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Republic Services, Inc. (RSG) CEO Donald Slager on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-30-19 Earnings Summary

Press Release SEC *10-Q*

EPS of $0.91 beats by $0.05 | Revenue of $2.65B (3.16% Y/Y) misses by $-45.72M

Earning Call Audio

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Republic Services, Inc. (NYSE:RSG) Q3 2019 Earnings Conference Call October 30, 2019 5:00 PM ET

Company Participants

Nicole Giandinoto - Senior Vice President Finance and Treasurer

Donald Slager - Chief Executive Officer

Jon Vander Ark - President

Chuck Serianni - Executive Vice President and Chief Financial Officer

Conference Call Participants

Tyler Brown - Raymond James & Associates, Inc.

Derek Spronck - RBC Capital Markets

Michael Feniger - Bank of America Merrill Lynch

Brian Maguire - Goldman Sachs

Sean Eastman - KeyBanc Capital Markets Inc.

Michael Hoffman - Stifel Nicolaus

Jeff Silber - BMO Capital Markets

Noah Kaye - Oppenheimer & Co. Inc.

Operator

Good afternoon, and welcome to the Republic Services' Third Quarter 2019 Investor Conference Call. Republic Services is traded on the New York Stock Exchange under the symbol RSG. All participants in today's call will be in a 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 Nicole Giandinoto, Vice Senior President [sic] [Senior Vice President] Finance and Treasurer. Please go ahead.

Nicole Giandinoto

Good afternoon, everyone, and thank you for joining us. I would like to welcome everyone to Republic Services' third quarter 2019 conference call. Don Slager, our CEO; Jon Vander Ark, our President; and Chuck Serianni, our CFO are joining me as we discuss our performance.

I would like to take a moment to remind everyone that some of the information we discuss on today's call contains forward-looking statements, which involve risks and uncertainties and maybe materially different from actual results. Our SEC filings discuss factors that could cause results to differ materially from expectations. The material we discuss today is time-sensitive. If in the future, you listen to a rebroadcast or rerecording of this conference call, you should be sensitive to the date of the original call, which is October 30, 2019.

Please note that this call is the property of Republic Services, Inc. Any redistribution, retransmission or rebroadcast of this call in any form without the expressed written consent of Republic Services is strictly prohibited. I want to point out that our SEC filings, our earnings press release, which includes GAAP reconciliation table and the discussion of business activities, along with a recording of this call, are all available on Republic's website at republicservices.com. I want to remind you that Republic's management team routinely participates in Investor Conferences. When events are scheduled, the dates, times and presentations are posted on our website.

Finally, please note, our third quarter volume results discussed on today's call are on the workday adjusted basis. Therefore, they exclude the benefit of an additional workday in the quarter versus the prior year.

With that, I would like to turn the call over to Don.

Donald Slager

Thanks, Nicole. Good afternoon, everyone, and thank you for joining us. We are pleased with our third quarter results. We continued to successfully increase price in excess of our cost inflation, expand underlying EBITDA margin by 60 basis points and drive double-digit growth in adjusted EPS and adjusted free cash flow.

During the quarter, we continued to see additional weakness in global recycled commodity markets and further declines in U.S. rig counts and drilling activity. Despite these macro headwinds, the business is performing ahead of plan. As a result, we are raising our full-year adjusted EPS guidance to $3.28 to $3.30. We also expect to achieve the upper-end of our adjusted free cash flow guidance range.

In the third quarter, we generated $372 million of free cash flow and approximately $1 billion of cash flow year-to-date. We utilized our free cash flow to invest back into our business and returned the remainder of – to our shareholders through dividends and share repurchases. We believe investing our free cash flow in acquisitions is the best way to increase long-term shareholder value.

We look for appropriately priced solid waste acquisition opportunities to further strengthen our leading market positions and expand into new markets with attractive growth profiles. We also look for opportunities to increase the scale of our environmental service offerings, including materials management and waste disposal. These offerings address the needs of our upstream E&P customers and downstream refinery and petrochemical customers.

In the third quarter, we invested approximately $275 million in acquisitions. This brings our year-to-date acquisition investment to $490 million. Our acquisition pipeline remains robust. For the full-year, we are on track to invest approximately $550 million and believe 2020 could be another strong year of acquisition investment.

