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Westinghouse Air Brake Technologies Corp. (WAB)

Q3 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Wabtec Third Quarter 2021 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] .

I would now like to turn the conference over to Kristine Kubacki, Vice President of 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 Third Quarter 2021 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 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, Christine, and good morning, everyone. Joining me today is our new Chief Financial Officer, John Olin. John is a well-respected leader with broad operational and financial experience. He is already bringing a great perspective to our business and long-term strategy with a clear focus on growing shareholder value. We're thrilled to have him on the team.

I also want to take a moment to thank Pat Dugan for his nearly 20 years of service to Wabtec. We're grateful for all that he has contributed to the company. With that, let's turn to slide 4.

I will start with an update on our business, my perspective on the quarter and our long-term value framework. And then John will cover the financials. Overall, we made significant progress against our strategy and delivered a strong third quarter, as noted by our sales growth, adjusted margin and adjusted earnings per share, each of which were up year-over-year.

Total sales for the quarter were $1.9 billion, driven by growing demand in Freight Services and Components, but offset by continued weakness in the North America OEM market. Adjusted operating margin was 17%, driven by strong mix and productivity, ongoing lean initiatives and cost actions.

Total cash flow from operations was $244 million. This takes year-to-date cash from operations to $759 million versus $458 million a year ago. This is a solid illustration of how the team is driving good operational performance. Cash conversion for the year is at 103%.

Finally, we ended third quarter with adjusted EPS of $1.14, up 20% year-over-year. Today, we're also pleased to share that we have achieved our $250 million synergy run rate, a full year earlier than expected at the time of the GE Transportation acquisition. We have consolidated and optimized our operations, reduced costs to drive stronger profitability, accelerated lean across the enterprise and created additional capabilities in best cost countries, we're already feeling the benefit of these efforts, which will continue to improve our competitiveness. So overall, really strong execution by the team as we continue to deliver on our long-term strategy.

Shifting our focus to slide 5. Let's talk about our end market conditions in more detail. Internationally, freight activity continued to improve in the third quarter across our major markets and our order pipeline remains strong. We expect long-term revenue growth in Russia, CIS, Brazil, Africa, Asia and Australia. Freight trends in North America weakened slightly year-over-year in the third quarter, not driven by lack of demand, but by global supply chain disruption that has impacted intermodal volumes and auto production.

Consumer and industrial activity continue to spur volume growth in chemicals, metals and materials. Locomotive parkings continued to decline despite weaker freight traffic in the quarter. We expect demand for reliability, productivity and fuel efficiency to continue to increase placing our services business in a position of strength.

When it comes to the North America railcar build, demand for railcars is improving, about 21% of the North American railcar fleet remains in storage, a slight improvement from the previous quarter and in line with pre-COVID levels. As a result, industry orders for new railcars are starting to improve. We forecast the railcar build this year will be in the neighborhood of 30,000 cars.

Transitioning to the transit sector, ridership remains a bit uneven in some markets. However, infrastructure spending for green initiatives continue to be a bright spot, especially as governments globally turn to rail for clean, safe and efficient transportation. Overall, the long-term market drivers for passenger transport remain strong.

Shifting to slide 6, we are developing innovative solutions that address the main cost drivers for our customers, including fuel efficiency and increased velocity in the transportation sector. Our commitment to succeed in this effort is underscored by our focus on continuing to position rail transportation as the safest and most sustainable way to move freight and people over land.

Today, we have the capability and expertise to transition diesel-powered locomotives to battery power and drastically reduce emissions as we're doing with our FLXdrive locomotive. We expect to extend this technology further to hydrogen fuel cells and help lead the industry to a zero-emission rail network of the future. And we're not stopping there. We have extended battery technology to other areas of our business as well. And we are driving several technology breakthroughs to boost transit efficiency and reduce emissions and pollutants.

An example of this is our Green Friction technology which drastically reduces brake emissions by up to 90%, an incredible milestone in significantly improving the quality of the air in our metros. We're also leading the change to create a safer and more efficient rail network. A great example of this and a solution of growing interest among Class I customers is Trip Optimizer Zero-to-Zero. This advanced technology allows an operator to autonomously start a train from zero miles per hour and stop it using software integrated with positive train control. It builds on Trip Optimizer's proven performance, which has saved railroads more than 400 million gallons of fuel since its inception and reduces emissions by over 500,000 tons per year.

Looking forward, we will continue to advance efforts towards cleaner, more energy efficient transport and we'll share our progress on this front as well as our broader environmental, social and governance priorities in our next sustainability report which will be released in a couple weeks.

Next, let's turn to slide 7 to discuss how our next-gen technology is helping us win in the market by covering a few recent business highlights. In the third quarter, we secured new orders for our FLXdrive locomotive. We also closed a significant order for international locomotive kits and won a digital contract in Asia to help our customers improve asset utilization and reduce emissions.

In Freight Services, we won a significant long-term service contract as well as an order for 100 locomotive modernizations in North America. Overall, mods backlog remains strong, and we are showing good momentum on deliveries. Finally, in Transit, we won new power collection, HVAC and service contracts in Germany, Switzerland and the UK.

