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Westinghouse Air Brake Technologies Corp. (WAB)
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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, welcome to the Wabtec Corp. Third Quarter 2019 Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note, this event is being recorded.

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

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

Thank you, Debbie. Good morning, everyone, and welcome to Wabtec's third quarter earnings call. With us today are President and CEO, Rafael Santana; CFO, Pat Dugan; and Corporate Controller, John Mastalerz. Before we start, I would like to point out a change to today's call. Based on feedback we received from you and our desire to drive continuous improvement, we will be sharing a slide presentation to support our discussion today during today's call. This presentation, along with our earnings release and financial disclosures, were posted on our website earlier today and can be accessed on our Investor Relations tab on wabteccorp.com.

As such, some statements we're making today are forward-looking and based on our best view of the world and our business today. For more detail of risks, uncertainties and assumptions relating to our forward-looking statements, please see 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.

And now, I will turn over the call to Rafael.

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

Thanks, Kristine, and good morning, everyone. Thanks for joining us. Today, I'll share some thoughts on our third quarter performance and strategic priorities for the remainder of the year. Then Pat will cover the quarter in greater detail, as well as an overview of both our Freight and Transit segments and our overall market dynamics.

As you can see on slide 3 of the presentation, our third quarter results were on track and we're well-positioned to deliver the continued strong performance. With sales of over $2 billion due to strength in our service businesses, continued growth in our international markets, as well as the Transit segment.

Our aftermarket offerings continue to be stable and prop the parts of our portfolio as well as the key differentiator as we partner with customers over the life cycle of their equipment. This includes our successful modernization program, which closed a significant milestone, which was a first of a kind international mods order in the third quarter.

We have also seen growth in Transit's aftermarket sales, which contributed to the overall Transit sales growth year-over-year. In line with our goal to drive continued margin expansions, we saw improvement in our adjusted consolidated margin as a result of higher freight mix and aftermarket along with early traction on our synergy and cost actions. We will continue to take action on improved project execution and will remain laser focused on the prioritization of resources and prudent capital allocation.
Cost reductions and synergy actions, stemming from Wabtec and the GE Transportation merger, are also ahead of plan. This is the result of several actions including a reduction of direct and indirect spend, efforts to consolidate over a million square feet across of our facility footprint and the discontinuation of several shared service contracts with GE ahead of schedule. I'm encouraged by what we have accomplished so far. And we remain confident that we will deliver a total of $250 million in synergies before 2022.

Finally, we continue to deliver strong cash generation in excess of $120 million for the quarter. This was largely driven by higher financial performance. Strong cash execution will allow us to drive increased shareholder value, while reducing our debt and creating the flexibility needed to fund organic growth, acquisitions, stock buybacks and dividends.

Based on our third quarter performance and current backlog and our assessment of key markets, we are affirming our cash flow from operations guidance for the full year of approximately $900 million. And we're narrowing our adjusted EPS guidance to the higher end of the range to between $4.15 and $4.20.

With that, I'll turn it over to Pat, who will provide you a deeper dive into the financials.

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Thanks, Rafael. As you can see from our press release this morning, we discuss both GAAP and adjusted numbers, so we encourage you to review the reconciliations that have been provided.

We continued solid momentum into the second half of the year and delivered a strong operating performance in the third quarter. We updated our guidance for sales, adjusted income from operations, adjusted EBITDA, adjusted EPS, and affirmed GAAP cash flow from operations, further illustrating that our business is performing well.

So turning to page 4 of our slide deck, sales for the third quarter were $2 billion. Adjusted sales were about $2.1 billion, which includes the effects of accounting policy harmonization. Increased sales year-over-year were mainly due to the merger of GE Transportation and increased revenues in Transit, offset somewhat by foreign exchange impact as well as lower sales for railcar components and electronics.

For the quarter, operating income was $169 million and adjusted operating income was $317 million, driven by favorable OE mix, seasonality in locomotive services and the timing of the policy harmonization. Adjusted operating income included $63 million from non-cash policy harmonization, consistent with our estimate in our original guidance at the close of the GE Transportation merger.

But adjusted operating income excluded pre-tax expenses of $85 million, detailed as follows: $69 million for transaction, restructuring and litigation costs; $16 million for onetime non-cash purchase price accounting charges. Again, please see our reconciliation table for the details.

In addition to these expenses, the company also had pre-tax expenses of $71 million or $0.28 in earnings per share for non-cash recurring purchase price accounting charges. They were not added back to the adjusted income from operations.

So looking at some of the other detailed line items. SG&A was $292 million, including $40 million of the $85 million in expenses I just discussed. We expect the adjusted run rate number for SG&A to be about $250 million
per quarter going forward. Engineering expenses increased to $59 million, due to mainly the addition of GE Transportation. And our amortization expense was $80 million. Going forward, we expect the amortization expense to be about $70 million per quarter.

Now looking at our net interest expense for the quarter, it was $58 million and was higher due to our debt balances. Our adjusted net interest expense was $54 million. Going forward, we expect interest expense to be about $55 million per quarter. Just remember that as a priority and a focus, we are intent on generating cash to reduce our debt and our interest expense.

