulrooney – *William Blair & Co.*

Ken, Jerry, good morning.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

Morning.

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

Good morning, Tim.

Tim Mulrooney – *William Blair & Co.*

Thank you for taking my questions. Two quick ones. So, on customer acquisition, Jerry, I think in your response to another question, you said the digital channel was flat to down in the third quarter. My question on that is, is that new, and was it up in the first and second quarters of this

year? Just trying to get a sense for how consumer demand in this particular channel has trended through the year.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

I would characterize that in the first five months of the year as somewhat up. I wouldn't say it was something that – we didn't see some sort of double-digit increases very consistently. We may have had better – some better months than others, but it wasn't up at a higher – significant higher level than prior year. There were ups and downs, and then it was – really June is where we saw that – that – almost that double-digit decrease for those three weeks in June, and that was sort of out of character, but then it just rebounded in July. So, I would say it's been dynamic and maybe the word is a little volatile over the summer a little bit, but then it's now seem to stabilize pretty consistently over the past few months in terms of flat year-over-year. So, I don't know if that helps, but I think that's the story of the last 9 or 10 months.

Tim Mulrooney – *William Blair & Co.*

No, that's extremely helpful. There's a lot of folks out there trying to figure it out on their own and looking at your trends. And so, just hearing it from you directly is very helpful, and fully appreciate that you have many different channels of which you acquire customers, but thanks for the detail on that.

The other thing I want to ask about is customer acquisition cost. Customer acquisition cost in the digital channel – I know it's risen over time, just like they have for everybody, curious if you're seeing a narrowing, I guess, in the gap of customer acquisition cost between digital and door-to-door. And if so, do you expect – do you plan to expand the usage of that D2D channel more extensively in future periods?

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

So, yeah, that is something that – that is a trend that we've seen as – as more and more pest control companies have gotten more mature in the digital space, we have seen, say, the Googles of the world be able to pass along higher cost to us in terms of – especially for things like pay-per-click, things along those lines. So, we – you see that rise. And I also want to point out, just because demand is flat through, say, Google Search data or something like that or it's down 1% year-over-year, something along those lines, doesn't mean you as a company can't perform or take a larger share of that demand through – we have great marketing teams, certainly at Orkin and throughout some of our other brands as well that do some of the digital activity. And they can achieve more with the dollars spent in that market.

But back to your original question, we certainly have seen over time over the last several years an increase in digital cost of customer acquisition that makes that gap between door-to-door and digital certainly narrower. And so, when you look at the door-to-door model and you think that's a – that can be a pretty good model if you sell it right, and especially when you consider that door-to-door is selling you density, because they're working neighborhoods and you're picking up a dense – more dense populations than, say, onesie-twosie stuff coming in from all over a metropolitan area on the digital side. So, when you factor the efficiencies that door-to-door bakes in long term, even though it's a little bit more money upfront, it may be a – it's a really strong offering from a long-term standpoint as well.

Tim Mulrooney – *William Blair & Co.*

Got it. Thank you.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

Yeah.

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

You're welcome.

Operator

Thank you. Our next question comes from the line of Josh Chan with UBS. Please proceed with your question.

Joshua Chan – *UBS*

Hi. Good morning, Jerry and Ken. Congrats on a good quarter. I guess I wanted to ask about the customer acquisition split, I guess. You mentioned digital and door-to-door mostly on this call, but I guess of the ways that you acquire customers, could you just give us like a rough ballpark on how – what channels they typically come through in?

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

Josh, you're asking like what percent of customers come through which channel?

Joshua Chan – *UBS*

Yeah. Exactly.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

Yeah. We really don't disclose that information.

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

But I would say that today much larger portion comes through a digital channel or more comes outside of door-to-door than comes from door-to-door.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

Yeah. There's digital, there's the consumer awareness that makes the phone ring when they call our customers – customer agents where they know our brands, they know our name and they call us automatically and never have to go to Google to do a search because they see our name, phone number, they see our vehicle in the neighborhood, and they make the phone call, right? So, the word of mouth is still a powerful channel. So, it's really all those things that come into play to drive that, but certainly, digital is an important part, but we also don't like to over-rely on it as well.

Joshua Chan – *UBS*

Right. Right. That makes sense. Okay. Thanks for the color there.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

And we also think about technician sales. We've put a great deal of emphasis. And one of the things that you learn in this business is when you're not staffed, your technicians don't sell. So, if they are – if they're too swamped with too much work to do, they're not going to go out and when somebody down the road talks to them, they're going to be a little less hesitant to want to sell that new job because it's just more work for them. But when you're staffed and you're staffed to healthy levels, your technicians get engaged. So, we see increases in our technician sales, in their activities as a result of our better staffing levels as well. So, it's all these ways that we can acquire customers.