Looking ahead, we are confident Wabtec will continue to capture growth with innovative and scalable technologies that address our customers' most pressing needs. We also will continue to control what we can and leverage this strength to combat the current challenges that we are facing due to supply chain disruptions, increasing metal and commodity costs, and labor shortages. These dynamic have adversely impacted our third quarter results and have resulted in significant cost increases.

Across the board, our team is working hard to mitigate the impact of these pressures by triggering price escalations and surcharges as well as driving operational efficiencies wherever we can. We anticipate that costs will continue to increase over the next few quarters, and we will continue to aggressively manage these challenges.

I'll turn the call over to John now to discuss this in more detail as well as review the quarter, segment performance and our overall financial position. John?

John A. Olin

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

Thanks, Rafael, and good morning, everyone. It's great to be with you, and I'm very excited to join the team at Wabtec. It is a storied company with incredible talent, deep innovation and best-in-class differentiated technologies that is well-positioned to deliver the future of rail while growing shareholder value. And I look forward to meeting with many of you in the coming months.

Now, turning to slide 8. Before getting into the financials, we would like to discuss the dynamic cost environment and supply chain challenges that we face. During the third quarter, we experienced delays in production and deliveries of our products, as well as significant increases in many key input costs.

On the revenue side, we are experiencing adverse impacts to our sales results due to shortages across many component parts, including computer chips which are causing delays in production and customer delivery. We believe that our enterprise revenues were 2% to 3% lower than they would have been without the supply chain disruptions and that the majority of these lower revenues represent delayed sales, not lost sales.

The impacts to Wabtec's cost structure come in four areas; first, commodity inflation, where markets year-over-year are up more than 200% for steel, 94% for aluminum, and roughly 40% for copper. The second area of impact is elevated freight and logistics costs, which in many cases are up over three to four times from pre-COVID levels.

Third is wage inflation and labor availability, which are adversely impacting the business. And finally, we are experiencing lost manufacturing efficiencies, largely due to component and ship shortages. Our costs have increased during the quarter and have impacted both our Freight and Transit segments.

We estimate that cost increases in the third quarter are in the range of $15 million to $20 million. Having said that, we expect these headwinds to intensify as the full cost of rising metals and lower manufacturing efficiencies work their way through our inventories and purchase contracts. We anticipate costs to continue to increase over the next few quarters.

Our team is working hard to mitigate the impact of these cost pressures and supply chain disruptions by triggering price escalation clauses that are included in many of our long-term contracts, implementing price surcharges, driving operational productivity and lean initiatives, and finally, through higher realization of synergies.

Turning to slide 9, I'll review our third quarter results in more detail. We had good operational and financial performance during the quarter. Sales for the third quarter were $1.91 billion, which reflects a 2.2% increase versus the prior year. Sales were positively impacted by the continued broad-based recovery we are experiencing across much of our portfolio, the acquisition of Nordco, and favorable currency exchange, partially offset by continued weakness in the North America OE locomotive market and lower year-over-year sales in Transit.

For the quarter, adjusted operating income was $325 million, which was up 10.6% versus the prior year. Most notably, we delivered margin expansion in both our segments, up 1.3 percentage points on a consolidated basis.

Margins were aided by strong mix favorability, improved productivity, and better than expected realization of synergies. As Rafael stated, during the quarter, we achieved our goal of $250 million of synergy run rate, a significant milestone delivered a full year earlier than originally forecasted.

What makes this quarter's margin expansion even more impressive is the fact that our margin gains were achieved in the face of an incredibly dynamic supply chain and inflationary environment.

Looking at some of the detailed line items for the third quarter. Adjusted SG&A was $257 million, which was up $16.1 million from the prior year, due to the normalization of certain expenses, higher incentive compensation and employee benefit costs, and the acquisition of Nordco.

For the full year, we expect SG&A to be about 12.25% of sales. Adjusted SG&A excludes $12 million of restructuring and transition expenses, of which most was allocated to further optimize our European footprint.

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

Our 2021 investment in technology, which includes engineering expense, remains at 6% to 7% of sales. Amortization expense was $72.5 million. And our adjusted effective tax rate during the quarter was 24.8%, bringing our year-to-date adjusted effective tax rate to 25.8%.

For the full year, we still expect to have an effective tax rate of about 26%, excluding discrete items. In the third quarter, GAAP earnings per diluted share were $0.69 and adjusted earnings per diluted share were $1.14, up 20% versus prior year.

We are pleased with our Q3 results in particular, our sales growth in the face of supply chain disruptions, our margin growth in the face of sharp cost increases. We remain diligent and proactive, as we work to minimize these challenges.

Now let's take a look at segment results on slide 10, starting with the Freight segment. Across the Freight segment, total sales increased 4.7% from last year to $1.3 billion, primarily driven by continued strong growth in our Services and Component businesses.

In terms of product lines, Equipment sales were down 5.7% year-over-year, due to fewer locomotive deliveries this quarter versus last year, and no new locomotive deliveries in North America, partially offset by strong mining sales. This year-over-year performance demonstrates the resiliency of our equipment portfolio.