Income tax expense was $23 million. And excluding the tax benefit from the transaction costs of the Transportation merger, adjusted income tax expense was $67 million for an adjusted effective tax rate of about 25%.

Our third quarter EPS, we had GAAP earnings per diluted share of $0.48 and adjusted earnings per diluted share of $1.03.

To reconcile the third quarter earnings per share, you can see the details in our press release. But just to recap, we have GAAP EPS of $0.48. You add back transaction, restructuring and litigation costs of $0.28; you include the policy harmonization, which adds $0.25; add back the one-time non-cash PPA of $0.06; and then reduce tax expense or adjust for tax expense for non-deductible transaction costs of $0.04; we end up with an adjusted EPS, excluding these items, of $1.03.

And to remind, the company also had after-tax expense of $0.28 per diluted share for non-cash recurring purchase price accounting charges, which we've not added back to the adjusted EPS. It's included in the GAAP numbers.

EBITDA, which we define as income from operations plus depreciation and amortization, was $292 million. And adjusted EBITDA was $440 million. Adjusted EBITDA included $63 million of policy harmonization but excluded the pre-tax expense of $85 million, which we previously discussed.

Depreciation was $43 million versus $18 million a year-ago quarter. The increase was due to the GE Transportation merger. And for the full year of 2019, we expect depreciation to be about $155 million. Amortization expense was $80 million compared to $10 million in last year’s quarter. The increase was also due to the merger. For the full year of 2019, we expect amortization expense to be about $245 million.

At September 30, our multiyear backlog was $22 billion and our rolling 12-month backlog, which is a subset of the multiyear backlog, was $5.7 billion. Just to note, the impact of foreign exchange on our total backlog number from last quarter was roughly $200 million.

Now turning to our segments, I’d like to discuss the market conditions and outlook along with the segment results in more detail. In the Freight segment, our business performed well despite challenging conditions in North America. North American carload volumes were down about 4% in the third quarter and are down about 3% year-to-date versus last year, driven largely by uncertain macro conditions that have led to a drop in intermodal traffic and declines in critical commodities like coal and agriculture.

We continue to expect carload volumes to be down mid-single digits versus last year and forecast the railcar build to be in the low 50s for the full year. These assumptions are included in our guidance for the full year.
Precision Scheduled Railroading, or PSR, is having some effect on new local orders, but continues to be offset by our modernization program and aftermarket service book. We continue to work closely with all the Class 1s to understand their current fleet strategies and remain confident that our business model as a technology leader and critical digital and service provider is very much aligned with driving efficiency and productivity for our customers.

Across our international installed base, we continue to see strong opportunities for growth, including regions like India where we will be delivering over 100 locomotives this year as part of our 1,000 locomotive contract, and are testing the 6,000-horsepower locomotive that is expected to enter revenue service soon.

Across the Freight segment, adjusted sales increased to $1.3 billion in the third quarter. The increase was due to the GE Transportation merger again, adding about $1 billion in sales. Organic sales decreased $45 million, primarily due to lower sales of freight car components and electronics. The segment operating income was $148 million and adjusted operating income was $256 million for an adjusted margin of 19%.

It is important to note that aftermarket services historically peak in the third quarter for the railroads as they prepare for winter. Therefore, the fourth quarter is usually a lower seasonal quarter for aftermarket services, which presents a mix in headwind for the segment. We have included – we have baked this into our fourth quarter assumptions. Finally, the segment backlog fell slightly from last quarter to $18 billion due to timing of locomotive and modernization orders.

Looking in the Transit sector, we continue to see steady growth in ridership and urbanization. Aging fleets across Europe and U.S. need to be upgraded, presenting unique opportunities for growth. And increased growth in infrastructure spending in emerging economies like India is driving tremendous growth opportunities for our business. Across our segment portfolio, we have firm multiyear backlog that will contribute to our growth.

Transit segment sales increased 3% to $706 million, driven by growth in OE sales. The increase was due to strong organic growth of about $44 million; acquisitions, which contributed about $2 million, which more than offset the negative impact of foreign exchange, which cost $26 million. This is the eighth quarter in a row where we've seen organic sales growth, which shows that our near-record backlog continues to drive multiyear top-line visibility.

Segment operating income was $56 million for an operating margin of 7.9%. Excluding about $11 million in restructuring costs, the adjusted operating margin for the segment was 9.4%, an improvement of about 20 basis points from last year.

We know, we recognize that we must do better in segment margins and the team is focused on driving margin improvement with prudent project selection, improved project execution and cost reductions. With these efforts underway, we remain confident that our Transit segment margins will improve over the company's strategic planning period. Excluding the impact of foreign currency, overall Transit backlog is down slightly but still stands at near-record highs.

Let's now turn to the balance sheet and our cash flow on page five of the presentation. We generated cash from operations of about $124 million, mainly due to the higher financial results. It's worth noting that in the quarter, we had about $40 million of cash outflows related to transaction costs, included in the results from cash from operations – so included in the cash from operations. Working capital at September 30 had receivables of about $1.7 billion, inventories were about $2 billion and payables were $1.1 billion. We expect improvement in our working capital performance going into the fourth quarter. Just to note, our receivables included unbilled receivables of $460 which were more than offset by customer deposits of $671 million.
At September 30, we had $587 million in cash and cash equivalents, mostly held outside the U.S. Our total debt was about $4.7 billion and net debt to adjusted EBITDA of about three times. Our debt and cash levels at the end of the quarter were impacted by the timing of cash received late in the quarter and the timing of our debt payments. However, by year-end, we are still targeting a net debt to adjusted EBITDA to be about 2.5 times.

