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Westinghouse Air Brake Technologies Corp. (WAB)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and welcome to the Wabtec Second Quarter 2022 Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to Kristine Kubacki, Vice President, Investor Relations. Please go ahead.

Kristine Kubacki

Vice President-Investor Relations, Westinghouse Air Brake Technologies Corp.

Thank you, operator. Good morning, everyone, and welcome to Wabtec's second quarter 2022 earnings call. With us today are President and CEO, Rafael Santana; CFO, John Olin; and Senior Vice President of Finance, John Mastalerz. Today's slide presentation, along with our earnings release and financial disclosures, were posted on our website earlier today and can be accessed on the Investor Relations tab on wabteccorp.com.

Some statements we're making are forward-looking and based on our best view of the world and our business today. For more detailed risks, uncertainties and assumptions relating to our forward-looking statements; please see the disclosures in our earnings release and presentation. We will also discuss non-GAAP financial metrics and encourage you to read our disclosures and reconciliation table carefully as you consider these metrics.

I will now turn the call over to Rafael.

Rafael O. Santana

President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

Thanks, Kristine, and good morning, everyone. Let's move to slide 4. I'll start with an update on our business, my perspectives on the second quarter, progress on our long-term value framework and then John will cover the financials.

We delivered a strong second quarter, which is evidenced by another quarter of adjusted margin expansion of 1.5 percentage points and adjusted earnings per share growth of 16%. More importantly, we continued our progress against our long-term strategies as evidenced by a significant expansion in the total backlog.

Sales were roughly $2 billion, which was up modestly versus prior year. Revenue was driven by strong performance in the Freight segment but partially offset by lower year-over-year revenue in the Transit segment. Excluding foreign currency exchange, consolidated revenues would have grown by roughly 5.5%.

Total cash flow from operations was $263 million for cash conversion of over 90%. Total multiyear backlog was over $23 billion, up $1.7 billion. And excluding the headwinds from foreign exchange, backlog was up $2.3 billion from last year.

Finally, we closed two strategic acquisitions in the quarter, Beena Vision and ARINC, and deployed over $100 million in share repurchases and dividends. So all-in-all, we had a very good quarter. We continue to invest for the future as we execute commercially and operationally with discipline and rigor. And we're well positioned to continue to drive long-term growth even with uncertainty and volatility in the overall economy.

Shifting our focus to slide 5. Let's talk about our end market conditions in more details. As we look at key metrics across our Freight businesses, we are encouraged by the continued momentum in our end markets and the strong pipeline of opportunities.

North America carloads are expected to improve in the second half of the year and locomotive parkings have continued to decline despite lower year-to-date freight traffic. We continue to see significant opportunities and demand for new locomotives and modernizations as our customers invest in their aging fleets and place a greater demand on reliability, productivity and fuel efficiency.

When it comes to the North American railcar build, demand for railcars is increasing from what we believe are trough levels. Railcars in storage are below pre-COVID levels with about 18% of the North American railcar fleet in storage. As a result, industry orders for new railcars continue to improve and the industry outlook for 2022 is for over 40,000 cars to be delivered. Overall, we believe we have the opportunity to build significant long-term momentum with growth and modernizations in new locomotive sales, in railcar builds and in rolling stock.

Internationally, freight car activity also continues to show positive signs. We have been growing our international fleet mid-single digits on average over the last five years. And we are currently executing on a strong pipeline of order opportunities. Overall, we expect long-term revenue growth in the majority of our end markets.

Finally, transitioning to the Transit sector. The long-term market drivers remain positive with continuing global infrastructure spending for clean, safe and efficient transportation solutions. Our team is committed to driving growth across both Freight and the Transit segments.

Next, let's turn to slide 6 to discuss a few recent business highlights. We recently secured some strategic orders, including a significant agreement with Union Pacific for 600 locomotive modernizations. This agreement, totaling more than $1 billion, will begin delivering next year and run over the next three years. It is the largest order for modernized locomotives in rail industry history.

The modernizations will enable Union Pacific to move more freight efficiently and sustainably, including a fuel efficiency improvement of up to 18%, a more than 80% increase in reliability and haulage ability increase of more than 55%. This total order will eliminate nearly 200,000 tons of emissions per year, roughly the equivalent of 45,000 passenger cars per year.

We also closed a significant order with Canadian National for 10 new Tier 4 locomotives, which will begin delivery in 2023, and 50 modernizations. The mods will be equipped with our FDLA Advantage (sic) [FDL Advantage] technology which will deliver the best-in-class fuel and emissions reductions. These wins build on several recent announcements we have shared with Canadian National, including their purchase of the FLXdrive battery-electric freight locomotives and a digital order for our Precision Dispatch System which will help accelerate network optimization for CN and the entire rail industry.

Finally, in Transit, we won a significant order for heating, ventilation and air conditioning units across Atlanta's metro system. This order marks the latest win in our longstanding relationship with Stadler and marks the first subway order with the car builder in the US.