In line with an improved outlook for rail, our Services sales grew a robust 13.6% versus last year. The year-over-year sales increase was largely driven by higher aftermarket sales from our customers' modernizing their fleets, the un-parking of locomotives, and the acquisition of Nordco.

The performance, reliability and availability of our fleet continues to drive customer demand as railroads increasingly look for predictable outcomes across their fleet. Excluding Nordco, organic sales for the third quarter were up 6.1%.

Digital Electronics sales were down 3.6% year-over-year, driven by delays in purchase decisions due to economic and cost uncertainties as well as chip shortages. We continue to see a significant pipeline of opportunities in our digital electronics product line, as customers globally focus on safety, improved productivity, increase to capacity and utilization.

Component sales continued to show recovery and were up 6.7% year-over-year, driven by demand for railcar components and recovery in industrial end markets. We remain encouraged by, the continuing trend of railcars coming out of storage, higher order rates for new railcars and accelerated recovery across industrial end markets.

Shifting to operating income for the segment, freight segment adjusted operating income was $266 million, for an adjusted margin of 20.6%, up 1.7 percentage points versus the prior year. The benefit of higher volumes, improved mix across our portfolio, and increased synergies and productivity were partially offset by significantly higher input costs. Finally, segment backlog was $18.2 billion, up $375 million from the prior quarter on the broad multi-year order momentum that Rafael discussed across the segment.

Turning to slide 11. Across our Transit segment, sales decreased 2.5% year-over-year to $612 million. Sales were down versus last year due in large part to supply chain issues and COVID-related disruptions. This was partially offset by positive ridership trends. Excluding near-term supply chain challenges, we estimate that transit sales would have been up slightly on a year-over-year basis.

We believe the medium and long-term outlook for this segment remains positive as infrastructure spending for green initiatives continues. Adjusted segment operating income was $77 million, which resulted in an adjusted operating margin of 12.5%, up 50 basis points versus the prior year. Across the segment, we continue to drive down costs and improve project execution despite the volatile cost environment.

For the year, we remain committed to deliver about 100 basis points of margin improvement for the segment. And the team continues to take aggressive action to mitigate rising costs and supply chain disruption, which will pressure the pace of near-term margin improvement. As we execute in the fourth quarter, we expect significantly improved operating margin driven by strong productivity gains, improved project mix and more favorable comps versus the prior year's fourth quarter. Finally, Transit segment backlog for the quarter was $3.6 billion, which was flat with the prior quarter after adjusting for the negative effect of foreign exchange.

Now let's turn to our financial position on slide 12. We had another strong quarter for cash generation. We generated $244 million of operating cash flow during the quarter, bringing year-to-date cash flow generated to over $759 million. This performance clearly demonstrates the quality of our business portfolio.

During the quarter, total CapEx was $23 million, bringing year-to-date CapEx to $78.5 million. In 2021, we now expect CapEx to be approximately $120 million. This is $20 million lower than our previous guidance as the team judiciously manages every dollar of spend.

Our adjusted net leverage ratio at the end of the third quarter was 2.6 times, and our liquidity is robust at $1.62 billion. Also during the quarter, we returned capital to shareholders, repurchasing $199 million of shares. As you can see in these results, our balance sheet continues to strengthen and we are confident we can continue to drive solid cash generation, giving us the liquidity and flexibility to allocate capital towards 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 13 to discuss our updated 2021 financial guidance. We believe that the underlying customer demand for our products and the end market momentum remains strong. As John indicated, we do expect continued headwinds from a more challenging sales and cost environment into the fourth quarter.

Taking into consideration this market backdrop and volatile cost environment, combined with our solid performance in the first three quarters, we are narrowing our full year revenue and earnings per share guidance. We expect sales of $7.9 billion to $8.05 billion and adjusted EPS to be between $4.20 and $4.30 per share. We expect cash flow conversion to remain greater than 90%, resulting in strong cash generation of about $1 billion for the full year.

Now let's turn to our final slide. Everything we have outlined today reinforces that we have a clear strategy to accelerate long-term profitable growth. That strategy is built on our expansive installed base and deep industry expertise grounded in innovation, breakthrough initiatives and scalable technologies that drive value for our customers and accelerated by our lean, continuous improvement culture and disciplined capital allocation.

I'm proud of the strong execution by the team in the third quarter despite a challenging supply chain, cost and market environment. You are seeing their efforts in the strength of the company and our financial results.

As we go forward, the rail sector is well positioned to increase share and address the critical issues facing the world's freight and logistics sector. We will continue to lean into the strong fundamentals of this industry and our company to deliver long-term profitable growth.

As we've said before, Wabtec's mission holds a larger purpose: to move and improve the world. After demonstrating strong performance in the first three quarters of 2021, I'm confident that this company will continue to deliver and lead the transition to a more sustainable future.

With that, I'll turn the call back 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] Our first question comes from Justin Long from Stephens. You may now go ahead.

Justin Long
Analyst, Stephens, Inc.
Q

Thanks. Good morning and, John, congrats on the new role. Look forward to working with you.