Joshua Chan – UBS

Right. Thanks. Thanks, Jerry. And then, I guess on the restructuring side of things, is there a way to think about the payback period of the costs and what kind of savings you expect to generate from those efforts?

Kenneth Krause – Rollins, Inc. – EVP, CFO & Treasurer

Yeah. That's an attractive payback, Josh. Thanks for the question. When you look at the spend, \$5-or-so million of spend, there's probably close to \$8 million to \$10 million of compensation associated with that. So, my experience has been a one year payback is very acceptable. You can see a six-month payback and the spend associated with the restructuring here. With that said, I think if you look at the prepared commentary, we're focused on reinvesting as well. And so, there was an opportunity to reinvest in new talent, a new talent like Lyndsey, she kicked off the call today, our new Head of IR, new folks across all of finance and accounting. IT, we're making significant changes in as well and other back office functions. So, we're looking at how do we upgrade the talent, how do we improve, how do we modernize what we do. And some of that is going to take some reinvestment of that \$8 million to \$10 million.

Joshua Chan – UBS

Sure. That makes a lot of sense. Thanks, Ken. Thank you both for your time.

Kenneth Krause – Rollins, Inc. – EVP, CFO & Treasurer

Thank you.

Operator

Thank you. Our next question comes from the line of Aadit Shrestha with Stifel. Please proceed with your question.

Aadit Shrestha – *Stifel, Nicolaus & Co.*

Good morning. Thank you for taking my questions and congratulations on the strong quarter again.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

Thank you.

Aadit Shrestha – *Stifel, Nicolaus & Co.*

So, what was the internal cost inflation? Is it still predominantly fleet related? And how do we – how has this trended actually through the year? And just kind of related to that, you talked about price/cost spread, it remains positive. I think it was around 50 basis points. How has that trended versus 2Q or 1Q and how do we think about it for remainder of the year and into 2024?

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

So, it's Ken. I think I'll take that question. Our focus is to continue to have a positive – and positively manage the price/cost equation. If you look at the input cost in our business, a large percentage on – on a cost of services provided are people costs, materials and fleet. For the most part, we've done a really good job at leveraging and improving the efficiency over those costs throughout 2023.

If I go back to Q2, for example, we saw improvements in margin. Some of that was related to Fox. We also had headwinds, if you remember, from the casualty reserve, but when you separate those two in the second quarter, we saw improved margin similar to what we saw this quarter. What we saw this quarter was outsized improvement associated with the casualty claims and insurance cost.

If you go back to last year in the third quarter, we were very transparent in talking about a very unfavorable headwind associated with insurance and claims. So, we were able to see improvement from what we saw last year. But our focus is to continue to be positive on the price/cost equation. Really the only headwind we saw in the quarter within our organic cost was

in fleet, which specifically was related to lower gains on the sale of leased vehicles. We actually talked about that in Q2 and highlighted that we would be seeing some of that here in Q3. We did see it, but we were able to fully offset that and see improvements. And so, that's the focus, continued improvement in margins as we go forward.

Aadit Shrestha – *Stifel, Nicolaus & Co.*

All right. Thank you so much. And just as a follow-up, I think free cash flow conversion, and you pointed out there was sort of a payment – a big payment you had to make in 3Q, brought it down to 94% conversion. I think year-to-date, you're tracking around 110%. Historically, it averages around 120%. So, do you expect 4Q sort of picks up and you actually get back to that 120% conversion for the year?

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

Yeah...

Aadit Shrestha – *Stifel, Nicolaus & Co.*

And how do we think about it long term, like beyond 2023 and maybe into 2024, how much more can this improve?

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

Yeah. It's a business that's very capital light. And so, when you look at the cash flow profile, it's hard to find a business that's investing 7% to 8% in working capital, has very little CapEx, and enjoys the benefits of that and has been compounding cash flow at 10% to 15%. So, our focus is just that, how do we continue to compound cash flow in that teen range, how do we continue to convert net income and earnings at above 100% of net income.

The third quarter had an impact. We saw payables come down considerably. We paid some payables as we closed out the third quarter. And our focus is to improve that as we go into Q4 and beyond. And so, that continues to be our focus. We're continuing to focus on driving high levels of cash flow performance and compounding in the ranges I previously discussed.

Aadit Shrestha – *Stifel, Nicolaus & Co.*

Thanks a lot.

