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Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Hello, and welcome to the Wabtec's Third Quarter 2022 Earnings Conference Call. All participants will be in listen-only mode. [Operator instructions] After today's presentation, there will an opportunity to ask questions. [Operator instructions] Please note, today's event is being recorded.

I'd now like to turn the conference over to your host today, Kristine Kubacki, Vice President of Investor Relations. Ms. Kubacki, 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 Third 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 to 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 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 tables 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 third quarter and progress on our long-term value framework. John will then cover the financials. We delivered a strong third quarter, which is evidenced by strong sales growth and an increase in adjusted earnings per share.

We achieved this despite significant headwinds, including the loss of business in Russia, supply chain disruptions and negative FX. Sales were roughly $2 billion, which was up 9% versus prior year. Revenue was driven by strong performance across the freight segment, but partially offset by unfavorable FX.

Total cash flow from operations was $204 million, which brings year-to-date cash flow to $628 million. Overall, our financial position remains strong. We continue to invest for future growth, reduce leverage and return cash to shareholders.

Total multiyear backlog was $22.6 billion, up $767 million year-over-year. And excluding the headwinds from foreign exchange, backlog was up $1.5 billion or up 7% from last year. We continued our progress against our long-term strategies as evidenced by continued expansion in the total backlog versus last year.

Overall, we had a strong quarter, which was very much in line with our plan for the year. 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 near-term uncertainty and volatility in the global 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 trade businesses, we are encouraged by underlying business momentum and strong pipeline of opportunities.

North America carloads were up slightly in the quarter after being down for the four previous quarters, and locomotive parkings are down from the same time last year despite lower year-to-date freight traffic.

We continue to see significant opportunities in demand for new locomotives and modernizations as our customers invest in their aging fleets and place a greater focus on reliability, productivity and fuel efficiency.

When it comes to the North America railcar built, demand for railcars is increasing from what we believe were trough levels in 2021. Railcars and storage are below pre-COVID levels with about 17% 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 about 40,000 cars to be delivered. Overall, we believe we have an opportunity to continue building significant long-term momentum with growth in modernizations, in new locomotive sales, in railcar builds, and in rolling stock.

Internationally, trade activity also continues to show positive signs. We have been growing our international fleet in the mid-single digits on average over the last five years, and we continue to execute on a strong pipeline of order opportunities. This strength is reflected in this quarter's equipment sales growth of 32%.

Finally, transitioning to the transit sector, the long-term secular drivers are positive as the industry continues to trend towards clean, safe and efficient transportation solutions.

Next, let's turn to slide 6 to discuss a few recent business highlights. During the quarter, we signed a strategic $600 million MOU with KTZ, the national railway company in Kazakhstan. This agreement will bring state-of-the-art technologies to both their yards and mainline operations that will significantly reduce greenhouse gas emissions and operating costs. This historic framework includes 150 FLXdrive battery electric shunters, along with kits to convert the traditional diesel locomotives to LNG. We will also collaborate on digital solutions for the fleet, beginning with Trip Optimizer.

We also recently signed two key deals in Australia to deliver additional locomotive kits. These locomotives will be built in Australia and sold to various Eastern Australian railroad customers. We also closed an order for new locomotives in Africa during the quarter.

Finally, in Transit, we secured a key order to supply platform doors for Panama's monorail station, which marks Wabtec's first transit project in Central America. We also signed a strategic five-year services contract with Akiem, a leading European rolling stock leasing company, which provides the critical maintenance for hundreds of locomotives in France and in Germany.

Turning to slide 7, before turning it over to John, I want to briefly discuss our ability to deliver predictable earnings through the economic cycle. During our Investor Day earlier this year, we talked about our track record of managing through challenging markets and significant disruptions. As a company, we are uniquely positioned to deliver resilient and predictable earnings given our favorable end markets, a robust backlog, a high level of recurring revenues and disciplined execution, all of which drives profitable growth and value for our shareholders.