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

Good morning, Justin.

Justin Long
Analyst, Stephens, Inc.
Q

I guess to start, I had a question on the revenue guidance. If we just take the low end of the revenue guidance, it still implies a pretty significant sequential pickup in revenue in the fourth quarter. I think it's around 13% of an increase sequentially to hit the low end of that guide. Can you just give a little bit more color about – around the areas where you see that sequential improvement and just the level of visibility you have?

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

So let me start there, Justin. I'll start with the pipeline of deals. That continues to strengthen. I mean, when you look at the impact in the quarter, it's really tied to supply chain disruption. If anything, versus last time we talked, I'd say we have a stronger pipeline. If you think about the 12-month backlog, it's up double-digits versus a year ago. This is the highest backlog we've had since, what, fourth quarter 2019. And this is a pipeline we continue to work on convertibility here. I think commodity demand remains overall strong for both agriculture and mining.

In North America, even in the quarter, demand for services and support for both fuel savings and reliability remained strong. Locomotives are running harder. Demand for freight car is on the rise from the forecast we had earlier in the year. And I think, most important, we are also continuing to build momentum on battery electric solution with customers around the world. So this is not a question around demand. I think the adjustment we did in the guidance for the year reflects some of that disruption, including going to the fourth quarter, which is reflected in the guidance we provided.

Justin Long
Analyst, Stephens, Inc. Q

Okay. And secondly, I wanted to ask about margins. One of the things that really stood out in the quarter was the adjusted operating margins for the Freight segment. We saw a sequential decline in revenue for Freight in the third quarter, but I believe the adjusted operating margins improved by over 200 basis points sequentially. So, is there any color you can provide around that? Was there anything that was one-time? And then maybe on the cost headwinds going forward that you said would intensify, any way to think about the order of magnitude around that and the pickup you expect?

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

Hi, Justin. This is John. Justin, with regards to the sequential and also year-over-year, the margin gains were about the same; year-over-year 1.7 points; on a sequential basis 2.1 points. The driver of that in the Freight organization is really the mix between the groups and mix within the groups. When you look between the group, we had Services, which has got higher-than-average margin of 13.6%, and Transit and the Equipment down anywhere between 2.5% and 5.7%. So that's really the driver of both the sequential and the year-over-year margin improvement.

With regards to the cost side of the question, we talked about the $15 million to $20 million, and that's, Justin, what has actually flown through the P&L. And so just to make sure that we're all straight, the largest of the predominance of that cost that we're seeing on the front end is for freight and – I'm sorry, yes, freight and logistics costs. Those don't flow through inventory and they hit us upfront. So the predominance of the $15 million to $20 million is in freight costs.

The other piece of it is the materials rising. As everyone knows, has risen a lot, as well as manufacturing inefficiencies. Now, those get inventoried and they flow through inventory and they'll be released in the future as those products are sold. If we look at what's on the balance sheet, that's at about the same amount that we saw pass through the P&L in the third quarter. So there's another $15 million to $20 million sitting on the balance sheet that will come. And that's what we've talked about in the prepared remarks is that we would expect costs to rise in the fourth quarter and the next few quarters.

Justin Long
Analyst, Stephens, Inc. Q

Okay. That's helpful. I appreciate the time.

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: Our next question comes from Jerry Revich from Goldman Sachs. You may now go ahead.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Yes, hi. Good morning, everyone, and John, welcome.

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

Hi, Jerry.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Rafael, I'm wondering if you could talk about the mod business. You've been on a really strong multiyear trajectory on that part of the portfolio. Can you talk about how the backlog looks and how attractive that option is for rails as they figure out their emissions reduction strategy longer term? Do you anticipate similar level of production growth for your mods business in 2022 as what you're delivering this year?

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

A

Yeah, Jerry, so first, we do see, I mean, growth in that business coming to this year. I think demand's still out there on this. When we think about growth, I think a lot of the elements of growth here for the mods business is more international. I think it remains a robust part of the solution for our customers in North America and that's tied very much to the announcement we made. But you're going to see us talking about some announcements around opportunity internationally for mods. So that's where I think a larger part of that opportunity is.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Terrific. And then in terms of international locomotive contracts, I know obviously you're not taking the commodity cost risk on those multiyear projects. But do your customers have the budgets to cover the significant raw material increases? And what's the process like to recover the additional costs that obviously it's going to take to complete those projects?

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

A

I think a lot of those customers are actually benefiting from that, Jerry. So, it's very much connected to it in terms of the opportunities for them to grow volume. A lot of it's demand around both the elements of mining, but also the elements of the agri business. And those remain robust. And I think the forecast is positive as we look around the world. So, going back very much to my remarks, it's not a function of a single geography. We're really seeing a pickup on different geographies.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

So no issues on customers [ph] who were writing checks as (33:16) they're facing higher steel costs and multiyear contracts, it sounds like? Okay. Thank you.

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

A

And Jerry, just to give more color to it. So, to a number of customers, we've even got multiyear contracts. So, those already kind of provide them some visibility in terms of cost escalations through that process. And I mean, we've been with a lot of, and most of these customers, we've had a longstanding relationship. So, we've gone through times like this.