Turning to slide 7. I wanted to briefly touch on Wabtec's operating system which drives many aspects of our culture and our performance, starting with our people and teams, addressing our customers' most critical business needs and developing operating plans, systems and processes to deliver best-in-class performance. We use this operating model to guide what we do, to measure how well we execute and to tackle where we need to improve.

One of the critical elements of our operating system is our annual strategic planning process and we are in the midst of this process right now. The goal is to look at opportunities across our markets and our company and identify those areas where we can further leverage our leadership and technology position, build on our extensive installed base, capitalize on trends such as electrification, digitalization, automation and sustainable transportation, which will all create positive outcomes for our customers.

We also look to accelerate investments across the company through our Integration 2.0 efforts as well as driving lean operations, continuous improvement and best-in-class productivity, all of which delivers long-term shareholder value. It's also a critical process in aligning our talent, our products, service and software investments to drive long-term profitable growth.

We are confident that we're well-positioned for the future and we expect to continue to deliver profitable growth ahead. Since 2019, this process and the Wabtec operating system have been the foundation for driving rigor, strategic alignment and efficiency especially while navigating profound volatility. As a result, we have been able to bring the full power of Wabtec to our customers while balancing the need for agility with a clear focus on strategy and execution to own the opportunities before us.

With that, I'll turn the call over to John to review the quarter, segment results and our overall financial performance. John?

John A. Olin

Chief Financial Officer & Executive Vice President, Westinghouse Air Brake Technologies Corp.

Thanks, Rafael, and hello, everyone. Turning to slide 8, I will review our second quarter results in more detail. We had another good quarter of operational and financial performance despite continued challenges in the supply chain, currency exchange and cost increases. Sales for the second quarter were $2.05 billion which reflects a 1.8% increase versus the prior year.

Freight segment sales were strong, up 11.5%, partially offset by lower year-over-year sales in our Transit segment. Q2 sales were negatively impacted by unfavorable currency exchange, which reduced our revenue growth in the quarter by 3.8 percentage points. For the quarter, adjusted operating income was $340 million, which was up 11.5% versus the prior year.

We delivered strong margin expansion, up 1.5 percentage points on an adjusted basis. Margins were aided by mix favorability, increased pricing and improved productivity partially offset by significantly higher costs. The team achieved margin expansion even in the face of rising costs and continued supply chain disruptions.

Through the first half of the year, our revenue growth, excluding foreign currency exchange, and our margin growth had been in line with our original plan, and in line with the cadence which we discussed when we issued our 2022 guidance. As we look forward to the second half, we continue to expect accelerated growth in revenue from the first half behind significantly increased locomotive deliveries and lower year-over-year margin percent due to unfavorable mix in our equipment sales and comparing against much higher back half margins in 2021.

More specifically, we anticipate this margin decline will be more pronounced in the third quarter than in the fourth quarter. We continue to expect our full year margin percent will be up modestly.

In the second quarter, adjusted earnings per diluted share were $1.23, up 16.0% versus the prior year. GAAP earnings per diluted share were $0.91, which was up 37.9% versus the second quarter a year ago. During the quarter, we had pre-tax charges of $4 million for restructuring and other one-time charges largely related to our Integration 2.0 initiative to further integrate Wabtec's operations and to drive $75 million to $90 million of run rate savings by 2025.

As Rafael noted, we were very pleased with our Q2 results especially in the face of significant foreign currency exchange headwinds and continued supply disruptions and our strong margin growth in the face of continued cost increases. We remain diligent and proactive as we work to minimize these challenges.

Turning to slide 9, let's review our product lines in more detail. Second quarter consolidated sales were up modestly at 1.8% and the underlying business is performing well, up 5.6%, excluding foreign currency exchange.

Equipment sales were up a very strong 16.2% from last year due to higher locomotive deliveries in this quarter versus last year and continued strong mining sales. Component sales were up 4.5% year-over-year driven by higher OE railcar build, lower number of railcars in storage and a recovery in the industrial end markets.

Digital electronics sales increased 1.2% driven by a partial quarter of revenue from the strategic bolt-on acquisitions of Beena Vision and ARINC partially offset by ongoing chip shortages. We continue to see improved demand for our core onboard locomotive products and our backlog in digital continues to increase.

Our services sales grew 14.3% versus last year. The year-over-year increase was driven by higher sales for modernizations and the continued unparking of locomotives. The superior performance, reliability and availability from our fleet continue to drive customer demand as railroads increasingly look for predictable outcomes across their fleets.

Across our Transit segment, sales decreased 17.5% versus the prior year to $558 million. Sales were down versus last year due primarily to the negative impacts of foreign currency exchange. We believe the medium and long-term outlook for this segment remains positive as infrastructure spending for green initiatives continue.

Moving to slide 10. Our adjusted gross margin expanded 1.7 percentage points to 31.6% driven by a richer mix of products, increased pricing and strong productivity partially offset by higher input costs and unfavorable foreign currency exchange.

Mix and pricing positively impacted our margins. Mix benefited margins as Freight sales outpaced our Transit sales. Additionally, higher pricing was realized from price escalations incorporated into many of our long-term contracts along with other price actions that were implemented to recover cost increases.