We believe our favorable end markets, combined with our leading technologies and solutions, will enable us to remain resilient during times of increased volatility. In Freight, the demand continues to accelerate the need to grow and refresh our expansive global installed base, accelerate the adoption of next-gen technologies, and expand our international footprint. In Transit, the investment in green infrastructure continues with structurally high energy prices and climate change making the need more urgent.

Our multiyear backlog of over $22 billion provides significant visibility and support for long-term growth. The backlog has consistently grown over the past two years despite the challenging economic backdrop. In addition, we have a strong level of recurring revenues, which is over shared in its profit contributions of approximately 60%.

And finally, we have consistently demonstrated our ability to execute our strategies and deliver growth. Our track record of strong operating margin expansion across the business is evidence of our ability to realize price, deliver productivity and aggressively manage costs. Our execution, combined with the strength of our business, leading products and technologies, result in Wabtec being resilient through economic cycles, delivering predictable earnings and superior shareholder returns.

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 good morning. Turning to slide 8, I will review our third quarter results in more detail. We had another good quarter of operational and financial performance despite continued challenges in foreign currency exchange, supply chain disruptions and still elevated input costs.

Sales for the third quarter were $2.08 billion, which reflects a 9.1% increase versus the prior year. Freight segment sales were very strong, up 18.2%, partially offset by lower year-over-year sales in our transit segment. Q3 Sales were negatively impacted by unfavorable currency exchange, which reduced our revenue growth in the quarter by 5.2 percentage points.

For the quarter, adjusted operating income was $343 million, which was up 5.5% versus the prior year. Adjusted operating margin in Q3 was 16.4%, down 0.6 percentage points. While we expected our margin to be down in the quarter behind unfavorable mix, margins came in modestly higher than we had expected. We now anticipate Q4 operating margins to be slightly lower than our Q3 operating margins.

In the third quarter, adjusted earnings per diluted share were $1.22, up 7% versus the prior year. GAAP earnings per diluted share were $0.88, which was up 27.5% versus the third quarter a year ago. During the quarter, we had pre-tax charges of $9 million for restructuring and other onetime charges, largely related to our Integration 2.0 initiative to further integrate Wabtec operations and to drive $75 million to $90 million of run rate savings by 2025.

We are pleased with our Q3 results, especially in the face of significant foreign currency exchange headwinds, continued supply disruptions and strong mix headwinds, which were expected in the quarter. We remain diligent and proactive as we focus on execution and work to minimize these challenges.

Turning to slide 9, let's review our product lines in more detail. Third quarter consolidated sales were strong, up 9.1%. Excluding foreign currency exchange, sales were up 14.3%. Equipment sales were up a strong 32.2% from last year due to higher locomotive deliveries this quarter versus last year.

Component sales were up 4.5% year-over-year, largely driven by the higher OE railcar build. Digital electronics sales were up 20.6%, which was driven by a robust demand for onboard locomotive products and software upgrades, along with revenue contribution from the strategic bolt-on acquisitions of Beena Vision and ARINC last quarter.

We are particularly pleased with our organic growth in Q3, as it was delivered in the face of continuing chip shortages. Our services sales grew at 14.8% versus last year. The year-over-year increase was driven by higher sales from a larger active fleet versus last year and increased MOD deliveries.

The superior performance, reliability and availability of our fleet, continues to drive increased customer demand for our services and solutions, as railroads increasingly seek predictable outcomes across their fleets.

Across our transit segment, sales decreased 10.1% versus prior year to $550 million. Sales were down versus last year due to the negative impacts of foreign currency exchange. Absent the impact of foreign currency, transit sales would have been up 2.6%. We believe the medium and long-term outlook for this segment remains positive as megatrends, such as urbanization and decarbonization, drive increased investments in green infrastructure.

Now, moving to slide 10, our adjusted gross margin declined, as expected, by 1.4 percentage points to 31.4%. Gross profit margin was lower driven by unfavorable mix, adverse foreign currency exchange and higher input costs, partially offset by increased pricing and strong productivity. Pricing positively impacted our margins.

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 increased costs. Mix was unfavorable in the quarter as we significantly increased our sales of locomotives at a lower margin than the average.