Jerry Revich
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Thank you.

Operator: Our next question comes from Saree Boroditsky with Jefferies. You may now go ahead.

Saree Boroditsky
Analyst, Jefferies LLC

Q

Thanks for taking my questions. Sticking on international locomotives, could you just update us on what you're seeing there, what were deliveries in the quarter and maybe some guidance around growth into 2022?

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

A

Sure. Well, first, I think it's a market where we're continuing to see good momentum. So, when I think about the 2022, 2023 timeframe, I think we see a positive momentum. It's all around convertibility of this pipeline into orders. And again, as I described, it touches different geographies and different elements of that. So, we do expect growth associated to that and when we go to the 2022, 2023 timeframe.

With regards to guidance into 2022, it's kind of early stages for us to really be discussing guidance at this point. But favorable demand in the 2022, 2023 timeframe.

Saree Boroditsky
Analyst, Jefferies LLC

Q

And then could you just talk to what you're seeing on the digital side in Freight? Comparables were a little easier this quarter, but you were still down. So, when do you expect this to inflect positively?

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

A

I'll start with, number one, efficiency, productivity, safety, those continue to be imperatives for our customers. We continue to see a strong commitment from them. Book-to-bill is above 1 year-to-date. We've had some strong quarters looking back in terms of some multiyear orders. And, I think internationally, we're keeping, expanding our penetration. One of the products, I think I've talked about it before, is PTC. It's probably an opportunity that is, when I think about outside of the U.S. as big as the U.S. opportunity.

We've started to execute now PTC into three different countries outside of the U.S. Now those are opportunities that, it takes some time in terms of working those through. In a lot of cases, we're dealing also with governments on adopting it, but a very good positive progress up to this point. And I think we have significant room to grow in terms of helping customers share with both the elements of driving productivity and decarbonization, which touches directly these products. So its going to go with automation and fuel savings at the end of the day.

Saree Boroditsky
Analyst, Jefferies LLC

Q

And if I could just squeeze one in, just from a modeling perspective. What was the contribution of Nordco to sales in the quarter?

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

A

2.1 percentage points on...

Saree Boroditsky
Analyst, Jefferies LLC

Q

[indiscernible] (36:33).

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

A

...an enterprise wide basis.

Saree Boroditsky
Analyst, Jefferies LLC

Q

[indiscernible] (36:39).

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

A

I'm sorry. I'm sorry. You asked for contribution. That was for sales. So we benefited in overall consolidated sales because of Nordco by 2.1 percentage points.

Operator: Our next question comes from Rob Wertheimer with Melius Research. You may now go ahead.

Rob Wertheimer
Analyst, Melius Research LLC

Q

Thank you. Thanks for all the commentary on cost and inflation and how it cycles through the balance sheet and the P&L. I mean also the gross margin was really good. So I'm just wondering if there's anything else to call out aside from the mix factors, John, that you already talked about on gross margin. And then just for clarification, with the price escalators and actions that you're taking, do those coincide with when that comes through? Or do we have a quarter or two of whatever and then you get back to the more positive dynamic?

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

A

Great, Rob. In terms of freight margin, yes, I'm sorry, certainly, mix was a driver, but the productivity and the synergy that the organization is spinning out is absolutely building our margins in those areas. Again, we talked about the synergy piece on achieving the overall synergies a year early. We're seeing some of the actual delivery of that flow through the P&L in the third quarter, as well as the entire organization focused on productivity and integrating these companies continues to drive strong productivity.

And again, that's partially offset by escalating costs. So let's talk a little bit more about that. We know that the costs are up $15 million to $20 million in the third quarter. We know that that's going to grow into the first, fourth quarter. And when we look at how we're going to cover that, as we mentioned in the prepared remarks, is we will do it through a series of price escalations, pricing and price surcharges, as well as a lot of hard work on accelerating productivity and kind of pushing off these cost increases as best we can.

But to your question, let's talk a little bit about the price escalators. Again, over half the company's revenue is tied up and locked into long-term contracts. So we've got built-in protection for a situation as we're experiencing now. There's not a lot, there's nothing that we have to do. It's already been predetermined for us on how these costs will be covered. So the question is, yes, there can be a lag.

Various contracts have different start dates, some are monthly, and those adjust every month, quarterly and annual, so that we would expect over the next couple quarters that we would continue to build up the revenue side of this cost equation and our trek to be price cost neutral to positive as we go forward. The other piece of it, aside from the escalator, so a little bit less than half of the overall cost increases, are being dealt with, with pricing and price surcharges. And again, this has all been factored into the guidance, which we've talked about, of the 50 point increase, 50 basis point increase in margins. And again, we're absorbing some of these costs and still hitting on the guidance that we previously put out there.

Rob Wertheimer Q
Analyst, Melius Research LLC

Got it, thank you.

Operator: Our next question comes from Courtney Yakavonis with Morgan Stanley. You may now go ahead.