Regarding 2020, given the predictability and consistency of our business, we are providing a preliminary outlook as we have in prior years. We are midway through our annual planning process. And assuming current business and economic conditions continue, we project the following for 2020, adjusted EPS of $3.46 to $3.51 and adjusted free cash flow of $1.15 billion to $1.2 billion.

We will achieve this by continuing to prioritize the safety of our people and communities above all else, targeting value-oriented customers to drive profitable volume growth, leveraging our scale to minimize costs and drive operational improvements, continuing to make disciplined acquisition investments to grow free cash flow, and further investing in technology to enhance the customer and employee experience. Similar to prior years, we will provide detailed financial guidance for 2020 in February of next year.

Before I turn the call over to Jon, I'd like to congratulate the Republic team for being certified as a great place to work for the third consecutive year. We believe an engaged and diverse workforce is the greatest indicator of our success. This is yet another recognition of the inclusive culture we are building at Republic, one where the best people come to work.

I'll now turn the call over to Jon to discuss our third quarter operating performance. Jon?

Jon Vander Ark

Thanks, Don. In the third quarter, the pricing environment remained favorable. We continued to price in excess of our cost inflation and maintain customer defection or churn of 7%. Core price, which represents price increases to our same-store customers, net of rollback was 4.7%. This included open market core price of 5.7% and restricted core price of 3.1%.

Average yield, which measures the change in average price per unit and takes into account customer churn, was 2.8%. Average yield was strong across all lines of business. In our small-container collection business, average yield was 4.1%. In our landfill MSW business, average yield was 3.3%. This level of landfill MSW pricing is especially impressive, given approximately two-thirds of our MSW volume is restricted.

As you can see, our team has made great progress moving our disposal contracts away from CPI-based pricing to a more favorable pricing mechanism. In total, including both collection and disposal-related contracts, we've converted $775 million, or 31% of our CPI-based book of business to a waste-related index, or fixed rate increase of 3% or greater.

Average yield is also benefiting from improvements in our municipal recycling collection contract. We are working to ensure, they reflect the true cost of recycling and include a more equitable risk-sharing arrangement. We've now secured price increases from approximately 35% of our municipal recycling collection customers.

Turning to volume. Total volume in the quarter decreased 40 basis points and was in line with our expectations. Underlying volumes increased 10 basis points after normalizing for the impact of intentionally shedding certain volumes, including non-regrettable contract losses in our residential collection business and work performed on behalf of brokers. We expect the broker-related headwinds in our small-container business to decrease in 2020, as we anniversary some of the larger losses.

In the third quarter, volume across all collection lines of business improved sequentially. At the same time, average yield for our total collection business was 3.1%. On the disposal side of the business, MSW volume growth continued to be strong at 1.8% and C&D volumes increased 15.8%. As expected, special waste volumes decreased versus the prior year due to a difficult comp. Looking forward, the Q4 pipeline remains strong.

During the quarter, recycled commodity prices continued to decline. Our average price per ton in the third quarter was $72. This represented a $6 sequential decrease from the second quarter and a $34 decrease versus the prior year. Prices have continued to decline in October, and we estimate our October price per ton to be approximately $68.

Importantly, we continue to make progress transforming recycling into a more durable, economically sustainable business model. As a result, next year, we expect our sensitivity to commodity prices to decrease.

Next, turning to our environmental services business. In the third quarter, rig counts in the U.S. continued to decline. At the end of September, total U.S. rig counts were down 18% versus the prior year. And in the Permian Basin, they were down 15%. As a result, environmental services revenue decreased and created a 40 basis point headwind to total revenue growth in the third quarter.

Finally, turning to margins. Our adjusted EBITDA margin in the third quarter was 28% and decreased 40 basis points versus the prior year. Underlying margins expanded 60 basis points, which was more than offset by a 50 basis point headwind from an additional workday in the quarter relative to the prior year and a 50 basis point headwind from lower recycled commodity prices.

We continue to see good operating leverage in the business, as we tightly manage costs and improve productivity. We expect this positive momentum to continue into 2020. Every year, we invest in innovative technology and equipment to enhance the customer experience, improve productivity, and make our employees' job safer, easier and more engaging.

For example, last year, we opened our first next-generation positive-sort recycling facility in Plano, Texas. To date, in Plano, we've seen about a 20% reduction in our total cost per ton. It's important to note, this improvement is net of the depreciation expense associated with the upfront capital investment.