Raw material costs were up again year-over-year, led by dramatically higher energy costs and increased metal costs. Foreign currency exchange adversely impacted revenues by 5.2 percentage points and adversely impacted third quarter gross profits by $20 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 driving operational productivity and lean initiatives.

Turning to slide 11, for the third quarter, adjusted operating margin declined 0.6 percentage points versus last year. As expected, our margins were lower due to mix and increased investment in future technologies, but were partially offset by lower adjusted SG&A as a percent of sales.

Adjusted SG&A was $256 million, which was largely flat versus prior year, but down 1.2 percentage points as a percent of sales to 12.3%. 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 the industry leader in decarbonization and digital technologies that improve our customers' productivity, capacity utilization and safety.

Now, let's take a look at the segment sales results on slide 12, starting with the freight segment. As I already discussed, freight segment sales were strong for the quarter and segment adjusted operating income was $307 million for an adjusted margin of 19.9%, down 0.7 percentage points versus the prior year.

The benefits of higher sales and improved productivity were offset by unfavorable mix and higher engineering investment. Finally, segment backlog was $19.17 billion, up $961 million or 5.3% from the end of Q3 last year. On a constant currency basis, segment backlog was up $1.26 billion from last year.

Now, turning to slide 13, transit segment sales were down 10.1%, driven by the negative effects of foreign currency exchange and the cyber incident that occurred late in the second quarter. Unfavorable foreign currency exchange impacted segment sales by 12.7 percentage points and we estimate an additional 5 percentage points due to the cyber incident.

Adjusted segment operating income decreased by $17 million to $60 million, which resulted in an adjusted operating margin of 11.0%, down 1.5 percentage points versus the prior year. We estimate that the temporary labor inefficiencies driven by the cyber incident was roughly $8 million during the quarter.

Excluding these temporary inefficiencies, adjusted operating margin would have been largely flat to prior year. We do not expect an adverse impact to our transit sales or earnings due to the cyber incident in the fourth quarter. 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 $3.44 billion, down 5.4% versus a year ago. However, on a constant currency basis, backlog would have been up 7.2%.

Now, let's turn to our financial position on slide 14. During the quarter, we generated $204 million of operating cash flow, resulting in a cash conversion rate of 72%. This brings our year-to-date operating cash flow to $628 million. Cash flow benefited from higher earnings, but was impacted by the proactive build of inventories ahead of our strong second half growth expectations and managing supply disruption of critical parts.

Our adjusted net leverage ratio at the end of the third quarter declined to 2.3 times and our liquidity is robust at $2.14 billion. During the quarter, we amended and extended our existing credit facility, increasing liquidity by $300 million and extended the facility through 2027. In addition, we established an 18-month delayed draw term loan for $250 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 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. We continue to feel strong about our portfolio of businesses and we have delivered against our regional plan financials despite the loss of business in Russia, high input costs, ongoing supply chain disruptions, unfavorable FX and a cyber incident.

We are adjusting our sales range to $8.15 billion to $8.35 billion, which reflects the expected impact from unfavorable FX in the second half. We're also narrowing our adjusted earnings per share range to $4.75 to $4.95, while keeping our full year cash conversion guidance of greater than 90%.

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 Wabtec is well positioned for long-term profitable growth.

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

With that, I want to thank you for your time this morning. And I'll turn the call 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 you 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: Thank you. [Operator Instructions] And our first question today comes from Justin Long with Stephens.

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

John, I wanted to start with the comment you made about fourth quarter operating margin stepping down from the third quarter slightly. I would think with mix supposed to improve, I believe, MOD should be up. The cybersecurity incident seems like it's behind us. I would think that margins should be getting better sequentially.

So, can you just help us understand what might be offsetting some of those tailwinds I mentioned sequentially? And then, I know you're not giving guidance on 2023 today, but any directional thoughts on margins next year versus this exit rate in 2022?