Our capital expenditure in the quarter was $51 million compared to $25 million in the year ago. The increase was due mainly to the merger. And we expect to spend about $200 million in 2019.

Overall, our balance sheet continues to provide the financial capacity and flexibility to invest in our growth opportunities. And our goal is to be an investment-grade credit rating company.

Now let's shift to the 2019 guidance for a minute as illustrated on slide 6. And I will turn the call back over to Rafael.

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

Thanks Pat. Based on our third quarter performance, our current backlog and our assessment of conditions in our key markets, our guidance for adjusted sales is about $8.2 billion. Adjusted EBITDA of about $1.6 billion, adjusted income from operations of about $1.2 billion and adjusted earnings per diluted share to between $4.15 to $4.20. And we've maintained our GAAP cash from operation guidance to be about $900 million. I also want to emphasize that we expect to see a normal positive seasonality in the cash flow generation in the fourth quarter.

Despite some uncertainty on the end markets, we continue to focus on controlling what we can and that's by delivering and executing on our commitments for 2019. It's about accelerating our cost actions and synergies into the year-end. The adjusted guidance includes the add-back related to non-cash accounting policy harmonization, but excludes estimated expenses for the GE Transportation merger for transactional, restructuring and litigation costs, as well as onetime purchase price accounting charges.

Excluding these expenses, our adjusted operating margin target for the full year is about 14% and our adjusted effective tax rate for the full year is expected to be about 24%.

I'd also like to point out that our adjusted guidance includes after-tax expenses of about $0.88 per diluted share for non-cash, recurring purchase price accounting charges. In other words, we're not adding that back to our adjusted EPS guidance. And as you model for next year, any add-backs from policy harmonization won't be repeated either.

Finally, we plan to host our Analyst Day in the first quarter of 2020. We're locking down the specifics for that event and we will share you more details when they're available.

So as you plan, and as you've heard throughout the morning and you see on page 7, Wabtec has had a solid performance in the third quarter. Growth in our aftermarket and services revenues demonstrates the importance of our significant installed base across, really both Freight and Transit, and the resilience of our portfolio. Cost reductions and synergies stemming from the Wabtec and GE Transportation merger are on target and we fully expect to deliver a total of $250 million in synergies before 2022.
Second, we are delivering strong [audio gap] (20:42), which continues to place the company in a position of strength and we are poised to deliver significant shareholder value while reducing our debt and creating the flexibility needed to fund future organic and inorganic growth.

We remain confident on our cash flow guidance for the full year of approximately $900 million and we're updating GAAP EPS guidance to be between $2.05 and $2.10 and we're narrowing our adjusted EPS guidance to the high end of the range between $4.15 and $4.20. In addition, our significant installed base across the Freight and Transit market, along with our globally diverse business model, provides a strong foundation for long-term growth.

Finally, we continue to make solid progress on our integration efforts. Together, we have a strong team committed to perform. We're building a culture really focused on execution and accountability and we're seeing that execution in our results.

With that, I hope you have a better sense for what we're seeing across the company – our strengths, our challenges and our strategy for moving forward.

Now we're happy to take any questions you may have. Operator?

QUESTION AND ANSWER SECTION

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

Justin Long
Analyst, Stephens Inc.

Thanks and good morning.

Patrick David Dugan
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Good morning.

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

Good morning.

Justin Long
Analyst, Stephens Inc.

So maybe I'll start with a question on the North American Freight aftermarket business. Is there anything you can give us that could help us size up that business today? And as we think about the recent underperformance we've seen in rail volumes, maybe you could speak to how that business has performed in light of that? And what you're kind of baking into the guidance or your thoughts going forward?

Rafael O. Santana
President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.
Okay. Just a couple thoughts here. Number one, we’re certainly feeling the impact of both carloads being down over 3% in the year, also the elements of locomotive parkings.

What I'm happy to say is we've seen strength in our business in both transactional parts, multiyear service agreements, especially in international markets, where our locomotive fleets continue to grow.

And not to mention our mods program, which I think you heard me talk about, our first order internationally, which continues to provide us significant opportunities moving forward. We like the portfolio we have. And in North America, especially when you think of our digital and electronics portfolio, we feel like we have strong products to help customers be more efficient, winning on fuel efficiency. And I think we’re progressing on that.

Justin Long  
Analyst, Stephens Inc.

Okay. Great. And then on synergies, it was good to hear the update there. I'm assuming that you're seeing that number ramp over the course of this year. But could you maybe share what you're assuming for synergies in the fourth quarter? And if there's any initial thoughts around 2020 and the step-up we could see next year, that would be helpful.

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Yeah. So, Justin, this is Pat. We're still on our guidance of net synergies of about $20 million being realized for the full year of 2019. There's a lot of activity that's ongoing related to the cost to achieve those synergies and how they're impacting us.