Raw material costs were again up significantly led by increased metal costs and dramatically higher energy costs. Foreign currency exchange adversely impacted revenues by 3.8 percentage points and adversely impacted second quarter gross profits by $15 million.

Finally, manufacturing costs were favorable due to productivity gains which were largely offset by higher transportation and logistics costs. Our team continues to execute well to mitigate the impact of these cost pressures by triggering price escalations, implementing price surcharges and driving operational productivity and lean initiatives.

Now turning to slide 11. For the second quarter, adjusted operating margin expanded 1.5 percentage points versus last year. Our margins benefited from higher adjusted gross profit but were partially offset by higher operating expenses primarily from increased investment in future technologies. Adjusted SG&A was $257 million, which was up slightly versus prior year but down 10 basis points as a percentage of sales to 12.5%.

Engineering expense increased from last year according to plan. We continue to invest engineering resources in current business opportunities. But more importantly, we are investing in our future as an industry leader in decarbonization and digital technologies that improve our customers' productivity, capacity utilization and safety.

Now let's take a look at segment results on slide 12 starting with the Freight segment. As I already discussed, Freight segment sales improved for the quarter and segment adjusted operating income was $301 million for an adjusted margin of 20.3%, up 1.8 percentage points versus the prior year. The benefits of higher sales, improved mix and productivity were partially offset by higher operating expenses. Finally, segment backlog was $19.68 billion, up $1.84 billion or up 10.3% from the end of Q2 last year due to the significant multiyear order momentum that Rafael discussed earlier.

Turning to slide 13. Transit segment sales were down 17.5% driven by the negative effects of foreign currency exchange, the exit of low-margin contracts in our UK business and a late quarter manufacturing disruption caused by a cyber incident. In addition, Transit revenue continues to be adversely impacted by supply chain disruptions.

As previously announced, on June 26, we detected a cybersecurity incident that impacted the company's network, which disproportionately affected our Transit business. This disruption modestly reduced Q2 revenues and is expected to have an impact on our Q3 Transit results. Adjusted segment operating income decreased by $15 million to $58 million, which resulted in an adjusted operating margin of 10.3%, down 0.5 percentage points versus the prior year.

Lower absorption, inefficiencies driven by the manufacturing disruption and unfavorable foreign currency exchange were partially offset by strong productivity and lower SG&A. Transit continues to focus on driving down costs, implementing lean and improving operational efficiencies despite the volatile environment. Finally, Transit segment backlog for the quarter was $3.55 billion, down 4% versus a year ago. Adjusting for the negative effect of foreign currency exchange, backlog would have been up 5.3%.

Now let's turn to our financial position on slide 14. During the quarter, we generated $263 million of operating cash flow resulting in a cash conversion rate of 92%. This brings our year-to-date operating cash flow to $424 million. Cash flow benefited from higher earnings but was impacted by the proactive build of inventories ahead of our strong growth expectations and managing supply disruptions of critical parts.

Looking forward, we are confident that we'll generate strong cash flow for the year. Our adjusted net leverage ratio at the end of the second quarter declined to 2.4 times and our liquidity is robust at $1.48 billion. We closed on the acquisition of two digital companies, Beena Vision and ARINC. The combined purchase price of these two businesses was $69 million.

Also during the quarter, we returned more cash to our shareholders repurchasing an additional $103 million of shares and paid dividends of $27 million. As you can see in these results, our financial position is strong and we are confident that we can continue to drive solid cash generation giving us the liquidity and flexibility to allocate capital toward the highest return opportunities and to grow shareholder value.

With that, I'd like to turn the call back over to Rafael.

Rafael O. Santana

President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

Thanks, John. Let's flip to slide 15 to discuss our 2022 financial guidance. In the first quarter, we issued guidance with sales growth at the midpoint of 8% and EPS of $4.65 to $5.05 or up roughly 14% at the midpoint.

Our guidance was based on improving industry momentum and strong underlying customer demand for our products. With the first half behind us, we continue to feel strong about our businesses. And we delivered against our regional planned financials despite unplanned loss of business in Russia and very unfavorable foreign currency exchange.

We are maintaining our full year revenue and cash conversion guidance and we are tightening our full year earnings guidance to $4.70 to $5. I am pleased with the strength and resiliency of our business. And more importantly, I'm extremely proud that our teams continue to deliver despite an ever-changing and challenging environment.

Now let's wrap up on slide 16. As you've heard today, our team delivered a strong quarter despite a challenging and evolving environment thanks in large part to our resilient installed base, best-in-class technologies and our team's focus on our customers. For these reasons and more, we are confident that Wabtec is well positioned for long-term profitable growth.

Looking forward, we will lean further into the strong fundamentals of the industry and of our company to extend our leadership position in rail, to deliver innovative scalable technologies for our customers and to harness the power of our lean and continuous improvement culture.

With that, I want to thank you for your time this morning. And I'll turn the call now over to Kristine to begin the Q&A portion of our discussion. Kristine?

Kristine Kubacki

Vice President-Investor Relations, Westinghouse Air Brake Technologies Corp.