Operator

Thank you. [Operator Instructions] Our next question comes from the line of Stephanie Moore with Jefferies. Please proceed with your question.

Harold Antor – *Jefferies*

Hello. This is Harold Antor on for Stephanie Moore. So, I guess a quick question. How did weather trend in the quarter and how did it impact this quarter's results? And then, also in 2021, I know you increased the hiring of sales professionals. So, are those individuals on full productivity and how does that impact organic growth in the quarter? Thank you.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

This is Jerry, Harold. On the weather side, we had a pretty good weather quarter. Last year, as Ken mentioned, we had a hurricane that came through at the end of September, affected South – and particularly Southwest Florida. So, we didn't have that type of event. So, I would generally categorize it as favorable.

And then as it relates to hiring of salespeople, we've been very effective. And when you look at our commercial growth, a lot of the investments we've made, both in commercial and to some degree in certainly the residential side in our termite and ancillary as a result of the effectiveness and the efficiencies that we were getting from a sales productivity standpoint of those sales, the sales teams that we've added and you look at our commercial growth, looking back over the third quarter of 2022, we've added over 60 more commercial account managers into the Orkin brand alone over the past year that's really helping us. That's an investment we make in the business. It's helping us drive that growth. We see a great opportunity in the commercial space and those are the investments that we've been making over the last 12 months.

Harold Antor – *Jefferies*

Thank you. And then, I guess, just on M&A, given where interest rates are and uncertain macro, are you seeing more willing sellers? How much P/E is in the market? And then I guess for your acquisition strategy, are you acquiring more traditional companies or more companies similar to Fox Pest Control that are door-to-door like? Thank you.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

We're seeing everything still in the market. Businesses are still – owners are still interested in selling their businesses and the pipeline flow remains good. And we're open to looking at all types of businesses that fit our model, that help us continue the growth pattern that we strive to achieve, help us – that are accretive to our margins, that are going to help us grow in a healthy, positive way. So, that side of it still seems very positive.

What would you add to that, Ken?

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

Yeah. The only thing I would add is pricing, which everybody's always focused on, what are we paying for acquisitions. Two points I want to – I'll raise with respect to that. One is, we don't compete on price. Our focus is to be the acquirer of choice. And we've been very successful being the acquirer of choice for a very long period of time. When people are ready to sell their business and they're focused on brand preservation and they're people, they sell to our business. And we've been very successful being the acquirer of choice for a very long period of time.

When we look at the business this year, we've invested \$350 million in acquisitions. I would say that the multiples that we've paid for that \$350 million investment is probably below the overall long-term average from a multiples perspective. So, we feel good about what we're spending, how we're competing, and the success that we're driving through acquisition.

Operator

Thank you. Our next question comes from the line of John Mazzoni with Wells Fargo. Please proceed with your question.

John Mazzoni – *Wells Fargo*

Hey. Good morning. Thanks for squeezing me in. Maybe just to double click quickly on the commercial side, could you maybe just talk more about the targeted vertical strategy as well as anything on technology that really is accelerating the kind of organic growth profile? And maybe also just – again, the 60 kind of added reps have been helpful, but just talk to about the kind of sustainability of that growth going forward. Thanks.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

So, on the commercial side with targeted verticals, we've talked about this over the last few years, especially as we're kind of coming out of the tail-end of COVID and the investments that we've made there. We know that – our research on our customer database shows there are certain – much more highly desirable verticals that we like to sell into and service into, in things like hospitality or healthcare, hospitals, logistics, warehouses, distribution centers. Not that we don't want everything commercial, but we have really targeted our focus on certain verticals. And when we bring on new, say, commercial account managers at Orkin, we're really getting them focused and targeted on working that type of material and going after those types of customers from a B2B standpoint.

So, it's really – I've also discussed some of our tools like Marketo that help us from a – on a B2B standpoint that have helped us get our outside salespeople on the commercial side warmer leads and make them more productive and make them more productive quicker. That's relationship sell. So, it takes some time. So, we've been very deliberate about that since – we started this program probably midway through COVID, seeing this as an opportunity come in once we're on the backside of COVID that will be great opportunity for us to capitalize on it. We're – again, long-term view and a long-term approach to our business, and that's – you're seeing the results and the payoff of that now.

So – and then on the technology side, certainly our marketing teams in particular, when we talk about accelerating organic growth, there are technologies, there's campaigns that we run where we're using technology, where we're using some automation. The marketing teams are certainly innovative looking at strategies along those lines. I don't like to get into specifics, but I can assure you that they're very creative and very helpful to our sales teams in terms of creating that organic demand.