And we're very confident that that $20 million net will be realized in the current year. And we're taking steps to – in some instances, to take the extra effort to see that we can accelerate those synergies into – going into next year.

We're not going to give a lot of guidance at this time about the synergy plan. But we did say that we feel very confident of the $250 million before 2022. And we'll continue to update people as we get into more 2020 guidance and our Investor Days.

Justin Long  
Analyst, Stephens Inc.

Okay. But from a high level, would it be fair to say in 2020 you'll see the biggest kind of year-over-year step-up over the course of the four-year implementation of the synergies?

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

Yes. Justin, if anything since I've started, I feel even more confident about our ability to drive improvement in our margins. We are seeing an acceleration on synergies. And we do expect that to go into 2020.

I think you've seen a number of plant consolidations that we've announced. In addition to that, we're certainly making the necessary adjustments for the business as we face new realities.

Justin Long  
Analyst, Stephens Inc.

Okay. Great. I'll leave it at that. Thanks for the time.
Patrick David Dugan  
*Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.*

Thanks, Justin.

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

Thank you.

Operator: The next question comes from Allison Poliniak with Wells Fargo. Please go ahead.

Allison Poliniak-Cusic  
*Analyst, Wells Fargo Securities LLC*

Hi, guys. Good morning.

Patrick David Dugan  
*Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.*

Morning, Allison.

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

Morning.

Allison Poliniak-Cusic  
*Analyst, Wells Fargo Securities LLC*

First, I want to talk on Transit. Margins have sort of been in the sub-10% range going back to last year. Wabtec was historically able to get it well above that. Is there something structural that you're seeing? I understand there's been some challenges there. But you guys want to be able to get back to that range at some point?

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

So, Allison, a couple points. Number one, back to the comment I made it before, if anything I'm really confident about our ability to drive margin the improvement.

And I've got to break that into two fronts. I think on the Transit side, Lilian [Leroux] and the team, he has added some new leadership, including a new CFO. They're being a lot more selective in terms of the quality of the order intake.

And just really increased the accountability in the business to make sure we continue to drive improvement from the [ph] as delivered (27:25) delivered margins. So I think early days, some progress. A long way to go in that business, but we're confident that – there.

On the Freight side of the house, I think we're really accelerating a lot of the synergy actions. We're starting to see some of the benefits. Pat mentioned the $20 million of net synergies we've guided for the year. We expect to exit the year ahead of that and to realize greater synergies in 2020.
Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.  

So, Allison, I would add to this is that the Transit business is also part of the overall synergy plan and restructuring. And if you look at the margins kind of on a quarter-over-quarter basis, I feel good that we're showing a positive trend, quarters that are improving. And the momentum going into the fourth quarter and into next year, we'll really start to show the benefits of those actions.

Allison Poliniak-Cusic  
Analyst, Wells Fargo Securities LLC  

Great. And then you had also mentioned the decline in electronics in the Freight side. Any color you can provide there, something unique going on that we should be aware of?

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

So a couple points. Number one, if you were to look into our sales this year versus last year, and if you were to exclude specifically PTC, you'd see a business that's still slightly growing. One thing we feel really positive and confident is our ability to grow our orders. And so far, year-to-date, we're seeing opportunities to consistently do that as we go into 2020.

Allison Poliniak-Cusic  
Analyst, Wells Fargo Securities LLC  

Okay. Thank you.

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.  

Thank you.

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

Thank you.

Operator: The next question is from Jerry Revich with Goldman Sachs. Please go ahead.

Jerry Revich  
Analyst, Goldman Sachs & Co. LLC  

Yes, hi, good morning everyone.

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.  

Good morning.

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

Good morning.
Jerry Revich  
**Analyst, Goldman Sachs & Co. LLC**

I'm wondering if you can talk about the puts and takes around the GE Transportation performance in the quarter. It looks like organic growth slowed to about 2% from better growth on a pro forma basis in the first half. Is that just timing of deliveries? And then, I'm also wondering if you could just expand on the $63 million non-cash policy harmonization point. Just help us understand that better, so we can get comfortable with that bag and lack of drag in 2020?

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

Okay. Well, let me start here. First, a couple of points to take into consideration in the third quarter. What you saw there is when you think of locomotive – equipment, freight equipments – that number came down in the third quarter in terms of the shipments and that's very much tied to timing of projects, so expected. At the same time, we saw pickup on revenues with regards to the freight services segment. And that's associated with the seasonality that's very much expected, as railroads really face into some of the preparation for inclement weather.

So those are certainly two elements that have impacted the numbers, but we have some other variation associated with policy harmonization. Pat, why don't you comment on that?

Patrick David Dugan  
**Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.**

So the policy harmonization, the majority of that number is really related to revenue recognition policy and really represents a bridge from the two – the legacy business to where we are today. These numbers are very consistent with what we included in our original guidance at the date we closed and even with some of the numbers that were provided in the merger documents in the pro forma and the proxy statements.