Courtney Yakavonis Q
Analyst, Morgan Stanley & Co. LLC

Great. Thanks, guys. If we could just maybe just follow-up on the comments about price escalations. Just to be clear, those will – are exposed to the commodities that you specifically called out, John, steel, aluminum, copper, and then if we see those prices eventually retract, do the price escalations stay or would we expect pricing to adjust downward in those contracts as well?

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

Yes, Courtney, it's a little bit of a misnomer to call them all price escalators because they're also price de-escalators when costs go down. So again, these are long-term contracts, could be many, many years long. So all of this is prescribed, and yes, they do cover all those commodities as well as labor and transportation costs. So we feel very good about where we're sitting in that part of the cost structure that's backed up by those long-term contracts.

Courtney Yakavonis Q
Analyst, Morgan Stanley & Co. LLC

Okay.

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

A

The one thing I'll add here is, we do have experience with those escalators. As we look at over time, the combination this escalation plus the productivity we drive, drive so, I'll call positive outcomes. So I'd want to tell you that.

Courtney Yakavonis
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Great. That's helpful. And then maybe just going back to some of the longer-term wins that you called out this quarter, Rafael, between the mods, the Class I service agreement, Trip Optimizer. Can you just help, and international loco kits. Can you help us just frame out when you would expect, what the timeframe of those orders apply to and when we could expect deliveries on them? And I don't think you called out any incremental Zero-to-Zero but just give us an update on whether you're making traction on that product line as well?

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

A

Well, we are making progress. I'll start there. Expect some continued announcement here as we drive convertibility. We expect, especially when you think of the OEE side, some of those might hit us more on the 2023 than the 2022 timeframe. But that's why I tell to you about the 2022, 2023 positive dynamics in terms of what we see out there in terms of revenue growth. So with that and considering the dynamics we still have in North America, we see the opportunity here to drive profitable growth in the 2022, 2023 timeframe despite still looking at, well, deliveries for North America locomotives still at zero, which is the same that we've had this year.

Courtney Yakavonis
Analyst, Morgan Stanley & Co. LLC

Q

Okay. Great. And then just lastly, one more follow-up on the supply chain, it did sound like the $15 million to $20 million costs that you called out, was that a gross number or a net number? It sounded like it was mostly freight and logistics. And I just want to make sure that's not covered under any of those escalations, so we should think about those costs as being kind of more substantial and harder to price out. Is that correct?

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

A

Yeah. Good question, Courtney. The $15 million to $20 million of higher cost is a gross number. And again, when we look at a net number, we are triggering some of those price escalators in the quarter. And we've also got some flow arrangements where they get priced automatically.

And again, the team is looking at surcharges and whatnot. If we take the other side of this equation, which is the revenue piece of this, it is about a little over half of the $15 million to $20 million.

So we're covering about half of that through these mechanisms, and again, we're on our way to price neutrality to positive. And we would expect that in the next couple quarters that we will have some margin compression as we kind of deal with the lag of mainly the long-term contracts that have price escalators in it.

Courtney Yakavonis
Analyst, Morgan Stanley & Co. LLC

Q

Okay great. Thank you.

Operator: Our next question comes from Scott Group with Wolfe Research. You may now go ahead.

Ivan Yi
Analyst, Wolfe Research LLC Q

Good morning. This is Ivan Yi on for Scott Group. First, I wanted to go back to the gross margins. Gross margins of 37% were higher than we've seen in some time.

Is that level sustainable? Or how much do you, would you expect that to tick down given the escalating costs that you mentioned? Thank you.

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

So first, I think you'll continue to see variation quarter-over-quarter on margins and sales. And I think for reasons we've described before, which can include timing of projects. It can include mix under absorption. So I'll stay away from really pinning us down on any specific results on any given quarter.

I think the overall commitment, which John spoke to, is despite of this pressure, as we talked to you on previous earnings, the commitments there, despite a higher risk to drive 50 basis points of improvement for the year and despite of the pressure on margins moving forward, the team is continuing to work on really offsetting those with some of the mechanisms we described.

And there are certainly elements of looking at alternative sourcing that the team is looking at it. And we certainly got the elements of also austerity on costs that we can add to the elements of pricing and the other things that John described.

Ivan Yi
Analyst, Wolfe Research LLC Q

Thank you. And then, I know, you're not providing 2022 guidance, but can you provide some additional initial color on next year? Do you expect a recovery in the North American loco market? What about railcars? So I guess what end markets kind of feel best and what end markets feel worst? Thank you.

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

I'll start with overall, especially when I look in the 2022, 2023 timeframe. I think we see overall positivism. It's certainly, I think, even more positive when I think about the elements of international.

I talked a little bit earlier about zero locomotives in North America. I think, ultimately, even when you think about the 2022, 2023 timeframe, the net impact of absorption, I think, certainly lessened, as we first, I mean, there's a lap of the impact of 2021, which is just a repeat of no locomotives this year. And we see the opportunity here to leverage, what I'll call, increased volume across really a more optimized cost structure as a result of the synergies and the cost actions that the team has driven. So, despite of this margin pressure, we continue on our commitment here to drive profitable growth for the longer term for the business.

Ivan Yi
Analyst, Wolfe Research LLC Q

Thank you.