Thank you, Rafael. We will now move on to questions. But before we do and out of consideration for others on the call, I ask that you limit yourself to one question and one follow-up question. If you have additional questions, please rejoin the queue. Operator, we are now ready for our first question.

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] And our first question will come from Justin Long with Stephens. Please go ahead.

Justin Long
Analyst, Stephens, Inc. Q

Thanks and good morning.

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp. A

Good morning, Justin.

Justin Long
Analyst, Stephens, Inc. Q

I wanted to clarify. Was the UNP order for 600 mods included in the reported backlog? And also just given that announcement and the announcement we saw earlier this year from NS and I guess we got some orders from CN this quarter as well, what level of growth in mods is already locked in looking into 2023? Could we be up 100 units, 200 units? Any order of magnitude just based on what you already have in the backlog for next year?

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp. A

So number one, yes, it is included in the backlog. And with that, Justin, one thing to also keep in mind is if you think just about the backlog from a quarter-over-quarter impact from FX alone, it's been over $400 million. Year-over-year, it's closer to $600 million. So I think it's important to highlight that. Otherwise, you might have expected a larger increase. But it is reflected.

Second piece is, as you described, I think we have strong momentum and it's not just internationally as we have largely described before. But as we've been saying for the past 12 months, I think we have a strong pipeline of opportunities that cuts across both internationally and in North America.

We continue to have, I'd say, opportunities to grow double digits in terms of the modernization demand. And of course, we're coming from trough levels in terms of demand for new locomotives. So it's good to see the momentum. I think the pipeline of opportunities that we see it on today is stronger than the one we described three months ago or six months ago. So continued opportunity here to further expand our backlog.

Justin Long
Analyst, Stephens, Inc. Q

Okay. And just to be clear, that double-digit growth in mods was referring to 2023?

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp. A

Exactly. And I think just to add to that, I think one of the important things about this – this is less about just 2023. It's really, I'd say, very much aligned on how we described our five-year plan.

Justin Long
Analyst, Stephens, Inc.

Q

Understood. And I guess, secondly, for John, thinking about the guidance. So the Transit segment saw a pretty significant sequential decline in adjusted operating income. Can you talk about what you're assuming for the back half in Transit? Are we expecting to get that closer to what we saw in the first quarter from an operating income perspective?

And then just anything on the cadence of margins and earnings in 3Q and 4Q. I know you said 3Q would be worse from a margin perspective year-over-year, but the comp's tougher. So I just wanted to think about things on maybe more of an absolute basis in the next two quarters.

John A. Olin
Chief Financial Officer & Executive Vice President, Westinghouse Air Brake Technologies Corp.

A

Well, let's start with – that's a lot, Justin. Let's start with the Transit business. Starting with revenue, when we look at the overall first half, we find that revenue was down about 12% and operating margin is down slightly, 0.1 point.

So number one is we believe that Transit's ability to hold margin in the face of lower revenue speaks to its resilience and underlying earnings growth. And more importantly, the decline in the first half revenue was caused by a few items that don't represent the business' underlying performance or, Justin, the future growth risk potential.

These items include the foreign currency exchange, which on the first half was 7 percentage points. And on a quarterly basis, it was up to 9 percentage points. We talked about in the first quarter, the exit of the low-margin UK business. That continues into the second quarter. We'll not continue beyond it and now we're lapping the full exit of that. And then finally, the manufacturing disruption we had from the cyber incident, which reduced revenue roughly 5% in the Transit business. And that incident largely hit the Transit business. But excluding these items, Justin, the underlying business is up modestly.

As we look to Q3, we do continue to expect headwinds on Transit revenue because of foreign currency and certainly some spillover of the cyber incident. When we look at the overall margin piece, that's been really driven by lower absorption in the second quarter as well as some of the inefficiencies due to the cyber event. In the back half, we don't provide guidance for the back half on Transit.

But with that, Justin, I'll transit into your next question which is on the cadence. As we've talked about this year – in the cadence, we've talked about really the story of two halves. On the first half, we would expect moderate growth. And ex currency, we're up a little over 5% in the first half. And we also talked about stronger year-over-year margin growth in the first half. And we were up about 1.4 percentage points on the half. So that really played out exactly as we had planned.

When we look to the back half, we said that the back half would be more pressured on margin growth. And actually, we said that it would be lower on a year-over-year basis. And that would be driven by much higher revenue that's coming from our equipment group and the delivery of locomotives predominantly in the back half.

So now if we look at the back half and parse that back a little bit better and talk about the cadence between quarters, we would expect the third quarter and the fourth quarter to be up significantly in revenue but a little bit more on the third quarter than the fourth quarter. And with regards to operating margin, we would expect the margin percent in the third quarter to be less than what we experienced in the fourth quarter.

Justin Long
Analyst, Stephens, Inc.

Q

Okay. That's very helpful. Thanks, John.

John A. Olin
Chief Financial Officer & Executive Vice President, Westinghouse Air Brake Technologies Corp.

A

Thank you.

Operator: Our next question will come from Chris Wetherbee with Citi. Please go ahead.