What it really represents is a business process that the GE Transportation used related to their service contracts, where the team would focus on getting more efficient. If you want to use the word lean, lean out some of the maintenance projects to understand what costs need to be incurred or don't need to be incurred, how we can do it more efficiently, how we can apply better productivity, better sourcing, or stagger some of the cost related to the projects in a manner that would be beneficial and take a cumulative catch-up adjustment related to those efforts.

The way they'll manifest for us on a go-forward basis is better profitability in those projects in the future years. That profitability will be real cash earnings and will show in margin expansion for those particular service contracts in each year as we do our planning.

So again, it's very consistent with what we've provided before. It's – the number hasn't changed – it hasn't grown. The seasonality matches the underlying business process and, in my mind, really represents the opportunity going forward in both our profitability and our cash.

Jerry Revich  
**Analyst, Goldman Sachs & Co. LLC**

Okay. And then the one million square foot reducing in combined capacity, can you just talk about where that is relative to the longer term targets? How far along are we in the facility rationalization phase? And what are you folks learning as you head through the process in terms of positive and any negative surprises as you consolidate the footprint? Thanks.
Rafael O. Santana  
*President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.*

I think at this point most of the announcements are really been around North America, and we expect that to be very much done within the early part of next year. I think there continue to be opportunities out there that we'll continue to be working on. I think another element to be mentioned, year-to-date, we've exited 84 office locations that were previously occupied and we're on track to exit close to 100 office locations by year-end. So, that's very much on track and we'll continue to look into the elements of driving further efficiency with the combined portfolios we have.

Jerry Revich  
*Analyst, Goldman Sachs & Co. LLC*

And I apologize for that part of the question, any significant variances versus the initial plan as it's being executed positive or negative – [ph] given a large delta in some (33:59)?

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

So, no. I'd say, if anything, we're just really working to accelerate some of these elements so we can capture more value earlier.

Jerry Revich  
*Analyst, Goldman Sachs & Co. LLC*

Okay. Thank you.

Operator: The next question is from Matt Elkott with Cowen. Please go ahead.

Matt Elkott  
*Analyst, Cowen and Company, LLC*

Good morning. Thank you.

Patrick David Dugan  
*Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.*

Good morning.

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

Good morning.

Matt Elkott  
*Analyst, Cowen and Company, LLC*

Rafael, if we see a modest 1% to 2% traffic growth on rail in North America next year, off of the very low base this year, what would that mean for your organic freight aftermarket business in North America directionally?

Rafael O. Santana  
*President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.*
Okay. A couple of points here. Number one, I'd stay, at this point, away from providing specific guidance in 2020. And I'll be careful with speculating on some of those changes translating immediately into the business, because you do have a number of locomotives parked. So, there's that element in place. So, what I'll tell you is we're seeing a very robust international business. We're growing our fleets internationally. When we look at the elements of transactional parts and multiyear service agreements, we see growth on those two segments. And it's part of really partnering with customers for better outcomes on their fleets, an element of reliability, but also an element of efficiency as they move forward.

Matt Elkott
Analyst, Cowen and Company, LLC

Okay. That's helpful. I mean, given the current environment in North America and the pockets of opportunities internationally, is it plausible that you could grow earnings next year?

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

Again, I'll not at this point provide specific guidance in 2020. But when we look at the opportunities, the pipelines, especially on the equipment side of the business, I'd say about two-thirds of that is coming from international opportunities. When you think of India, Southeast Asia, those are really part of important growth dynamics for our business and we're tracking a number of projects into their next phase. And we feel we have a strong backlog which really provides us visibility to multi-years. As I mentioned before, in the last two years, I think we've captured a number of multiyear orders, which provide us with visibility into the next couple of years. And we feel strong about that. It's very much the case for both the Transit and the Freight segment.

Matt Elkott
Analyst, Cowen and Company, LLC

Got it. And then just one final quick question on guidance this year. This whole year we've seen rail traffic decline become more and more pronounced. PSR implementation going according to plan, if not better actually, helped by the weak traffic. Meanwhile, you guys for two consecutive quarters have either maintained or slightly improved your guidance for the full year. So can you help us understand how you're able to maintain or slightly improve your guidance in the face of a worsening environment? Did you maybe start off with an especially conservative guidance, or – just trying to kind of bridge that gap between what happened with the environment and the fact that your guidance has remained intact?

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

I'll start first. I mean, I think there's an element of controlling what we can and we've been really strong on taking the necessary actions to adjust our business proactively to new realities. I think there's an element of the synergies and the framework we've laid out earlier on and we're certainly taking advantage of that in terms of accelerating this. And we feel very strong about the installed base we have and the ability to really partner with customers and support outcomes.

Our international fleet continues to grow and we're seeing some of those numbers coming through in terms of our transactional parts, in terms of our multiyear service agreement. And I wouldn't underestimate just the strength of the portfolio in terms of not just the elements of international, but when we look at just diversity of the portfolio to better navigate cycles than we've ever had before.
Matt Elkott  
Analyst, Cowen and Company, LLC  
Great. Thank you very much.

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

Operator: The next question is from Scott Group with Wolfe Research. Please go ahead.

Scott H. Group  
Analyst, Wolfe Research LLC  
Hey, thanks. Morning, guys.

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.  
Good morning.

