Wabtec Corporation (WAB) CEO Rafael Santana on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-31-19 Earnings Summary

Press Release *10-Q* *Slides*

EPS of $1.03 beats by $0.02 | Revenue of $2.05B (90.45% Y/Y) misses by $-117.85M

Earning Call Audio

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Wabtec Corporation (NYSE:WAB) Q3 2019 Earnings Conference Call October 31, 2019 10:00 AM ET

Company Participants

Kristine Kubacki - Vice President, Investor Relations

Rafael Santana - President and Chief Executive Officer

Patrick Dugan - Chief Financial Officer and Executive Vice President

John Mastalerz - Corporate Controller

Conference Call Participants

Justin Long - Stephens

Allison Poliniak - Wells Fargo

Jerry Revich - Goldman Sachs

Matt Elkott - Cowen

Scott Group - Wolfe Research

Steve Barger - KeyBanc Capital Markets

Matt Brooklier - Buckingham Research

Saree Boroditsky - Jefferies

Ken Hoexter - Bank of America

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

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 on 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 detailed 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 Santana

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 three of the presentation, our third quarter results were on track and we're well-positioned to deliver the continuous 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 segments.

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 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 we'll remain laser focused on the prioritization of resources and prudent capital allocation. Cost reductions and synergy actions, stemming from Wabtec and 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 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 Dugan

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 today 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 four 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 lower part 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 estimates in our original guidance at the close of the GE Transportation merger.

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

In addition to these expenses, the company see also had pretax 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 for 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 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 cost 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 is - we've now 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 that 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 30th, 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 decline 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 contracts, 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 the lower seasonal quarter for aftermarket services, which presents a mix in headwind -- for the segment.

We have included, we haven't baked this into -- 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 the Europe and U.S. need to be upgraded, presenting unique opportunities for growth.

And increased growth and infrastructure spending in emerging economies like India is driving tremendous growth opportunities for our business. Across our segment portfolio, we affirm 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 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 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 Santana

Thanks Pat. Based on our third quarter performance, our current backlog and our 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 noncash accounting policy harmonization, but excludes estimated expenses for the GE Transportation merger or 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 expense 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 are available.

So as you plan - as it works 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 - 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 are 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 chance for what we're seeing across the company, our strengths, our challenges and our strategy for moving forward.

Now, we are happy to take any questions you may have. Operator?

Question-and-Answer Session

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

Thanks. And good morning.

Rafael Santana

Hi, good morning.

Justin Long

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 can speak to how that business has performed in light of that and what's your, kind of, baking into the guidance or your thoughts going forward?

Rafael Santana

Okay. Just sharing a couple of thoughts here. Number one, we're certainly feeling the impact of 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 the international markets where our locomotive fleets continue to grow.

And not to mention our mods program, which I think you hardly talked about in the first quarter internationally, which continues to provide the significant opportunities moving forward. We like the portfolio we have in North America, especially when you think about 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

Okay, great. And then on synergies, it would be 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 will be helpful.

Patrick Dugan

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 all 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 for 2022 and we'll continue to update people once we get into more 2020 guidance and our investor days.

Justin Long

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?

Patrick Dugan

Yes. Justin, if anything – since I've started, I'm feeling more confident about our ability to drive improvement in our margins. We are seeing an acceleration in synergies and we do expect that to go into 2020. I think you've seen a number of planned consolidations that we've announced. In addition to that we're certainly making the necessary adjustments for the business as we face the new realities.

Justin Long

Okay. Great. I will leave it at that. Thanks for the time.

Patrick Dugan

Thank you.

Operator

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

Allison Poliniak

Hi, guys. Good morning.

Rafael Santana

Good morning, Allison.

Allison Poliniak

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

Rafael Santana

So Allison a couple of points. Number one back to the comments I made it before, if anything I'm really confident about our ability to drive margin improvement. And I've got to break that into two fronts. I think on the transit side, Lillian and the team added new leadership including a new CFO, they're being a lot more selective in the terms of the quality of the order intake and there is really increased the accountability in the business to make sure we continue to drive improvement from the outsource deliver margins.

So I think early days some progress a long way to go in that business, but we are confident there. On the Freight side of the house, I think we are really accelerating a lot of the synergy actions.

We're starting to see some of the benefits. That mentioned $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 Dugan

So Allison, I would add to that is that the Transit business is also part of the overall synergy plan and restructuring. And if you look at the margin 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 into next year will really start to show the benefits of those actions.

Allison Poliniak

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?

Rafael Santana

So a couple of 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'll 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

Okay. Thank you.

Rafael Santana

Thank you.

Operator

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

Jerry Revich

Yes, hi, good morning everyone.

Rafael Santana

Good morning.

Patrick Dugan

Good morning.

Jerry Revich

I'm wondering if you can talk about the puts and takes about 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 noncash policy harmonization point. Just help us understand that better, so we can get comfortable with that back and lack of drag in '20?

Rafael Santana

Okay. Let me start. 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 variation associated with policy harmonization. Pat, why don't you comment on that?

Patrick Dugan

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 and 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 provided before. It's -- the number hasn't changed, 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

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 the positive and any negative surprises as you consolidate footprint? Thanks.

Rafael Santana

I think at this point most of the announcements are really being around North America, and we expect that to be very much done within the early part of next year. I think – continue to be opportunities out there that we continue to be working on.

I think another element to mention 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

And I apologize. For that part of the question, any significant variances versus the initial plan as its being executed positive or negative -- consolidation?

Rafael Santana

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

Okay. Thank you.

Operator

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

Matt Elkott

Good morning. Thank you.

Rafael Santana

Good morning.