In the third quarter, we began to roll out our RISE platform in our dispatch operations and large-container business. The platform leverages the operational foundation we've been building over the last several years. It includes additional mobile and in-cab technology with more real-time routing information and data visualization tools.

Ultimately, this platform enables us to digitally connect our customers, drivers, dispatchers, supervisors and trucks. Through this technology, we will further differentiate our product offering, empower our employees and increase productivity.

Next year, in partnership with Mack Trucks, we will begin piloting our first electric vehicle on a residential collection route. As you can see, we have a lot of exciting projects underway and we're looking forward to discussing them more in 2020.

With that, I will now turn the call over to Chuck to discuss our third quarter financial results, our 2019 guidance and the 2020 outlook in greater detail.

Chuck Serianni

Thanks, Jon. Year-to-date adjusted free cash flow was $993 million and in line with our expectations. In the third quarter, we invested approximately $275 million in acquisitions, or $228 million net of divestitures. We also returned $271 million to our shareholders through dividends and share repurchases.

At the end of the quarter, leverage was three times and within our optimal range of 2.5 to 3 times. Interest expense in the quarter was $98 million and included $12 million of non-cash amortization. Our adjusted effective tax rate in the third quarter was 18%. We also incurred a $4 million non-cash charge related to solar energy investments that qualify for tax credits.

For the full-year, we expect an adjusted effective tax rate of approximately 15% and a $140 million non-cash charge. Relative to our original guidance, the benefit from lower tax-related expense is approximately $0.17. This benefit is being fully offset by two macro headwinds. First, a $0.13 headwind from lower recycled commodity prices and a $0.04 headwind from a decline in drilling activity.

Before opening the call for questions, I'd like to provide some additional detail on our 2020 preliminary outlook. Regarding our adjusted EPS outlook, we're assuming recycled commodity prices remain at current levels of approximately $68 per ton. Next, we're assuming an adjusted effective tax rate of 21% and a non-cash charge of approximately $110 million. The year-over-year increase in tax-related expense in 2020 results in a $0.16 headwind to earnings relative to 2019.

Turning to our adjusted free cash flow for 2020. Our outlook includes $100 million of CapEx associated with the reinvestment of tax-reform savings. These funds represent continued investments in updated locker rooms, brake rooms and training facilities for the benefits of our frontline employees. This $100 million capital investment will not reoccur in 2021.

Our 2020 cash flow outlook also includes an incremental headwind of approximately $40 million from working capital. The working capital headwind is due to the timing of disbursements in 2020 relative to 2019 and will not reoccur in 2021.

Lastly, regarding capital allocation in 2020. Although we believe next year will be a strong year of acquisitions, our outlook only contemplates $200 million of investment. Additionally, we're assuming we spend approximately $400 million in share repurchases.

With that, I'd like to open the call to questions.

Question-and-Answer Session

Operator

Thank you. We will now begin the question-and-answer session. [Operator Instructions] Our first question today will come from Tyler Brown with Raymond James. Please go ahead.

Tyler Brown

Hey, good afternoon, everybody.

Donald Slager

Hey, Tyler.

Chuck Serianni

Hey, Tyler.

Tyler Brown

Hey, Chuck. So my big question here is on free cash as we think about 2020. So I just want to make sure welcome all mixed up. So you're talking the high-end free cash this year, I call it, $1,175 million and your preliminary midpoint is $1,175 million. I think that's right. I get the incremental CapEx on the facilities, but you're saying there's an incremental working capital headwind into 2020 as well Are those the two big kind of puts and takes, or is there something else in there?

Chuck Serianni

Yes. Yes, just – let me make sure I'm clear, right? So if you go to the midpoint of the guide right now for 2020, it's $1,175 million. And then we have a total of $100 million of CapEx included in that number, right, for tax reform. So you would add that to that amount and then you would add back that working capital I talked about that $40 million. And when you do all that math, Tyler, you come up with a baseline free cash flow of $1.3 billion.

Tyler Brown

Okay. As we kind of think out into 2021, am I right on that?

Donald Slager

Yes.

Chuck Serianni

Yes. So if you think out into 2021…

Tyler Brown

Okay.

Chuck Serianni

…you've got that baseline of $1.3 billion, plus the growth on top of that, just the natural growth in the business.

Tyler Brown

Right. Okay. And then just frankly, Chuck, I'm just still confused on the solar energy investment. So, is there – is this like a CapEx item? Is it a M&A type of item? Or is it just a charge on the P&L that gives you a benefit on the tax form? I'm just, frankly, a bit confused there.