Elijah Winski
Analyst, Citigroup Global Markets, Inc.

Q

Hey, thanks. Good morning, guys. This is Eli Winski on for Chris. So maybe...

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

A

Good morning.

Elijah Winski
Analyst, Citigroup Global Markets, Inc.

Q

Morning. So I just want to go to the revenue segment for a second, Freight. So I understand that equipment growth will look really strong. Is that where the focus is right now in growth within Freight? And I understand that mods are doing well. But maybe on the components and just digital electronics side, like how should we be thinking about some of the revenue growth in those two areas as well?

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

A

Well, if you think about the quarter, per se, it's certainly led not just by equipment. You see it on the services side as well. If you think about components, we do expect to continue to gain momentum there as you're coming from the trough. And we do expect that the number of freight cars shipped will be above 40,000. So that's a positive too. I think the other element, which is digital electronics, we expect a strong second half in terms of sales. And certainly, when you look at backlog dynamics, it's certainly reflected in both in terms of the digital electronics business and the component business, both with book-to-bill above 1.

Elijah Winski
Analyst, Citigroup Global Markets, Inc.

Q

Okay, great. That makes sense. Thanks, Rafael. And then, John, I appreciate the help on the cost and the margin. But I feel like there's been a lot of talk about just FX. And just maybe can you help us clarify what the specific impact of FX was in this quarter and how does it compare to last year? I just want to understand how that impacted...

John A. Olin
Chief Financial Officer & Executive Vice President, Westinghouse Air Brake Technologies Corp.

A

Certainly...

Elijah Winski
Analyst, Citigroup Global Markets, Inc.

Q

...each of the segments and then on the full business and then what that looks like year-over-year.

John A. Olin
Chief Financial Officer & Executive Vice President, Westinghouse Air Brake Technologies Corp.

A

Great. Good question. So let's start with what's driving it. The euro is driving it. The US dollar strengthened dramatically, as you know, against the euro. And if we look at the average euro a year ago, it was at $1.20. And in the second quarter that we just exited, it's at $1.07, so about 12% strengthening against the dollar.

What this does is translates into our revenue, which on a consolidated basis was down $76 million. And if you look at that in terms of a percentage of growth, that was 3.8 percentage points of growth that kind of went away because of currency. That was much more predominant when you look at our Transit business. It was $60 million that hit Transit and just shy of 9 percentage points decline in revenue due to it.

Now, as we move to the earnings impact, it's considerably less than the impact on revenue. And that's a result of the company's natural hedges and the way we're manufacturing and a lot of that being locally. Gross profit on the quarter was down $15 million due to unfavorable foreign currency exchange. And then operating income was only down $4 million.

Elijah Winski
Analyst, Citigroup Global Markets, Inc.

Q

Okay, got it. Thank you.

John A. Olin
Chief Financial Officer & Executive Vice President, Westinghouse Air Brake Technologies Corp.

A

Thank you.

Operator: Our next question will come from Matt Elkott with Cowen. Please go ahead.

Matthew Elkott
Analyst, Cowen and Company, LLC

Q

Good morning. Thank you. Would love to hear an update on the performance of the FLXdrive and any possible issues that still need to be worked out. Also, any update on the number and cadence of deliveries over the next few years would be appreciated. I know you guys had been taking orders from several railroads over the past year or so. So any insight into when deliveries might kick in over the next few years would be helpful.

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

A

So let me start with the second half of your question and I'll go down into the FLXdrive question. I think on the pipeline of deals, we really have relevant opportunities across key geographies at this point. I think volume dynamics continue to be a positive in Kazakhstan. We have a number of projects under discussion in Asia and Australia. We continue to follow up specific projects in Africa that are tied to commodity exports.

In Brazil, I think despite of the drop in carloads year-to-date, there's significant opportunities tied to renewal concessions. And mining is also a positive in that context. I think in North America, despite of carloads being down for the first half, we continue to see growing demand for modernization and new locomotives. And that's, again, driving efficiency and reliability with a direct impact to the operating ratio of our customers and bringing, certainly, enormous impact to their ESG targets as well.

So when we look at the cadence moving forward, I think we certainly feel like we're very well positioned to deliver five-year guidance that we provided at our Investor Day. We certainly feel stronger about it now than we did three months ago and than we did six months ago. And that's very much aligned to, I think, the pipeline of opportunities we've started to describe over a year ago. On the FLXdrive...

Matthew Elkott
Analyst, Cowen and Company, LLC

Q

All right.

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

A

...the comment there is we continue to see interests from customers out there. We're continuing discussions and you're going to see that moving through all other geographies. And I think that's very much aligned how we see the evolution here. And you're going to see also permutations of that product going to not just full battery-electric but also hybrid as we've also described on previous calls.

Matthew Elkott
Analyst, Cowen and Company, LLC

Q

Got it. And then just anything – is everything going as expected as far as the testing and the performance of the FLXdrive, Rafael?

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

A

Yes, it is. We're certainly paying a lot of attention and working very closely not just with our customers but also with suppliers in that context and making sure that we continue to progress with all the elements of that and special with regards to the battery. And as you know, we have a partnership here established with GM. And we're working very closely with them in order to make sure we continue to progress in that direction.