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

Scott H. Group  
Analyst, Wolfe Research LLC  
I want to start on the gross margins, 34% in the quarter. We haven't – I don't know if we've ever been there before. Can you just talk about what's driving that and how sustainable that is, how you think about gross margins going forward?

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.  
Yes. Scott, I mean, clearly, it's – the quarter has got some benefits from the mix of sales. You have a higher mix of aftermarket sales, especially in the freight area and the – and coupled with the policy harmonization – I think it really just lends itself to a really good margin performance here. It's – so that mix is the biggest impact.

Scott H. Group  
Analyst, Wolfe Research LLC  
To the extent we think that OE pressures continue, do you think that 34% gross margin is sustainable?

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.  
No. I think when you kind of take a step back, you really need to look at that full year view of sales mix. We're going to probably for the full year get back to our more historic mix of about 40%, 45% OE, 60% to 55% on the aftermarket side. That's kind of our traditional mix of sales for a full year period. And when you have that kind of traditional mix, you're going to end up with margins that are pretty consistent with our guidance. I just think that
our third quarter just ends up being over-weighted to aftermarket. The OE side of our business for Q3 is on – especially in Freight – is somewhere around 30%.

Scott H. Group
Analyst, Wolfe Research LLC

Okay. Now, I get you don't want to talk about 2020 yet. But can you maybe help us with some of the accounting puts and takes that we should be thinking about for – both from an earnings standpoint and a cash flow standpoint? And then, have you guys made any decisions in terms of guidance next year if it's going to be adjusted earnings or for cash earnings guidance, just any visibility?

Patrick David Dugan
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Yeah. Yeah. No. I mean, we've obviously been going through our IR strategy and talking about how we cast and describe the business to you and to others. We're going to move to more of a cash EPS kind of viewpoint. Obviously, there's a lot of pluses and minuses in the results. It's a little bit noisy, because we really want to try and simplify it by going to a cash EPS goal.

And then also, take these accounting harmonization type things and really step back from them, because we're going to be on a policy. We're going to have an approach and that is combined and consistent across the company. And we'll just include all those kind of aspects of accounting into our guidance.

So think of it as including all the accounting harmonization type things and adding back for the non-cash kind of expenses that have occurred as part of the transaction.

Scott H. Group
Analyst, Wolfe Research LLC

So what are the specific sort of puts and takes for next year from a cash flow standpoint then?

Patrick David Dugan
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

So what do you mean puts and takes for cash flow? I mean I think that you're going to end up – I don't want to get into – we agree that we don't want to talk too much about 2020 yet.

But I think that you're really kind of describing, if you look at the full year impact of these – those things, not including the policy harmonization, but not including the impact of the recurring PPA, I think those are the kind of aspects of modeling that we should consider.

Scott H. Group
Analyst, Wolfe Research LLC

Okay. Thank you.

Patrick David Dugan
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

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

Thank you.

Operator: The next question comes from Chris Wetherbee with Citigroup. Please go ahead.

James Monigan
Analyst, Citigroup Global Markets, Inc. (Broker)

Hi, guys. James Monigan on for Chris. Wanted to ask about the relationship between rail volumes and your Freight revenue. Should we expect your revenue to improve lockstep when rail volumes improve? Or should there be a lag in between it? And also, if rail volumes continue to decelerate, should we expect your revenue growth to decelerate as well?

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

I think there's a correlation, but there's certainly going to be an element of a lag, especially when you take into consideration the number of parked assets that are currently out there. That's of course [ph] a little picked up from (44:15) – if you think just about our services business, which will – filled out in a more direct way.

James Monigan
Analyst, Citigroup Global Markets, Inc. (Broker)

Got it. Then also wanted to ask about the locomotive backlog. Could you give us an update there? I think last quarter it was 1,900 locomotives and 800 mods. What would that be now? And what's the international mix? Just trying to get an understanding of how it's changing, if there's cancellations, things like that.

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

So from that number, I'd say – from that combined number it's – the counts have come down to right around 3%. And that's where we stand it. And you've got about very much, say, 50% of that backlog. I should say two-thirds of that pipeline tied to international and about one-third tied to North America.

James Monigan
Analyst, Citigroup Global Markets, Inc. (Broker)

Thank you.

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

Thank you.

Operator: The next question comes from Steve Barger with KeyBanc Capital Markets. Please go ahead.

Steven Barger
Analyst, KeyBanc Capital Markets, Inc.

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

Good morning, Steve.

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Morning, Steve.

Steven Barger  
Analyst, KeyBanc Capital Markets, Inc.

You affirmed the operating cash flow of $900 million, which includes the $100 million of merger expense. As we think about organic growth trends next year and synergies and working cap initiatives, should we think about that as a target to achieve for next year or more of a floor to build on?

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

That sounds like 2020 guidance to me, but, yeah. I think the cash flow view is, it continues to be strong. I think we’ve talked a lot about some of the headwinds we – were reality for the company, as we combined. I think it’s – I think, with all cases, our target, our expectation is to do better. And so that $900 million is with the type of EBITDA profile that we’ve provided in previous communications would indicate that it’s – we have a real opportunity to improve upon it.

Steven Barger  
Analyst, KeyBanc Capital Markets, Inc.