Chuck Serianni

Yes. We're looking to more of it as an M&A type of item. So this is a – an investment that we've been able to take advantage of. It gives us a really good return on investment. It is extremely low risk. And the great thing about it is, because of the tax credits, we get that benefit immediately. And so that's why you see a reduction in our effective tax rate and our cash taxes equal to the amount of the investment that we're making here.

Tyler Brown

Okay.

Nicole Giandinoto

Tyler, this is Nicole. Just to put a one point of clarification there. When we talk about our acquisition investment in the quarter of $275 million and year-to-date of $490 million, that does not include the solar investment, although it runs through the same line item on the statement of cash flow.

Tyler Brown

It does. Okay. So that'll be a Q4 item?

Nicole Giandinoto

Yes, yes.

Chuck Serianni

Yes.

Tyler Brown

Right. Okay. And then just maybe my last one for Don. Just so I appreciate the color on M&A, but I'm curious. So have all of your transactions this year been in traditional solid waste, or there is some other verticals, it sounded like that may be the case?

Donald Slager

It's a mixture. We're still seeing great activity in the pipeline on really good solid waste companies, both collection and infrastructure like. And we're seeing some good opportunities in environmental services that are very adjacent to what we do. We're looking at opportunities that, again, are things that our customers have said they want to buy from us products and services in areas things that we're good at.

So I think maintenance, fleet operation, container management, land management, permitting, engineering, all those great capabilities that we have. We're finding great opportunities to move into a little space, more space that still has a great margin profile and works very well with our core business and our core capability.

Tyler Brown

Okay, all right. I appreciate the color. Thanks, guys.

Donald Slager

You bet.

Operator

Our next question will come from Derek Spronck with RBC. Please go ahead.

Derek Spronck

Okay. Thanks a lot for taking my questions. Just on the acquisition front and just to follow-up just on the solid waste business side. Are they primarily tuck-in acquisitions? And do you have any opportunity to move into new markets here?

Donald Slager

Well, they tend to be primarily tuck-in acquisitions. And one of the reasons for that is, again, we're – we tend to be first or second place in – whatever 5% of our revenue, so we've got a big market position. Tuck-ins tend to have the highest return. They're the easiest to integrate. They come with the lowest risk.

So there are still a fair number of small companies out there that are getting to a place in their company life cycle, where they're thinking about selling. And we've got some degree of longstanding relationships with those sellers. And so we're well-positioned to buy those companies.

We have moved in some new geographies in the solid waste. There has been a couple of acquisitions we made recently that we're moving into adjacent geographies or into brand-new geographies, and we'll do that for the right deal, for the right market position. And so we think there'll be more of that in the future just as companies, again, come to a certain point in our life cycle.

Jon Vander Ark

And if we take a look going forward, the pipeline is robust. It will primarily be existing geographies only because we're in 42 states. So that's where the bulk of our opportunities will set, but we have plenty of things we're looking at in terms of – to Don's point, adjacent geographies or new geographies, we moved into Bend, Oregon recently and that was a very value-creating acquisition for us.

Derek Spronck

Okay. And what would you say is the average size from an acquired revenue perspective that you're making at this point of the acquisition cycle? And finally, any potential plans ever to come up here into Canada?

Donald Slager

Okay. Well, I'm not going to give you the average, because it'd be misleading. Most of the acquisitions are small. Again, these are small companies, I think, five, 10 trucks, right? And occasionally, you do get to a opportunity to look at a larger company, where maybe that company didn't have a successful succession plan, or the next-generation, or the third-generation really wasn't all that interested in it, or it was time to sort of monetize a lifelong work.

So there are – there have been a handful of sizable ones, but primarily, they're going to be small. So it's a lot of work to integrate small businesses and spend as much money as we have intelligently. We haven't made deals to do. As it relates to – but we look at everything large or small. That's kind of a battle cry if you look at everything, that makes sense for us.

And then as far as Canada goes, I would say this, we always kind of describe ourselves as a North American solid waste and recycling company on purpose. We like Canada. There's some great business up there. And we would have to be looking at opportunities that gave us a strong market position, which is really the sort of first pillar of our strategy. We're now looking to be a number nine in a market with no path to number three. And so that would answer your question. If there's things available that interest us, we're not going to shy away from that.