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

A

Thanks, Justin. Nothing has really changed since we've come out on the year. The back half is going to be lower than prior year and, certainly, the first half, largely driven by mix. And Justin, to zero in on the fourth quarter, we do expect mix to still be the largest driver of the lower margin.

What we said last quarter, though, was that we expected the third quarter to be the lowest margin of the year. And the reason – I'm sorry, and given where we ended up at 16.4%, that came in exceeding our expectations. And really what that does, Justin, is just pushes the fourth quarter down to be slightly lower than the third quarter.

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

A

Justin, I'll add a couple of things there. Just keeping in mind, we have over 60% of the new locomotives being shipped in the second half of the year. So with that, we've got some givens and takes between third and fourth quarter. I think most important is we expect margin expansion in 2022. And most importantly, our teams are executing well and we're in a strong position to continue margin expansion into 2023 and beyond.

Justin Long
Analyst, Stephens, Inc.

Q

Okay. Great. That's helpful. And thinking about next year, there's a little bit more concern around rail volumes and where we shake out. If we're in an environment where rail volumes are down low-single digits, maybe even mid-single digits, is that still an environment where you feel like you can grow Freight segment revenue, given your backlog for MODs and international locomotives and digital?

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

A

Yes. It's early, certainly, to provide guidance in 2023, but we continue to see strong demand across the business. When we think about the pipeline of deals, we have relevant opportunities across geographies. We have progressed with the pipeline of opportunities, both in North America and internationally. We expect to finish the year with book-to-bill, Justin, above 1 for all the businesses, as we did in 2021. I'd say we're very much on track to finish 2022 with double-digit increase on orders versus prior year despite of FX. And that just provides us strong coverage for 2023 and beyond.

If I was to expand a little bit on what we're seeing across various geographies, you certainly saw some of the wins we had in Australia and Africa. Volume dynamics continue to be positive in Kazakhstan. We have a number of projects under discussion in Asia. Even mining demand continues to hold with [ph] our digital point (00:25:16) services actually growing faster than equipment as we go into 2023.

In North America, I think despite of the carloads being down year-to-date, we continue to see demand for both MODs and new locomotives, so a number of discussions going to that, and certainly a significant opportunity for some of the Class 1s to further improve operating ratio and to also bring significant impact to their ESG targets. So, Transit, I think infrastructure spending continues to be a positive for us. And I think, all in all, going to 2023, we're well positioned from a backlog coverage and I had – from a backlog coverage from what we had a year ago.

Justin Long
Analyst, Stephens, Inc.

Q

Got it. Thanks for the time.

Operator: Thank you. And the next question comes from Jerry Revich with Goldman Sachs.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yes. Hi. Good morning, everyone.

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

A

Hi, Jerry.

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

A

Good morning, Jerry.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Hi. I'm wondering if you can talk about the pricing cadence that you folks have seen in the Freight segment over the course of the year, really strong organic growth in the quarter. What proportion of that is pricing? And what we're seeing from other industrials is actually pricing accelerating into early 2023. I'm wondering if you can comment on whether that cadence applies for your business as well, please.

John A. Olin A

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

Yeah, Jerry, I think the year is unfolding very much the way we expected with regards to the costs that we're seeing, and they are continuing to rise, and we saw them rise quite a bit from the second quarter into the third quarter. In addition, we are seeing our pricing rise. We've talked about, as we exited the second quarter, we were at price/cost equilibrium at that point. We continue to remain there. But to your point, Jerry, we did see a large jump in the pricing recovery that we got during the quarter as well as the higher costs that we – and matched up well with the higher costs that we realized.

Rafael O. Santana A

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

Jerry, I'd say, in the near term, we expect inflation to persist. And as an organization, we'll remain diligent on both cost management and on pricing.

Jerry Revich Q

Analyst, Goldman Sachs & Co. LLC

And as you look forward to, hopefully, the supply chain loosening at some point over the next 12 to 18 months, how should we think about the efficiency gains in that environment? Should we think of the company getting to keep that spread as we have less rework, less waiting for parts, et cetera? Do we keep that as a margin at some point using the lower cost structure that you folks have established to improve margins versus the pre-supply chain environment? Is that an opportunity?