Got it. Okay. And just going back to your comment a few minutes ago about looking to more of a cash EPS outlook. I mean that – you have $0.88 of non-cash amortization on the income statement right now. So in that framework you’d be adding that back in terms – and trying to get people to think about earnings profile in that context?

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Right. I think so. I think it would be very useful. And I think it goes well with the EBITDA profile of the company, and that's the plan. So we're going to go forward in terms of 2020 guidance and describing the business and include that in the numbers.

Steven Barger  
Analyst, KeyBanc Capital Markets, Inc.

Right. So a nice step up from that. As we think about the impact of integration synergy and the Transit projects you mentioned in the prepared remarks, do you expect to drive more margin expansion from Freight or Transit next year?

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

We're certainly driving to – well, margin expansion in both segments. I think we're coming from certainly a low base on the Transit side, so we do expect a broader shot of opportunities there, but it goes for both segments.
Steven Barger  
Analyst, KeyBanc Capital Markets, Inc.

Yeah. Okay. And just one last one. When do the cash outflows from the transaction roll off? Are we about done with that? Or will we be done in calendar 2020?

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Yeah, so in terms of transaction costs, I think we should be pretty close to having most of those paid here in the third quarter. We still have some restructuring costs that we'll incur, some cash, some non-cash. We'll be updating on those type of things. And also cash to achieve our synergies will be baked into the guidance.

But I think that the vast majority of specific transaction costs like fees and professional fees and banker fees, things like that, have been taken care of.

Steven Barger  
Analyst, KeyBanc Capital Markets, Inc.

Great. Thanks for the time.

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Okay.

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

Thank you.

Operator: The next question comes from Matt Brooklier with Buckingham Research. Please go ahead.

Matthew Brooklier  
Analyst, The Buckingham Research Group, Inc.

Hey. Thanks and good morning.

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Morning.

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

Good morning.

Matthew Brooklier  
Analyst, The Buckingham Research Group, Inc.

What drove the restructuring charge in Transit in the quarter?
Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

So as part of the consolidation of some of the operating facilities – we talked about the consolidation of about 1 million square feet of operating facilities – that did have some impact on our Transit businesses. The cost incurred on moving some of that work. It's transaction costs that – restructuring costs rather – that we included in the add-back.

Matthew Brooklier  
Analyst, The Buckingham Research Group, Inc.

Okay. So related to the merger and integration process of what's going on.

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Absolutely. And we have facilities that do both. Yeah, exactly. They do both Transit and Freight work. And as we consolidate them there's impact to both sides of the segments.

Matthew Brooklier  
Analyst, The Buckingham Research Group, Inc.

Okay. Got it. Good to hear. And then, I'm going to ask about GE, a little bit differently. Rafael, as we look at the business now, what percentage of revenue is being derived from North America? And then, what percentage of revenue is being derived from your international businesses?

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

I think we continue to see international, [ph] will continue(49:56) to be more than 50% of our business. And as we look into, I'll call it the pipeline for growth, especially going to 2020, that wants to be a more robust pipeline in terms of the orders case.

Matthew Brooklier  
Analyst, The Buckingham Research Group, Inc.

Okay. So, the more tailwind than headwind, let's say, 55%, 60% of the business at GE going forward, the balance is North America and it's pretty clear that we've had more headwinds than tailwinds in that business right now?

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

Yeah. Softer from a North America perspective versus internationally.

Matthew Brooklier  
Analyst, The Buckingham Research Group, Inc.

Okay. And then, you talked to the modernizations of the locomotives. It sounds like it's a growth business. I think you quantified it loosely as you're going to be doing a couple hundred of those units this year. Is there any way to maybe give a little bit more color in terms of the magnitude of modernizations and is that going to be a tailwind as we look to 2020?
Rafael O. Santana  
*President, Chief Executive Officer & Director, Westinghouse Air Brake Technologies Corp.*

I think we have the opportunity to make that a continuous tailwind for us. I think we spoke about the opportunity of modernizing installed base and I think the order we got in the first quarter internationally is really the first one. And we'll certainly have a large installed base internationally to build from. So, I think we've done that for North America. It's an opportunity moving forward.

Matthew Brooklier  
*Analyst, The Buckingham Research Group, Inc.*

Okay, great. Appreciate the time.

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

Thank you.

Operator: The next question comes from Saree Boroditsky with Jefferies. Please go ahead.

Saree Boroditsky  
*Analyst, Jefferies LLC*

Hello.

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

Hi, good morning.

Saree Boroditsky  
*Analyst, Jefferies LLC*

Good morning. Last quarter you talked about the strength in your mining business. Can you update us on what you're seeing in the mining industrial business to date and maybe expectations going forward?

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

When I think of the mining business, I think we're continuing to see a robust — I'll call it services — opportunities for upgrades. There's certainly a lot of changes on that market right now and there could be elements of softness as you go into 2020, but I wouldn't be saying more than that.