Operator: Our next question comes from Steve Barger with KeyBanc Capital Markets. You may now go ahead.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

Hi. Good morning. I know we're early in the process for the 7-megawatt battery electric locomotive. But can you talk about how this changes, how customers are talking about equipment acquisition in coming years? Does this increase mods and decrease OE to some extent while customers wait for this? Or how are they talking to you about it?

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

A

I don't think customers wait for this. I think some of the things that we announced here in the quarter, it's really us continuing to build momentum in battery electric solutions. And it's with customers really around the world, I think.

The importance of this is really we do expect, and we've talked to you about it on building, what I'll call, a solid baseline demand that actually helps us accelerate the introduction of this technology, which builds off on the longer-term profitable growth for the business. So there's not a way to show a lot more in terms of our discussion on how to best integrate that into their operations.

There are some discussions that happen along the lines of applying that into specific corridors where they're able to have that dedicated fleet and test some of these premises out. And I think what's important, we're past, what I call, the invention of this product. This is really about putting into revenue services and working with customers to accelerate introduction in the areas that it makes sense.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

And as that starts to roll out, is that positive for mix for you?

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

A

We like this product very much. I think there's positives in terms of how we look at what we're introducing. Just keep in mind you're not now just introducing, what I'll call, locomotive. A lot of the fuel goes with that locomotive upfront. So we like a lot of the dynamics on what that can provide in terms of value for both our customers and ourselves.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc.

Q

Got it. And then, John, I know it's early to talk about 2022, but do you have a general view on what consolidated incremental margin should look like in a modest growth environment, or better yet, if you want to drill down into the two segments, how you think about incrementals?

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

A

Steve, what we're going to do is spend the next three months really refining our plans, absorbing the cost shock that we have now, and we'll be back to you in about three months and provide a good view as to what we do believe will happen in margins in 2022. But, at this point, we feel good as we look forward.

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

We see the opportunity on the 2022, 2023 time line to drive profitable growth, as I had highlighted. In terms of some of the specific segments, I think we've been open about it in terms of one of the North Star for our transit business, which is really getting margins to the [ph] mid-teens (50:01), the opportunity to continue to drive margin improvements for our freight businesses as well.

Steve Barger
Analyst, KeyBanc Capital Markets, Inc. Q

Understood. Thanks.

Operator: Our next question comes from Allison Poliniak with Wells Fargo. You may now go ahead.

Allison Poliniak-Cusic
Analyst, Wells Fargo Securities LLC Q

Hi. Good morning. Just want to go back to the digital business specifically. Obviously, component and chip shortage has been well documented here. Is there a way to understand what that specific headwind to growth for that product category has been?

And then I guess, Rafael, your comment around certainly delayed but not lost sales. How do you expect that to kind of, I guess, self-correct? Do you have any thoughts on when that starts to smooth out for you, whether it's based on just the availability of those components or kind of things that you're doing to sort of attack that as well?

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

So let me start with the second part of your question. When we gave the guidance with, associated with this year, that certainly implies, what I'll call, stronger headwinds than we've had in the third quarter when it comes down to supply chain disruptions. With that, I mean, there's a series of actions being taken by the team and really proud to see the progress the team has had.

So I'm not going to anticipate when those will finish or not. I think this is a very dynamic situation, and we're really focused on things that we control. And it's really tied to a cost austerity, continuing to drive productivity, making sure that we are looking at alternative sourcing and that we're acting on pricing. I think those are some of the things that we're focused on.

On digital electronics, we, the dynamics are, I'm going to call them moving the right direction here with the business. As I look into the book-to-bill, moving the right side, strong opportunity here for us to grow penetration and we have the opportunity, especially as we evolve some of these technologies. We talked quite a bit about battery electric. It's really significant, the opportunity to have a much more interconnected ecosystem. And that's going to drive significant value for our customers. It's going to drive competitiveness for rail overall, and we can certainly benefit from that.

Allison Poliniak-Cusic
Analyst, Wells Fargo Securities LLC

Q

Got it. Helpful. And then, John, obviously, decent leverage at Wabtec, strong cash performance. Would love to get your perspective on capital deployments and where you think the priority should be at this point?

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

A

Well, Allison, number one, as I would say, I can't wait to get our owners' perspective on capital deployment and our capital structure, and I'll be out in the next several months talking to a lot of them to get their feedback.

The second thought that I have on the topic is what a great problem to have. The company has done a fantastic job of becoming very consistent on delivering a very strong cash conversion ratio, and as we look at this quarter, $1 billion of free cash. So number one is to make sure that we maintain a strong balance sheet, which the company has and continue to strengthen that.

The second area, Allison, is to continue to invest in the organic side of the business. I've been here now seven, eight weeks, and I've seen a lot of capital requests, and the returns are absolutely fantastic on those investments in terms of driving improved profits over that period of time.

And then finally is the remainder of the cash. We will look at M&A and share buybacks no differently. We'll prioritize the returns to the shareholders and we'll continue the buybacks as we did in the third quarter. So again, a great quarter in terms of share buybacks at $199 million, and we'll apply what makes sense in terms of strategic acquisitions and look to how do we continue to drive the shareholder value of the company forward.