John Mazzoni – *Wells Fargo*

Great color. Thank you. And then maybe just to quickly touch on competition, have you seen any change in the competitive landscape? And perhaps, has there been any pullback in either smaller regional players or large national players?

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

Competitively, it's – I mean, it's still a healthy competitive market, highly fragmented and lots of players out there. So, no, we haven't seen any significant change from a competitive standpoint that's probably noteworthy or remarkable. It's still competitive out there.

John Mazzoni – Wells Fargo

Okay. Thank you. Perfect. Thanks, again. Congratulations on the strong results.

Kenneth Krause – Rollins, Inc. – EVP, CFO & Treasurer

Thank you.

Jerry Gahlhoff – Rollins, Inc. – President & CEO

Thank you.

Operator

Thank you. Our next question comes from the line of Oliver Davies with Redburn Atlantic. Please proceed with your question.

Oliver Davies – Redburn Atlantic

Yeah. Morning, guys. Just a couple of questions for me. You mentioned on the Q2 call that organic growth is running at about 10% in July, which sort of implies that the rest of the quarter is about 7.5%. So, can you just talk through the sequential movement you sort of witnessed through the months and into quarter end?

And then just another one on growth before margin, are you able to give a split of organic growth between kind of new customers and cross-selling into the existing customer base?

Kenneth Krause – Rollins, Inc. – EVP, CFO & Treasurer

So, on the second point with respect to the margin profile of customers, we unfortunately do not track that and have that – enjoy that level of detail in the business. But what I can tell you is, cross-sell is certainly always a big part of our strategy. When you look at the strategy, it's important to sell multiple services to one customer for a multitude of reasons. And so, it's certainly continuing to be a focus for us and we're continuing to see good momentum in that part of our business.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

Yeah. When you look sequentially between July, August, September from a growth rate, you're right, July was a pretty big month where we saw higher levels of organic. But then, as we moved through the quarter, it remained strong, too. It was more in line with our historical averages. It was strong organic growth to close out the quarter as well.

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

Yeah. The only thing we would add on that is – and I don't want to start to split hairs, but when you look at Q2, we talked at the end of Q2 about a weak June. And so, it's not out of the question to think or out of the realm of reason to think that some of that business in Q2 may have pulled into Q3 in July and pushed that number up a bit. And so – but there's – I don't – looking at Jerry, there's nothing other than that, that was really out of the ordinary with respect to growth. It was healthy throughout.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

Yeah.

Oliver Davies – *Redburn Atlantic*

Thanks. Sorry, I meant just can you give a split of organic growth between new customers and cross-selling.

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

No.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

Yeah...

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

We don't – I mean, there's – we don't – unfortunately, we don't track that level of detail to a point where I could provide that to you right now. But I can tell you that the growth's healthy. I mean, the growth is healthy across both of those areas. It's been healthy for us.

Oliver Davies – *Redburn Atlantic*

Okay. Thanks. And then just on adjusted EBITDA last year, I think was negatively impacted by 140 basis points from the casualty reserve increase. So, I guess if you add that back to last year's margin, you sort of get 24.7% versus the 24.8% delivered this quarter. So, can you just talk about the moving parts and is that still a pretty big drag on margin?

Kenneth Krause – *Rollins, Inc. – EVP, CFO & Treasurer*

Yeah. The big point you're missing with that is the fact that the insurance markets have been really challenging. And so, claims are one thing, but insurance is continuing to tight on us. And so, when you look at last year, you did have that negative impact on the claims that came through, but unfortunately – and those have come down this year in Q3, but the insurance costs have not come down. And so, you're seeing really good improvement in the underlying business. It's not 150 basis points. And that's why we were transparent in saying that in the quarter when you set the improvement on the casualty reserve aside, you set the Fox improvement aside, we saw 50 basis points of improvement in the underlying margins in the quarter alone, but we feel pretty good about our ability to continue to improve margins as we go forward.

Oliver Davies – *Redburn Atlantic*

Okay. Thanks very much.

Operator

Thank you. Ladies and gentlemen, that concludes our question-and-answer session. I'll turn the floor back to management for any final comments.

Jerry Gahlhoff – *Rollins, Inc. – President & CEO*

Thank you, everyone, for joining us today. We appreciate your interest in our company and we look forward to updating you on our fourth quarter earnings call early next year. Thanks again.

Operator

Thank you. This concludes today's conference call. You may disconnect your lines at this time. Thank you for your participation.