Saree Boroditsky  
*Analyst, Jefferies LLC*

Okay. And I know you guys have moved away from providing too much color on locomotive deliveries. But can you just help us understand as you think about 2020, just it seems like it's going to be tough comparables on the Class 1 side of the business. Can you offset these with international deliveries?
Sure. I think, number one, as I mentioned before, I think we’ve got about a third of the pipelines probably associated with North America, two-thirds associated with our international opportunities. I think it's very important the fact that we have multiyear orders, especially work in the course of the last couple of years, that provides us visibility to the next couple of years for the business. And that's true for both the Freight and the Transit side of the business.

Saree Boroditsky  
Analyst, Jefferies LLC

Okay. And then just one last thing. This has been asked a couple different ways. But on the accounting policy harmonization, you have a $115 million benefit to sales to date. Is that all reversed out in 2020?

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Yes, exactly. So, when we get into the guidance next year, we will not be taking any of these as add-backs or adjustments; they will be included in our guidance.

Saree Boroditsky  
Analyst, Jefferies LLC

But it will be a headwind to sales for next year since they're included in 2019?

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Yes. Well, I think the way to think of it is it will be a headwind to sales because the process, the way it was handled it in the past was to book these kind of cumulative adjustments for these projects. Where it will be a benefit or a tailwind will be the fact that it will result in real margin expansion, not nearly as much because it's really kind of within the quarter as incurred in real cash, but it will be a tailwind as these projects are – we execute on these projects and get the benefits.

Saree Boroditsky  
Analyst, Jefferies LLC

No, I appreciate that. I'm just trying to understand -- 2019 to 2020 – that revenue is a headwind. Okay, that's perfect. Thank you so much for taking my question.

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Thank you.

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

Thank you.

Operator: The next question comes from Ken Hoexter with Bank of America. Please go ahead.

Ken Hoexter  
Analyst, Bank of America Merrill Lynch
Great. Good morning Rafael, Pat, and Kristine.

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

Good morning, Ken.

Ken Hoexter  
Analyst, Bank of America Merrill Lynch

I guess to revisit Scott's questions earlier on the margins, but maybe just to take it to the Freight side a little bit more direct. You mentioned that there's some mix impacts in the third versus fourth quarter and you expect the margin impact. Can you quantify that, I guess, shift into the fourth quarter? And I guess really looking for what's the margin pullback you're expecting because of that.

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Yes. So I think we've talked about where we think the margins will be for the full year and it will be roughly the 14% that we talked about. Where is the mix, where is – how is this manifesting itself – if we have higher OE deliveries on some projects for locos and other OE projects which is – and we talked about the fact that the third quarter, especially for freight loco services, is probably always the strongest part of our – the strongest season for that time because of the timing and how the Class 1s do their maintenance.

So I think between those elements and the guidance you can kind of get a sense of where the quarter EBIT margin's going to be and we've included all those factors, those assumptions, in our full year guidance.

Ken Hoexter  
Analyst, Bank of America Merrill Lynch

Okay. And then, I guess, maybe just a bigger-picture thought you ramped up your Freight backlog for the next 12 months, but obviously it also declined long term. Maybe just your thoughts on kind of the – your view on the market right now?

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

I think we continue to look at some robust opportunity internationally. And as we go around the world, I mean Asia seems to certainly be a brighter spot for us, whereas if I talk about Australia and New Zealand or India, we certainly see a good amount of opportunity in Indonesia as well.

As far as the Transit market goes, the team is working strongly on opportunities in both Europe and North America as well. We're following through a number of the next phases of projects we've done in Africa. And I think that's an exciting part of the portfolio, where we have the opportunity to offset some of the softness of North America.

Ken Hoexter  
Analyst, Bank of America Merrill Lynch

And just a last one if I can on the U.K. transit contract. Any update on kind on when that fully rolls off and, I guess, ability to kind of end that margin impact overhang?
Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Yes. I mean, we’re largely still on the same schedule that we talked about before. The margin is very low and we have about $25 million of revenue impact quarter, every quarter, okay. So we’re still looking, as these projects wind up at the end of 2020 with a little bit still – not nearly so much $25 million anymore – but a little bit rolling into the first quarter of 2021. So we see this as – it’s a little bit of a margin headwind for – it’s part of our plan to burn off this backlog and be more selective on any projects going forward so we don’t have the same situation.

I just want to emphasize one thing about the backlog question. I mean, quarter-to-quarter we have fluctuations. It’s a lumpy business. You win projects. You add them and so you can have some kind of variability quarter-to-quarter and really, for me, is we focus on the order intake and kind of year-over-year view.

Ken Hoexter  
Analyst, Bank of America Merrill Lynch

Is there any seasonality to that, to kind of timing of wins or just consistent on the fluctuation side?

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

No. Like I said, it’s just about your customer’s timing and when they’re awarding the projects. And so, they can have some pretty – it can have some impact to the quarter-to-quarter on how you look at the backlog change.

Ken Hoexter  
Analyst, Bank of America Merrill Lynch

Helpful insight. Appreciate it. Thank you.

Patrick David Dugan  
Chief Financial Officer & Executive VP-Finance, Westinghouse Air Brake Technologies Corp.

Thanks.

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

Thanks.

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

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

Thank you, Debbie. Thank you everyone for your participation today. We look forward to speaking to you next quarter and we’ll have more details about our upcoming Analyst Day early next year. Take care. Thank you.

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