Allison Poliniak-Cusic
Analyst, Wells Fargo Securities LLC

Q

Perfect. Thank you so much.

Operator: Our next question comes from Chris Wetherbee with Citi. You may now go ahead.

James Monigan
Analyst, Citigroup Global Markets, Inc.

Q

Hey, guys. James on for Chris. I wanted to talk about or ask about Freight Services revenue. It didn't necessarily show the seasonal step-up we might normally expect. Just kind of wanted to understand the puts and takes around that and sort of how we should sort of think about the fourth quarter, is that essentially sort of the baseline to operate off of, is some of that pushed out? Just wanted to understand the dynamics there.

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

A

Let me take that. Starting with Freight Services. I mean, revenues are up 13.6%. And even if we were to discount the acquisition of Nordco, you'd still have seen a sales increase of 6% into the quarter. Back to some of the elements of we could see variation quarter-to-quarter, and that's based on timing of projects, mix as well can play an element there. But this is a business that continues to have what I'll call high demand for really the elements of providing reliable power. Unparking of locomotives continue and demand for really modernization, it's also out there, and we're continuing to see higher aftermarket demand as some of the fleets get unparked. So right dynamics, nothing, I'll say, specific to highlight on the business.

James Monigan
Analyst, Citigroup Global Markets, Inc.

Q

Yeah. All right. Got it. And then I guess, given the dynamics you've highlighted around the unparkings and moving into the fourth quarter and further out, should we start to see essentially sequential improvement off of that? Just like the math of the unparkings would suggest that you could see a step up off of what you have in the third quarter there?

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

A

When I look at the 2022, 2023 timeframe, I think the expectation is that, I mean, we look at an opportunity here for growing demand. I'll stay away from really highlighting specifics on going through the early part of next year just based on a lot of the things that we described here to the call. But demand is there. What we've seen up to this point is really disruption tied to supply chains. And we see the opportunity to continue to drive long-term profitable growth for the business. Team is executing on the strategy and we're confident about our ability to position here the company for that long-term profitable growth.

James Monigan
Analyst, Citigroup Global Markets, Inc.

Q

Okay, got it. Thank you.

Operator: Our last question comes from Matt Elkott with Cowen. You may now go ahead.

Matt Elkott
Analyst, Cowen & Co. LLC

Q

Good morning. Good to see the sequential increase in the total backlog. And I think year-over-year, both the total backlog and the 12-month backlog increased. Rafael and John, can you talk about the decrease sequentially in the 12-month backlog? What are the reasons behind it, are there order deferrals? And specifically on the transit backlog, because I think this is the second quarter in a row that we see a sequential decrease in the 12-month backlog?

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

A

Sure, Matt. This is John. Matt, as we look at the 12-month backlog, you're right, it is down about $115 million or a couple percent and that is driven by Transit. And there are two things, which are driving that reduction. One is about half of it is foreign exchange. So take that right off the top.

The other piece, the other half of it in Transit is our exiting some non-profitable contracts. As you remember, a couple quarters ago, the company talked about a U.K. restructuring. And so these are our contracts that we're exiting because they weren't delivering the level of profits that we would expect from our transit organization.

So those are the two pieces that explain the bulk of the reduction from the second quarter to the third quarter. What I'd also point out, Matt, is when you look on a year-over-year basis, so a year ago quarter, 12-month backlog is actually up very strong. It's up over 10%.

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

A

And I'll just add, we just went through our strategic planning and as I look at the elements of both Transit and the overall franchise, we have the opportunity here to drive profitable growth.

Matt Elkott
Analyst, Cowen & Co. LLC

Q

Got it. That's very helpful. And then a question on the, it's good to see the locomotive, parked locomotives decrease, heading in the right direction. But if you listen to at least a couple of the railroads so far, their active locomotive fleets have declined a bit. So, any thoughts on that Rafael or John?

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

A

This is a very dynamic environment. So I'm not going to pretend to explain any movements on any specific railroads at this point. But as you look at the dynamics of demand, especially as you go into the 2022, 2023 timeframe, those are largely positive. And I think we have the opportunity here to benefit from that.

Matt Elkott
Analyst, Cowen & Co. LLC

Q

Got it. And Rafael, this is a question that I've been meaning to ask you on the call. But can you talk about the Trip Optimizer and its interoperability with the competition? Just trying to get a gauge on, if the industry has to head in one direction or another as far as software.

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

A

I think we have invested in a portfolio of solutions over time. I think despite of the cycles, we, that's a commitment we have had, which is really longer term. And tech, we have come up with a number of solutions that can benefit not just our own fleets, but can be taken into serving other fleets. We've demonstrated the ability to do that with PTC. And it's something that we're certainly looking at it. It's the opportunity to take that into other markets and other products.

Matt Elkott
Analyst, Cowen & Co. LLC

Q

Great. Thank you, very much.

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

A

Thank you.

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 for your participation everybody. We look forward to meeting with you over the next couple months and certainly next quarter. Have a great day.

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