Chuck Serianni

We are already there today, both in the East and the West, largely in a post collections or disposal arrangement. So that gives us some ties or relationship already into those markets.

Donald Slager

You bet.

Derek Spronck

Okay, great. Thanks, guys.

Operator

Our next question will come from Michael Feniger with Bank of America. Please go ahead.

Michael Feniger

Hey, guys, thanks for taking my questions. I understand your earnings per share is up. I'm just – if I look on a trailing 12 months basis, I think your EBITDA is up like 2% year-over-year. In a rather solid waste backdrop, it's below your peers and everyone is contending with their cycling issue. I'm just trying to get a sense of – is there anything structurally that we should be aware of in terms of your business mix or cost basis or regional mix? Help us understand that, that differential and how that differential might close in the next 12 months?

Chuck Serianni

Yes. I think the two big things that impacted EBITDA this year, in particular, were commodities. And that ended up being an over $50 million headwind for us. The other thing was environmental services, and we had talked about that Permian cooling down a little bit. And that was another almost $20 million of a headwind for us also on EBITDA.

Now, the good news is that, we were able to offset that – from those headwinds through some advantageous tax planning. But as we look into the future, and as we look in particular into 2020, we're saying at this point that we're going to have EBITDA margin expansion. And that's because we feel really good about how the base business is performing.

Michael Feniger

Chuck, just to be clear on that. So you're saying into 2020, you're confident you can get EBITDA margin expansion on the overall business, even with the – if OCC prices stay exactly where they are right now, and you extrapolate that into 2020?

Jon Vander Ark

That's exactly right. That's what I'm saying.

Michael Feniger

Okay. And just like on the intentional shedding. When we go into 2020, is that over and do we see that finally drop out in – into next year?

Jon Vander Ark

We're expecting to grow the business next year, obviously, at very solid price environment and volume growth next year. That will be a mix of taking on a lot of profitable customers and still some shedding of less attractive customers. But, as we said in the prepared remarks, that will start to trend down overall. But that we believe we can grow the business, both price and volume. That's our aspiration. We've proven we can do it. When forced to make a trade-off, we'll take price every time, right, that's how we think about the business.

So, again, to Chuck's point, with 2020, we've got really solid plan for, feel really good about the economic backdrop and how we're going to grow the business. And that will involve slowing down of the shedding and taking on a lot more profitable business.

Operator

Our next question will come from Brian Maguire with Goldman Sachs. Please go ahead.

Brian Maguire

Good afternoon.

Donald Slager

Good afternoon.

Brian Maguire

Chuck, just wanted to come back to the $40 million of working capital that seems to be swinging around a little bit. Am I thinking about it right that you're kind of maybe pulling that forward into 2019 and that's what's getting you from more like the lower-end of the range to the upper-end of the range? And then that's just sort of coming out of the 2020 number as a – as an offset?

Chuck Serianni

No, it's really the timing of disbursements in 2020. It has to do with the calendar. And when we, honestly, when we cut AP checks, and it just happens to be a worst-case scenario for us in 2020. And that's why I said in my comments that it will reverse in 2021. That's a one-time headwind for us, that will reverse. It has to do with the calendar.

Brian Maguire

Okay. So you get the benefit then in 2021 as opposed to 2019 from that progressing?

Chuck Serianni

Correct.

Brian Maguire

Got it. Okay. And then just wondering, if you could comment on your outlook for special waste volumes. I think yesterday, they were down, but mentioned that was mostly because of a year-ago comp. Wondering what you're seeing in the pipeline there and the outlook there into fourth quarter?

Jon Vander Ark

Pipeline is solid, both for Q4 and then in early 2020. Beyond that, it's hard to say, but really solid outlook. And this – the nature of that business is a bit episodic, as you know. It can move around quarter-to-quarter, you see that with us, you see that with our competitors. And it's always a little down this quarter, C&D way up this quarter. So there's a little bit of swing in the nature of those jobs because they're project based. But we feel very good about the pipeline.

Brian Maguire

Okay. And just last one for me. Just on the – back on the tax rate in these solar credits, I think initially, you talked about kind of a $60 million offset in the non-cash line from that. It seemed like in the quarter it was only four. So running a little bit lower that. Is it just going to be a little bit lumpy and a lot in 4Q?