John A. Olin A

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

Jerry, we would expect the same thing as we saw going up as coming down. Hopefully, the cost will come down. We're seeing a lot of mixed signals. Some are moving in the lower direction and others are actually still rising. But if they do come down, they'll be very similar in the fact that, remember that about 60% of our revenue is tied up in long-term contracts that have price escalators. So, they will adjust as we see those prices adjust. And the additional 40%, if costs are going up, we'll go out and get more pricing. And as they come down, we may see a little bit of a benefit there.

Jerry Revich Q

Analyst, Goldman Sachs & Co. LLC

Yeah. Super. Thanks.

John A. Olin A

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

Thank you.

Operator: Thank you. And the next comes from Matt Elkott with Cowen.

Matthew Elkott Q

Analyst, Cowen and Company, LLC

Good morning. Thank you. Rafael, I think before the GE acquisition, you guys did two to three bolt-on acquisitions per year. Do you think you'll ease back into that base next year or the year after? And any update on the acquisition opportunities would be helpful.

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

Well, we're continuing to explore bolt-on acquisitions. I think we're going to be, again, opportunistic here. They all need to be strategic with stronger returns and helping us drive ROIC higher and driving faster, but also we're continuing to evaluate opportunities there. We think there's opportunities for prices to still come down on those. And with that, I mean, we're committed to, ultimately, just really apply cash towards higher returns to shareholders. So, share repurchase will also be something we're looking at.

Matthew Elkott Q
Analyst, Cowen and Company, LLC

Got it. And then, just my second question is, you're on pace for 2022 revenue. That's about 37% of the year-end backlog at the end of 2021. I know that's not necessarily a perfect metric to gauge future revenues. But is there any reason why that percentage should be vastly different next year?

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

Well, as I have mentioned before, I think going to 2023, we're well positioned from backlog coverage, certainly ahead of what we were a year ago, I think even the underlying performance of the business. We're really very well positioned to deliver on the five-year guidance that we provided during the Investor Day last March. So, this is less then just about 2023. It's really making sure we're progressing towards the guidance we provided during Investor Day.

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

Our 12-month backlog adjusted for currency is up approximately 15% at this point in the year versus prior year.

Matthew Elkott Q
Analyst, Cowen and Company, LLC

Got it. Thanks, Rafael. Thanks John.

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

Thank you.

Operator: Thank you. And the next question comes from Scott Group with Wolfe Research.

Scott H. Group Q
Analyst, Wolfe Research LLC

Hey. Thanks. Good morning, guys.

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

Hey, Scott.

Scott H. Group
Analyst, Wolfe Research LLC
Q

Wanted to ask, the one-year freight backlog was down about 5% from last quarter. I don't know if there is any FX impact there, but any color. And then, you talked about mix as a headwind for Q4, any early thoughts about mix as a headwind or tailwind for next year?

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

Scott, with regards to the backlog, we certainly saw it come down sequentially by 4.7%. However, on a year-to-date basis, we're up 9.8% prior to currency. And when you adjust for currency, we're seeing it up about 15%. And again, we've talked about backlog, sometimes they can be a little bit lumpy. So, sequentially, we're down a little bit, but I think the right way to look at it is over time. And we certainly feel very good about the fact that, ex currency, we're up 15% for the 12-month backlog. The second question was with regards to...?

Scott H. Group
Analyst, Wolfe Research LLC
Q

This mix, you talked about as a headwind in Q4, just if you have any thoughts on next year.

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

I think that overall, Scott, over the next several years, mix is going to be a headwind, right? And this is what we had talked about at Investor Day, as we look to the railroads are starting to renew their fleets and we saw some of that activity this year with the UP and CN as well as the NS MODs deals, that we're going to face some lower headwind – or mix headwinds over the next several years.

But having said that, we've got a lot of growth and a lot of fixed costs to absorb, and we would expect to see our margins grow by 250 to 300 basis points over the next five years. So call it an average of about 0.5% over that period of time. That's inclusive of mix headwinds.