Matthew Elkott
Analyst, Cowen and Company, LLC

Q

Got it. Just one quick follow-up. Rafael, you mentioned mining. We've seen some slight guidance reductions on CapEx from some of the miners this earnings season. Nothing big. I guess end market demand continues to be solid. But given the slight CapEx reductions and the lower commodity prices, are you guys concerned about the mining segment beyond this year? I know your outlook for this year is positive, but what about 2023?

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

A

I think that can certainly be an element of, I'm just going to call, the cycle moving forward. We are working very closely with customers and with Komatsu in that regard. We see solid opportunities ahead. And we'll continue to make sure we're balancing that with other levers in the business. I think there's a lot of positive news here in terms of what we could be seeing in terms of opportunities for the rail side. So solid, no concerns for the year. We'll continue to work closely here with customers to understand demand into 2023 and beyond.

Matthew Elkott
Analyst, Cowen and Company, LLC

Q

Great. Thank you very much.

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

A

Thank you.

Operator: Our next question will come from Scott Group with Wolfe Research. Please go ahead.

Ivan Yi
Analyst, Wolfe Research LLC

Q

Yes. Good morning. This is Ivan Yi on for Scott.

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

A

Good morning.

Ivan Yi
Analyst, Wolfe Research LLC

Q

Good morning. First, can you discuss the rough margin percentages on these locomotive modernizations? And how does that compare relative to margins on new locomotives?

John A. Olin
Chief Financial Officer & Executive Vice President, Westinghouse Air Brake Technologies Corp.

A

Yeah, Ivan. We don't provide specific margins, obviously. But when we look at mods versus new, the way to think about it is that certainly the revenue is somewhat lower on a mod than a new. However, the margin is somewhat higher on a mod than a new.

Ivan Yi
Analyst, Wolfe Research LLC

Q

Great. That's helpful. And secondly, what has been the impact of poor rail service on the pace of loco unparkings? And also, have you started having any initial conversations with the rails about buying any new locomotives? Thank you.

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

A

Thanks. Of course, I think services, as you look at least into the past several months, have translated into unparking of locomotives. As you look forward, it's going to be balanced with carloads being a bit more positive here in the second half of the year. So I think that's part of the balance.

When you think about investment on new locomotives, it's part of the construct and the dialogue that we have with North American customers. You see that as part of the announcement of some purchases of Tier 4 units this past quarter. And this is very much part of the dialogue. It's going to depend some of the solutions in order to solve for some of the productivity and efficiency, while we are convinced that there is an opportunity here to invest and drive both reliability and efficiencies from the existing fleet very much aligned with the opportunity here to improve operating ratios and also aligned to driving, I think, significant elements of the decarbonization targets that were laid out there.

Ivan Yi Q
Analyst, Wolfe Research LLC

Thank you.

Rafael O. Santana A
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

Thank you.

Operator: Our next question will come from Rob Wertheimer with Melius Research. Please go ahead.

Rob Wertheimer Q
Analyst, Melius Research LLC

Thank you. Good morning, everybody.

John A. Olin A
Chief Financial Officer & Executive Vice President, Westinghouse Air Brake Technologies Corp.

Good morning, Rob.

Rob Wertheimer Q
Analyst, Melius Research LLC

My question is a little bit on the bigger picture on inflation margin. You guys have had really solid margin performance perhaps without as much at least backward-looking cycle and revenue support as some other end markets.

I'm curious if – when you look at your supply chain and you look at your costs, is there any wave of inflation coming that you have not yet dealt with? Maybe you could just give sort of a general outlook on how the inflationary cost pressures in your supply chain, in your backlog, in your outlook compare with your forward-looking ability to price. Thank you.

John A. Olin A
Chief Financial Officer & Executive Vice President, Westinghouse Air Brake Technologies Corp.

Okay, Rob. The inflation that you're referring to came in an initial wave of higher costs in the third quarter of last year. And it takes a while for that to roll through our inventory. And we saw our costs build and rise in the third, fourth and first quarter of this year. And we did have and see another cost shock at a much smaller level than what we saw in the third quarter and that was due to the war in Ukraine. So as some of that rolls through, we would expect costs to rise a little bit through the first cost shock.

Now having said that, we are seeing some tempering of costs out there. Metals had a good quarter. They're down but they're still at historic highs and up on a year-over-year basis, but tempering. We feel good about that. In terms of the logistics costs, we are continuing to see very high cost of transportation and logistics, in particular, in containers coming from Asia. But they've tempered slightly as well. So all this is going to take time to get through our P&L. But we would expect costs in the third quarter to be up a bit from what we're seeing here in the second quarter.

Rafael O. Santana A
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

I'll just close saying that we're committed to grow margins forward. We could and will have significant variations sometimes quarter-to-quarter. I think this is especially given the mix with much higher growth in equipment. There's also the elements of what John spoke about in terms of inflation.