Matt Elkott

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

Rafael Santana

Okay. A couple of points here. Number one, at this point I'd stay 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 part. 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 fleet 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 and element of reliability but also an element of efficiency as they move forward.

Matt Elkott

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

Rafael Santana

Again, I'll not at this point provide specific guidance in 2020. But when we look at the opportunity, the pipelines, especially on the equipment side of the business, I'd say about two-thirds of that is coming from international opportunities. And 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 this ability to multiyear. So, as I mentioned before in the last two years, I think we've captured a number of multiyear orders, which provided 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

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?

Could you maybe start off with 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 Santana

I'll start first on the 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 part 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 a cycle than we've ever had before.

Matt Elkott

Great. Thank you very much.

Rafael Santana

Thank you.

Operator

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

Scott Group

Hey, thanks. Morning, guys.

Rafael Santana

Good morning.

Scott Group

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 has sustainable it is, how you think about gross margins going forward?

Rafael Santana

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 of harmonization. I think it really just lends itself to a really good margin performance here. So that mix is the biggest impact.

Scott Group

To the extent we think that ROE pressures continue, do you think that 34% gross margin is sustainable?

Rafael Santana

No. I think we kind of take a step back. We 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 -- 50 to -- 50%, 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 tends up being over weighted to the aftermarket. The OE side of our business for Q3 is on -- especially in Freight is somewhere around 30%.

Scott Group

Okay. I get you don't want to talk about 2020. 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 the 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?

Rafael Santana

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 some more of cash EPS kind of viewpoint.

Obviously, there's a lot of pluses and minuses in the results. It's a low bit noisy, because we really want to try to 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 -- 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 Group

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

Rafael Santana

So when you mean puts and takes free cash flow, I mean, I think that you're going to end up -- I don't want to get into it. We agreed that we don't want to talk too much about 2020 yet, but I think it's really kind of describing it if you look at the full year impact of these 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 Group

Okay. Thank you.

Rafael Santana

Yeah. Thank you.

Operator

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

Unidentified Analyst

Hi, guys. It's Jason [ph] singing on for Chris. I wanted to ask about the relationship between rail volumes and 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 revenue – your revenue growth to decelerate as well?

Rafael Santana

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, if you looked at – definitely, if you think just about our services business, which we'll filled out more directly.

Unidentified Analyst

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 to kind of getting an understanding of how it's changing, if there's cancellations, things like that.

Rafael Santana

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

Unidentified Analyst

Thank you.

Rafael Santana

Thank you.

Operator

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

Steve Barger

Hi. Good morning.

Rafael Santana

Good morning, Steve.

Steve Barger

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

Patrick Dugan

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

Steve Barger

Got it. Okay. And just going back to your comments 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 of – and trying to get people to think about the earnings profile in that context?

Patrick Dugan

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.

Steve Barger

Right. So a nice step up from that. As we think about the impact of integration synergies 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 Santana

We're certainly driving to – well, margin expansion on both segments. I think we're coming from certainly a low back on the Transit side, so we do expect a broader shot of opportunities there, but it goes for both segments.

Steve Barger

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

Rafael Santana

Yeah. In terms of transaction costs, I think we should be pretty close to having most of those pay here in the third quarter. We still have some restructuring costs that will incur some cash, some non-cash. We'll be updating on those types of things and also cash achiever synergies will be baked into the guidance. But I think the vast majority of the specific transaction costs like fees and professional fees and banker fees, things like that have been taken care of.

Steve Barger

Great. Thanks for the time.

Rafael Santana

Okay. Thank you.

Operator

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

Matt Brooklier

Hey. Thanks and good morning.

Rafael Santana

Good morning.

Matt Brooklier

What is sort of restructuring charge in Transit in the quarter?

Rafael Santana

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 -- restructuring costs rather that we included in the add back.

Matt Brooklier

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

Rafael Santana

Absolutely. And we have facilities that do both. Yeah. Exactly they do both transit and freight work. And as we consolidate them there is impact to both sides of the segments.

Matt Brooklier

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 Santana

I think we continue to see international that wants to be more than 50% of our business. And as we look into, I call the pipeline for growth especially going to 2020 that wants to be a more robust pipeline in terms of the order stake.

Matt Brooklier

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

Rafael Santana

Yeah. Softer from a North America perspective versus internationally.

Matt Brooklier

Okay. And then, you talk to the modern ideations 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 more color in terms of the magnitude of modernization? Is that going to be a tailwind as we look to 2020?

Rafael Santana

I think we have the opportunity to make that 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.

Matt Brooklier

Okay, great. Appreciate the time.

Rafael Santana

Thank you.

Operator

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

Saree Boroditsky

Hello.

Rafael Santana

Hi, good morning.

Saree Boroditsky

Good morning. The 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 Santana

When I think of the mining business, I think we're continuing to see a robust services opportunity 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

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; 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?

Rafael Santana

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 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

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

Patrick Dugan

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

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

Patrick Dugan

Yes. Well, I think the way to think of it is it will be a headwind to sales because the process, the way we've 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

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 Dugan

Thank you.

Rafael Santana

Thank you.

Operator

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

Ken Hoexter

Great. Good morning Rafael, Pat, and Kristine. 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.

Rafael Santana

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 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 kind of 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 – quarter EBIT margin is going to be and we've included all those factors those assumptions in our full year guidance.

Ken Hoexter

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

Rafael Santana

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 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

And just 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 – in that margin impact offering?

Rafael Santana

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 at 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 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 you can have some kind of variability quarter-to-quarter and really for me as we focus on the order intake and kind of year-over-year view.

Ken Hoexter

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

Rafael Santana

No. Like I said, it's just about new customer timing and when they're working on 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

Helpful. Appreciate it. Thank you.

Rafael Santana

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

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.