Scott H. Group
Analyst, Wolfe Research LLC
Q

Okay. And then, just last thing, is there anything in this IRA bill that benefits you guys for next year?

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

The IRA bill?

Scott H. Group
Analyst, Wolfe Research LLC
Q

The Inflation Reduction Act, anything in there that could help you guys next year – starting next year.

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

A

No. No, there's not, Scott. With regards to the Inflation Reduction Act, there's a couple of things. One is there's a tax on, I'm sure, repurchases that everyone is aware of. Secondly, there is a minimum tax that could have an impact on our cash next year. At this point, we don't know enough because not enough of the regulations are out, but they should be out in the first half, and we'll know a little bit more of the overall impact to the company then.

Scott H. Group
Analyst, Wolfe Research LLC

Q

I was thinking like maybe along like the lines of the investment in battery or hydrogen that you guys are doing, if there's something that could help...

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

A

We're seeing some specific opportunities really tied to the railroads and some of the operators there, Scott, and we're following up with those opportunities as we work along. I mean my only comments would be just in battery electric overall, I think the interest continues to be strong on that portfolio that we continue to build. Certainly saw that with the order or the MOU we've signed with Kazakhstan and the level of interest continues across various geographies. So to your point, we could see some benefit coming from some specific projects, customers we'll look at driving in North America.

Scott H. Group
Analyst, Wolfe Research LLC

Q

Thank you, guys.

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

A

Thank you.

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

A

Thanks.

Operator: Thank you. And the next question comes from Allison Poliniak from Wells Fargo.

Allison Poliniak-Cusic
Analyst, Wells Fargo Securities LLC

Q

Hi, good morning.

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

A

Hi, Allison.

Allison Poliniak-Cusic
Analyst, Wells Fargo Securities LLC

Q

Can we just talk on transit a little bit? I know you talked about infrastructure funds benefiting. But as we think about flow-through over the next few years, does it become more impactful in 2023 or 2024? Or is it more even? Just trying to understand how I should think through that in our model.

Rafael O. Santana A

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

Let me start, Allison, on transit, just overall. I think if you think about really the underlying drivers for the business, still positive. If you look at the backlog coverage for the year, at the end of the third quarter, we were 5 points ahead of the same time last year. Our 12-month backlog cover – backlog, if you look at constant currency, it's up 16.5%. Our total backlog is up 7.2% on the same basis. And we'll finish 2022 with a book-to-bill above 1. So with that being said, I think we're continuing to take action to drive profitable growth in the business and we're continuing to see investment in that regard.

John A. Olin A

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

And Allison, when we look in the near term, we are certainly seeing some headwinds in our transit business, currency being the most notable. And again, when you look at the quarter with revenues being down 10.1%, you reverse out currency, you'd be up 2.6%. And then, again, we had the other headwind of the year, which is the cyber event that largely hit our transit group. That held back about 5% of revenue in the third quarter.

So, we'll be up over 7% in the underlying business, and that's the best we've been in numerous quarters. So, we feel good about that. And again, from a margin standpoint, while margins were down in the quarter, 1.5 points, that's explained again by the cyber incident. We had about $8 million of temporary variable labor inefficiencies. So, this is labor that was idled, more severely underutilized as we worked through the cyber incident. And with those, they're both behind us. And as we look forward, we would expect no impact from cyber moving forward.

Allison Poliniak-Cusic Q

Analyst, Wells Fargo Securities LLC

Great. Thanks. And then, just, I think I might have missed it, but the CapEx, there is a slight reduction there. Just anything notable driving the change in that number?

John A. Olin A

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

No. I think it's just the fact that the team is very focused on doing more with less. Kind of the overall lean principles that are being deployed throughout the company is – it's coming through in our capital budgets as well. So as you noted, from 2% of revenue estimate, we're down to 1.75%. And also, to note, that we didn't talk about in the prepared remarks, is our effective tax rate is down from an expectation of 26% to 25%.

Allison Poliniak-Cusic Q

Analyst, Wells Fargo Securities LLC

Great. Thank you.