And then just thinking about it more longer-term, how many more years do you kind of anticipate having this sort of a weird lower tax rate and a higher non-cash other expense in there? And assuming, it does, and at some point, do we go back to that kind of high-20% tax rate at some point, or somewhere lower now?

Chuck Serianni

Yes. So we like the weird lower tax rate. I'd like to keep that as long as we can. Back to your first question, yes, it will be a – most of the investment will occur here in Q4 for 2019. And these tax credits right now start to phase out through 2022 into 2023. So, we think that we have an opportunity to take advantage of these tax credits for the next few years.

Certainly, they're on the books. But at the same time, we need to make sure that we got the appropriate investments that those are available to us. And these investments typically have returns in the mid – high to mid-teens. And we're making sure that they don't just provide us with a tax benefit here that they're – that we're getting overall a good return on these investments.

Brian Maguire

Okay, thanks very much.

Nicole Giandinoto

So for those of you that's dialed in and entered the queue ahead of the start of the call, it looks like you've dropped off. So if you want to get back into the question queue, please press star and then one.

Operator

Our next question will come from Sean Eastman with KeyBanc Capital Markets. Please go ahead.

Sean Eastman

HI, team, thanks for taking my question. I just wanted to go back to the environmental services, kind of acquisitions and stuff being folded into the mix here. It looks like this run rate here on the environmental services line actually picked up really nicely in the third quarter. And I believe that item was called energy services last quarter, so maybe I missed some sort of reclassification. But nevertheless, I'm just kind of wondering if maybe some of the acquisitions done this year are going into that line. And what the run rate on that looks like as we go into 2020, particularly considering the softness on the E&P waste side?

Donald Slager

Yes. So we've kind of broadened the category, okay?

Sean Eastman

Yes.

Donald Slager

And so when we first went into the E&P space, we call that Energy Services and that was, again, primarily handling oilfield waste, landfilling, and waste processing from the drilling rigs and so forth. And that's been a good business for us, a good investment. Again, it could be a little cyclical, right? And it could be impacted by some of the global issues that we face.

But all in all, still good business. We like it. We've got great market position. A lot of that depends on sort of on your geography. A lot of those customers that we serve in the oilfields are customers that we serve in the solid waste space. And as we've looked to sort of connect dots, we talk about going sort of upstream and downstream here. We find opportunity to do other things in and around that space that fit very nicely into what we're capable of.

So it comes down to, again, what's the margin profile of the business? How does it fit with our customers? Does it help us with stickiness? Does it help us to do more for current customers and kind of bigger wallet share? And does it fit within our capability? You won't ever see us do things that we don't know how to do, right?

And so yes, so it's opened up new doors. And it's not that much different, frankly, from when, I think, Jon, talked about a new geography in Bend, Oregon. We wouldn't have maybe known those people and had an opportunity, we weren't in Oregon. So, as you move the geography footprint out, it opens you up to new opportunities because of new relationships and so forth.

So not that much different there when we think about what's happening in the geography of the country, where Energy Services and Petrochem has got a big concentration.

Sean Eastman

Okay. And maybe you can just expand on the acquisition opportunities in that environmental services category, as you see it today?

Donald Slager

Yes. So we're not really ready to break it out. Again, as Jon and I both said, the majority of our acquisition activities still going to be in solid waste. Yes. So, these are, I would call it, sort of fringe opportunities. We're not going to do a natural act and try too hard. We're just going to make sure that we're making – being opportunistic and being intelligent and staying within our adjacent capability set. But most of the investment will still be in and around good old-fashioned core solid waste for the time being.

Jon Vander Ark

Yes. The only thing I'd add is that, space is pretty fragmented. And our customers have asked us to be there, right? We've been in this space for a long time in plant on properties. They understand our safety record. They understand our commitment to sustainability. They understand our performance levels that we can execute against. And therefore, they've asked us to broaden our product and service offering to better serve them.

Sean Eastman

Interesting. Yes. I mean, it sounds like just another big consolidation runway. I guess, just to close it out there, maybe how this particular piece of the business, that's all kind of lumped together at this point. Just how it's kind of moving into 2020, some high-level comment on that would be helpful?

Donald Slager

Yes. I mean, I think that into 2020, obviously, you're going to see that line item on the – on our revenue breakout continue to increase because of the acquisitions that we made this year. And, as Jon mentioned, that we're going to remain opportunistic here in 2020 and see if there's any other opportunities that we can also include in that piece of our business.