Specific for the second half of the year, I just want to emphasize here how big the mix impact is. And specific in the third quarter, if you think about it, we have over a third of our shipments of new locomotives happening in the third quarter. So I couldn't highlight enough some of the elements of mix and variation that we can see from that quarter-over-quarter.

Rob Wertheimer Q
Analyst, Melius Research LLC

Okay. Thank you.

Rafael O. Santana A
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

Thanks.

John A. Olin A
Chief Financial Officer & Executive Vice President, Westinghouse Air Brake Technologies Corp.

Thanks, Rob.

Operator: Our next question will come from Saree Boroditsky with Jefferies. Please go ahead.

Saree Boroditsky Q
Analyst, Jefferies LLC

Hi. Good morning. Just building on your last comment. You talked about a third of the locomotive shipments happen in the third quarter. Could you quantify how much of the mix headwind you expect on margins just from these locomotive shipments?

John A. Olin A
Chief Financial Officer & Executive Vice President, Westinghouse Air Brake Technologies Corp.

No, we can't quantify that, Saree. Just the overall concept that, while we have strong margins in our equipment business, [ph] but (00:43:21) lower than the average. And as Rafael had mentioned, we'll have a significant revenue growth driven by that and that will pull down the margin. It's something that we planned on all year long and we are expecting. And again, that's why we've talked about, in the back half, that our margins on a year-over-year basis will be lower than year ago. But on a full year basis, our margins will be up modestly as we've discussed.

Rafael O. Santana A
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

I'll just reemphasize that for the year, we expect results very much aligned to the guidance we provided in February this year and how we described on previous earnings calls. So it's all about higher margins in the first half of the year, higher volume in the second half with a significant element of mix coming in.

Saree Boroditsky
Analyst, Jefferies LLC

Q

Got it. And then you previously talked, I think, about the opportunity for 500 mods per year. Just given the recent orders, how are you executing on this opportunity? And are these orders incremental to this or just in line with your outlook?

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

A

We have not provided any specific guidance with regards to total number of mods. So we certainly see opportunity to continue to expand on that. And I think we've been clear about that on previous calls. So the opportunity is there. It's certainly reflected in the pipeline and you're seeing that being realized as backlog continues to grow.

Saree Boroditsky
Analyst, Jefferies LLC

Q

Great. Thanks for taking my questions.

Operator: Our next question will come from Nathan Ho with Bank of America. Please go ahead.

Nathan Ho
Analyst, Bank of America Merrill Lynch

Q

Good morning, team.

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

A

Good morning.

Nathan Ho
Analyst, Bank of America Merrill Lynch

Q

Thanks again for taking the time [indiscernible] (00:45:02). Just a quick question on the cyber attack and sort of the 3Q impact on operations. Would you mind maybe giving a little bit more detail on how this affected both quarterly operations as well as, say, margins? Thanks.

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

A

Okay. Just in terms of the second quarter, I think John said it. It was about 5% in the third quarter. We expect...

John A. Olin
Chief Financial Officer & Executive Vice President, Westinghouse Air Brake Technologies Corp.

A

5% in Transit.

Rafael O. Santana A
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

5% in Transit in specific. We expect that to be less in the third quarter. We don't expect impact for the year and that's part of why we've reaffirmed guidance at this point.

Nathan Ho Q
Analyst, Bank of America Merrill Lynch

Got you. Thank you so much. And then also just, John, on your comments regarding supply chain challenges. We've seen some incremental debottlenecking for the auto sector. For your digital electronics, are you witnessing anything similar there? Is there sort of signs of incremental improvement?

John A. Olin A
Chief Financial Officer & Executive Vice President, Westinghouse Air Brake Technologies Corp.

Nathan, as we look from first quarter to second quarter, we don't see any improvement. The good news is I don't feel it's getting worse. The unfortunate news is we don't feel it's getting better as well. And again, as Rafael had mentioned earlier, that's certainly a big impact on our first half revenues with digital. But chips are hard to come by. We're not seeing a change from the first quarter and we're hopeful as we move forward.

Rafael O. Santana A
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

Just a couple of comments on the digital. Orders grew double digits last year. Book-to-bill for this year is very positive. It's the highest between our businesses year-to-date. There's a number of multiyear agreement. We expect the second half – strong sales second half in the year. And with that, as John mentioned, chip shortages have had an impact for the business.

Nathan Ho Q
Analyst, Bank of America Merrill Lynch

Got it. Thanks [ph] for the insights. (00:47:01)

Rafael O. Santana A
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

Thank you.

Operator: Our next question will come from Jerry Revich with Goldman Sachs. Please go ahead.

Jerry Revich Q
Analyst, Goldman Sachs & Co. LLC

Good morning, everyone.

Rafael O. Santana A
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

Good morning, Jerry.

Jerry Revich Q
Analyst, Goldman Sachs & Co. LLC

I'm wondering if you folks can talk about your capacity for mods, how quickly you can ramp up considering the size of the Union Pacific order compared to your production to date. An update on how you're thinking about capacity for that line of business would be helpful. And also, Rafael, if you could comment on your assessment of using mods to reach essentially the greenhouse gas reduction targets for other rails. How optimistic are you on others taking a similar approach?