Operator: Thank you. [Operator Instructions] And the next question comes from Chris Wetherbee with Citi.

Q

Hey. Good morning. This is [ph] Matt (00:37:52) on for Chris. We wanted to touch a little bit more on just broader demand topics. We were wondering what you guys are seeing in terms of the trends in 4Q and, more specifically, how the inflationary environment, supply chain dislocations have impacted ordering? And where do you see those trends moving forward? I know you touched a little bit on 4Q, but also if you could give any additional color on 2023, that would be fantastic as well? Thanks.

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

A

Let me start; I'll pass it on, then, to John. But with Transit, in specific, at this point, we're not seeing any operational disruptions with regards to cyber, as John described. In fact, when we think about fourth quarter, we would actually expect some level of both manufacturing production and revenue catch-up during the fourth quarter on that.

In terms of overall dynamics, we're continuing to see a strong pipeline of opportunities out there. I did mention here that strength really playing out across various geographies and, in many ways, across the business. It's all about really driving convertibility into that. We're certainly proud of what we've seen in the digital electronics business, which is one that – I mean, we're continuing to also see very positive dynamics year-to-date being one of the highest businesses from the book-to-bill perspective.

So, it's all about converting that pipeline of opportunities, and we are certainly in a stronger position to be driving profitable growth into 2023 than we were a year ago. And we feel certainly strong about five-year outlook we provided in the business during the Investor Day.

Q

Great Thanks, so much

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

A

Thank you.

Operator: Thank you. And the next question comes from Dillon Cumming with Morgan Stanley

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

Q

Great. Good morning. Thanks for the question. I just wanted to go back to the discussion on Freight margins for a second. I think there wasn't kind of as much margin dilution in the quarter as I would have expected, just given the step-up in loco deliveries. Can you just talk to if that was more of a function of maybe better-than-expected volume leverage on those deliveries, or if there was kind of a mix element to it? Because I know, John, you mentioned that you thought mix would be a kind of quarter-on-quarter headwind going into 4Q. I think, historically, you've had some like maintenance activity and after market activity the Class 1 levels pulled forward into 3Q. I'm not sure if that was kind of a driver in the quarter as well, but just wondering if you can kind of speak to those dynamics for the quarter.

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

A

Yeah. When we look at the Freight margin coming in a little bit higher than expected, I think there's two things to look at, Dillon. Number one is mix was a little bit less unfavorable. And then, secondly, the foreign currency exchange, right? That was actually a benefit to the margins during the quarter, and they came in a little bit more than we had expected in terms of the overall impact on our business. But again, it hurts profits, but helped out margins a little bit.

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

Q

Got it. Thanks, John. And then, maybe just my last one, in terms of the progression of locomotive on parking, just given that carload volumes kind of moved positive year-on-year in the quarter. I know last year was really a story of network disruption and network congestion kind of driving higher active fleets, but now that kind of carload trends seem to be stabilizing a bit, is the message from the Class 1's that they actually need more fleet to service more carloads? Or do they feel like fleets are relatively right-sized with the level of kind of volume growth that we've been seeing in 3Q, maybe into the end of the year?

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

A

I think it's early to describe what we'll see in 2023 from a volume perspective. But certainly, I think with some of the elements of what you described in both terms of network velocity improving and dwell time reducing, that could be a headwind, parkings. I think on the other side, I think we've got enough tailwinds to offset that with both demand for MODs and demand for services, overall. So that's, I think at the end of the day, a positive for us.

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

Q

Okay. Great. Thanks for the time.

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

A

Thank you.

Operator: Thank you. And the next question comes from Adam Roszkowski with Bank of America.

Adam Roszkowski
Analyst, BofA Securities, Inc.

Q

Hi. Adam on for Ken Hoexter. Thanks for taking my question. Maybe just to drill down on one of the last questions, I believe you mentioned about you expected a third of the locomotive deliveries in 2022 to happen in the third quarter. So, was that relatively in line? Maybe just give me a sense of that and where you expect in 4Q. And maybe also, if that was a part of the mix benefit in 3Q. Thanks.