Jon Vander Ark

Don mentioned some cyclicality, we expect a little bit of headwind on a year-over-year comp. If drilling activity remains flat, obviously, that could pick up and move up depending on where oil prices go. The downstream side of that business is much more steady from an underlying demand profile. And you'll see nice growth year-over-year there because of the acquisition that we made in the space.

Sean Eastman

Thanks, gents. Really helpful. I appreciate it.

Operator

Our next question will come from Michael Hoffman with Stifel. Please go ahead.

Michael Hoffman

Hi. Thank you very much. So just to tease out that last set of conversations, the $51.5 million, that now core environmental services a year ago. Was that pretty much purely energy and now 57.8 has the combinations of things to some – make sure I'm understanding this whole conversation that just happened?

Jon Vander Ark

Yes. We're pulling a little bit from the core business. We've been in the downstream for a long, long time. So we've pulled a little bit of that into the business, but it's just the combination of both upstream and downstream and called environmental services, largely because that's what the space calls it, right? That's what our customers are…

Michael Hoffman

Yes, I got that, Jon, but a year ago, was it basically just all ups – upstream energy and this year, it's got a mixture of things?

Jon Vander Ark

Primarily.

Donald Slager

Yes, primarily. So…

Michael Hoffman

Yes, just...

Donald Slager

…but we've tried to say this a couple of times. Look, we've been in and around this space for a long time. We've had little sort of outpost in our business that have, call it, wandered into the space and done pretty well with it. So none of this is all new to us. It's just aggregating it into one place. And then as Jon said, it's somewhat of a fragmented business and customers want to sort of have that one neck to grab and where that reliable, well-known entity. And so it just seems to go together pretty well. So you'll see it now aggregated, and you'll see some good growth, as Jon pointed out.

Michael Hoffman

Yes. I'm – sorry, guys. I just want to make sure I understood what was in the mix. I don't dispute the need or been in and all that. On the free cash flow side, one of the things that I think that also needs to be thought about is there at $68, that's an incremental level of pressure in the next year relative to the run rate through this year, and that would equal cash headwind as well that you're overcoming?

So when you start with a – we're flat year-over-year at the upper-end versus the new guide of midpoint at just $25 million for the incremental lock room spending and the like for employees, $40 million for working capital. There's some cash tax benefit. There's also an added headwind as some recycling cash, too, right?

Chuck Serianni

Yes, that's absolutely right, Michael. You're right on with that. And that was probably circa $20 million or so.

Michael Hoffman

Okay.

Chuck Serianni

And, obviously, that's a negative in our 2020 preliminary outlook in terms of the cash flow.

Michael Hoffman

Right.

Donald Slager

So, Michael, your point is right, that just further makes the point of the underlying strength of the business.

Michael Hoffman

Right.

Donald Slager

…right? Chuck made a point that our baseline free cash flow is really $1.3 billion. And then all the good work that the team is doing on restructuring recycling contracts, at some point, we're going to gate that year-over-year impact to nothing, right? We're just going to

– we're going to move the risk over where it belongs and then we won't have that conversation anymore.

Michael Hoffman

So can we shift the price for a second? So I love the progress that's being made on both. What needs to change either within your control or macro that you can narrow the gap between the yield reported and the core that's being offered? That's the ideal scenario, right? Is that gap closes overtime? What can you do to close that gap?

Chuck Serianni

Yes. That's obviously us focused on maintaining that stickiness and increasing that stickiness with the customers, right, because what we're talking about now is that what we have historically called churn. The difference between that yield in that core price. And then that's where all of the technology that Jon talked about and that connectivity with the customers really come into play.

Nicole Giandinoto

And then, Michael…

Michael Hoffman

So what I'm hearing is, you're tending to – I'm sorry, go ahead, Nicole.

Nicole Giandinoto

I was going to say, the other thing that helped us and will continue to leverage in the future is the capture pricing tool.

Michael Hoffman

Right.

Nicole Giandinoto

Because as Chuck said, you increase the stickiness to reduce customer defection and then all your new units by leveraging the capture pricing tool, we've got that discipline to move with the market when we sell.

Donald Slager

Keep in mind, customer defection is at 7%.

Michael Hoffman

Yes.