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

A

Yeah. Jerry, first, in terms of the manufacturing footprint to deliver on these orders and more, we certainly feel strong about having that capacity. And we certainly have the manufacturing capacity to do that. But it's about more than that. It's making sure that we're continuing to work very closely with our customers, suppliers in that process so we can ultimately anticipate demand. Certainly, lead times, when you look at a couple of years ago, have extended. And I think a big piece has been really making sure that we're close to customers so we could anticipate demand. And you see, to some extent, some of that certainly has impacted our inventory numbers as part of that. But that's a piece of it.

When it comes to mods, I think that continues to be a very positive story. And it's really part of a dialogue that varies customer by customer in terms of the solutions. I think we see some significant opportunities for customers to actually be working on being more productive. That, in some cases, means reducing the number of locomotives that pull a certain number of cars. And that has translated into also applying some of the fuel solutions that we've described. And we see opportunity to continue to expand on that.

I think what's important here is we see that part of really a growing multiyear backlog. This is, I think, less about what 2023 is going to be. It's back to the comment I made, which is really tied to the five-year plan that we described. And we feel like we're very well positioned to deliver on that five-year guidance that we provided at our Investor Day last March despite of all the macroeconomic uncertainties out there.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

And speaking of the uncertainties, you folks pointed out the Russia headwind. And looking at your Freight results in the quarter, it's tough to pinpoint which lines of business the Russia headwind played out in. Obviously, organic growth would have been stronger without it. Can you talk about which lines of business the exit impacted the most in the quarter within Freight?

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

A

Certainly, Freight, probably a combination of equipment and services. That's where we really saw the bulk of that impact.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

And Rafael, was the full 5 points that you anticipated at Investor Day on a consolidated basis?

John A. Olin
Chief Financial Officer & Executive Vice President, Westinghouse Air Brake Technologies Corp.

A

Jerry, that would be 2%. So the revenues that we had in 2021 were about 2% of our sales.

Jerry Revich Q
Analyst, Goldman Sachs & Co. LLC

Yeah. Super...

Rafael O. Santana A
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

And for the year, as we've described, it's 5%. We can have variation again quarter-to-quarter, but that's about the magnitude of what we expected for the year.

Jerry Revich Q
Analyst, Goldman Sachs & Co. LLC

Thank you.

Operator: Our next question will come from Dillon Cumming with Morgan Stanley. Please go ahead.

Dillon G. Cumming Q
Analyst, Morgan Stanley & Co. LLC

Great. Good morning. Thanks for the question.

Rafael O. Santana A
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

Good morning.

Dillon G. Cumming Q
Analyst, Morgan Stanley & Co. LLC

Just wanted to go back, Rafael, to one of your comments on the parked loco count. I think we understand why that's kind of moving lower through the year. It's reflective of the service issues at the Class 1 level. I guess from our perceptive, it seems like more of the Class 1s are shifting their tone around potential parkings in the back half.

So I guess my question is – in your view, if freight traffic does start to more fundamentally weaken next year, not reflective of the service issues but more reflective of actual declines in rail demand; is your view that the Class 1s actually can park more fleet? Or would you say the service issues are more supportive of kind of a structurally higher active fleet?

Rafael O. Santana A
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.

I think the element of parkings is not just going to be a function of service improvement but also what carloads do in that period. So I think that's something that we'll continue to watch and work very closely as part of that. And I think what's a positive? I think it's a lot of the underlying investment that you see in terms of really guaranteeing fleet reliability, ultimately driving efficiency across the fleets. And I think we continue to see momentum there. So if that comes counterbalanced with any elements of potential parkings, I think that's a story we still see and we'll be working closely with our customers in that regard.

Dillon G. Cumming Q
Analyst, Morgan Stanley & Co. LLC

Okay. That's helpful. Thank you. And then maybe just a question on the back half margin related issues or headwinds as it relates to international deliveries. I guess I was wondering. Longer term, do you have scope to structurally improve the margin profile of those international deliveries? Because I think given your commentary on the pipeline, it feels like volume should be accelerating next year and into 2024 as well. So just curious if this is more of a recurring issue or if you feel like you can actually start getting a better level of incremental margin on those international deliveries going forward.

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.
A

So that's actually a positive. And it's something that we've been able to is to ultimately drive as-delivered margins better than as-sold margins, something that we track very closely in the business. So there's certainly continued opportunity there. And I think the other piece is making sure that we're continuing to expand on growth on some of these markets where we've really had really I'll call the best-in-class products to work with customers. And we see some good momentum there.

Dillon G. Cumming
Analyst, Morgan Stanley & Co. LLC
Q

Okay, great. Thank you.

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.
A

Thanks.

Operator: This concludes our question-and-answer session. I would like to turn the conference back over to Kristine Kubacki for any closing remarks.

Kristine Kubacki
Vice President-Investor Relations, Westinghouse Air Brake Technologies Corp.

Thank you, operator. And I'd like to thank everybody for their participation today. And we look forward to speaking with you next quarter. Goodbye.

Operator: The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.