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

A

So, my comment was with regards to the second half of the year. And I said over 60% of the new locomotive deliveries would have happened in the second half. With that, there is, again, some gives and takes between third quarter and fourth quarter. And as you would expect, we could see some variation here as we progress through that.

Adam Roszkowski
Analyst, BofA Securities, Inc.

Q

Got it. And then, maybe just clarify. So, velocity is improving, volumes improving and also dwell time coming down a little bit. So, net-net, as we think about 2023, should we be – still be thinking growth in the freight services business with the MODs built into that? And maybe just any thoughts on mix and margins as well. Thanks.

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

A

So yes, we do expect growth in the service business despite of the dynamics you just described there. And I think I'll go back to we continue to drive towards margin expansion. We feel we're in a strong position here to do so, as we look at the coverage we've got going to next year. So, that's a positive. We've got strong digital growth, as you see it in the numbers as well. And so, yes, we do expect margin expansion going through 2023 and beyond.

Adam Roszkowski
Analyst, BofA Securities, Inc.

Q

All right. Thank you.

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

A

Thank you.

Operator: Thank you. And the next question comes from Felix Boeschen with Raymond James.

Felix Boeschen
Analyst, Raymond James & Associates, Inc.

Q

Hey. Good morning, everybody.

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

A

Good morning.

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

A

Good morning.

Felix Boeschen
Analyst, Raymond James & Associates, Inc.

Q

Hey, John, I was hoping we could hone in on the cost side of things real quick. I think you mentioned you're at price/cost equilibrium in the quarter. Just want to understand if that was a comment inclusive of the higher energy costs. And if you have any more directional color around how operations are tracking in Europe in light of all of that?

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

A

Yes. The comment was inclusive of all of our costs – rising costs of goods sold basically. Yes, we're at price/cost equilibrium as we exit the third quarter. With regards to, I think, your question specifically on energy, we're managing the best we can. We've got a lot of alternative energy sources in our facilities in Europe, but costs are rising quite a bit.

We're certainly happy to see some of the cost controls coming out, but we're in the same boat as all of our competitors are, and probably from a locational standpoint, maybe a little bit better positioned in some of the countries that we're in. But we're managing through it the best we can.

Rafael O. Santana A

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

I'll just add, our teams continue to work through contingency plans. So, we're certainly looking at dual supplier sourcing and that's something they've been looking at, as we really prepare ourselves for an outcome that's still uncertain in a lot of ways. But we have invested on really moving some of our sites into lower energy intensity use and continue to invest on alternative energy storages there.

John A. Olin A

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

And also, the cost side of that is like any other rising costs, we will look to price to cover it and to manage our margins regardless of whether it's an energy spike or a metal spike or a labor spike. We're very focused on continuing to build those margins.

Felix Boeschen Q

Analyst, Raymond James & Associates, Inc.

Okay. That's super helpful. And then, just secondly for me, I think Nordco has been in the model for just over a year at this point. And I'm just curious if you can maybe touch on how Nordco is performing against the original estimates, maybe both from a top line and a synergy perspective, if that's possible?

Rafael O. Santana A

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

So, we're happy with the acquisition of Nordco. We're ahead of the pro forma. The team continues to progress very well. We're certainly excited about the opportunities here to drive growth beyond what we have planned for, especially in the international markets. And that's something the team is very focused on. It's about utilizing the footprint that we already have established in other countries to be able to drive that product line. There's a couple geographies that are really keen for us here, and you'll hear more on some of the progress there on the following quarters.

Felix Boeschen Q

Analyst, Raymond James & Associates, Inc.

Thank you.

Rafael O. Santana A

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

Thank you.

Operator: Thank you. And this concludes the question-and-answer session. I would like to turn the call to Kristine Kubacki, Vice President of Investor Relations, for closing comments.

Kristine Kubacki

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

Thank you, operator, and thank you, everyone, for participating today. We look forward to speaking with you next quarter. Thank you. Goodbye.

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