Donald Slager

That's pretty well below. Can we get to six? We've been below seven before. Can we get it to five? We'll see, right? But you have a certain amount of defection just from businesses failing, going bankrupt moving out of the country, et cetera. So that that's all in that number. So we start with a pretty low defection number

But everything else we're doing around all of our customer service initiatives, even fleet reliability, all the new technology, the RISE platform the Jon talked about, all that is to create differentiation in the product value. And can we gain more customers at a higher price? That goes hand in hand with – using the capture tool? Can we keep customers longer? That reduces this thing called churn over time?

Jon Vander Ark

It does. When I say differentiation helps us on both fronts. The other thing that is helping us is upward pressure on landfill pricing, which you've seen now for a number of cores in a row that we've done a good job with, right? We pass that right through to our collection company, right? And that collection company then is charging higher price than the Street. So we're getting – we're taking on customers at a higher price, which ultimately reduces the churn.

Michael Hoffman

Okay. Thank you very much.

Operator

Our next question will come from Jeff Silber with BMO Capital Markets. Please go ahead.

Jeff Silber

Thanks so much. That's close enough. Excuse me, I know there have been some media reports about some strikes that have been struck against your company in a number of your markets. I'm just wondering if you – has there been any impact on your business in terms of extra costs to send in replacements, et cetera? Any color would be great?

Jon Vander Ark

Sure. No, yes. So first of all, we're pro employee, that's where we start the conversation from a values basis. This has been incredibly narrow. This is one business unit in the Northeast, right? It's less than two dozen employees. And we are targeting good faith. Local team is doing a great job, right? And we're hoping we get back to work soon.

There has been a couple of one day events in a handful of markets. Good news is, customers are not disrupted. We're getting the recycling and garbage off the ground, right, in the Northeast and data in those minor kind of disturbances, right? And from a cost standpoint, it's been nominal for the quarter.

Jeff Silber

Okay. I appreciate you putting that in perspective. My follow-up question, one of your competitors had mentioned, if you look at the different end markets, there seem to be a bit of a bifurcation between those that are more industrial-related like the special waste area and more – and those that are more consumer-focused. I'm just wondering if you're seeing the same kind of different trends between those end markets? Thanks.

Jon Vander Ark

Yes. Well, just to put it in perspective, only less than 10% of our revenue is really tied to manufacturing. We're really tied more so to the consumer, right? So as we look at our various lines of business right now, we're not seeing a lot of weakness in that manufacturing piece of the business that I talked about.

Keep in mind also that, when you think about a manufacturer, you think about a plant, if they are going to do away with a shift or so – their waist doesn't go down to zero, right? They still need the waste service. They may just not needed as often. So that might be a little bit of a service decrease, but it would have a minor impact on our overall revenue.

Donald Slager

Yes, overall, we would say, the underlying economy is pretty, pretty strong. And, as Jon pointed out, certain parts of our business are event-driven. We see some fluctuations in construction with seasonality, some special waste. There are large events jobs that come and go. But, as you average through the year, we're growing the business. We don't get too excited about seasonality and we don't get too excited about these episodic things.

The fact is, we've got this great portfolio. We're across 42 states and 200-plus markets. And so, if there's a weather event, or a forest fire or work stoppage, or this or that, or whatever, this portfolio sort of kind of wins the day, and it always has and we think it always will. It's one of the benefits of being – having the size of scale we have. And then, of course, we lag.

So if the economy gets a little soft, we kind of lag that, right? So sometimes we find ourselves just kind of working through these little blips that otherwise people get excited about. And our view now and our view for 2020 is, the economy is in a pretty good shape. And we're well-positioned…

Jeff Silber

Okay.

Donald Slager

…across the markets and we're going to get our share of the growth that we want to get.

Jeff Silber

Got it. Thank you so much.

Operator

Our next question will come from Noah Kaye with Oppenheimer. Please go ahead.

Noah Kaye

Thanks very much. The color you provided on the solid returns from the solar investments was helpful. But I was hoping to kind of broaden the question to the general topic of sustainability commitments. You called out in your release, your environmental commitment to 35% greenhouse gas reduction by 2030. I believe some of the other sustainability goals you announced in July include increasing landfill biogas reuse, 40% increase in materials recovery.

And I just want to understand maybe be helpful, as we think about your capital priorities and how they are aligning with the sustainability goals, how does that impact or what are the areas we should expect to see increasing focus on four capital deployments over the next few years? Besides the solar investment, what would you maybe call out in the 2020 CapEx plan or other investments you're making that address this?

Donald Slager

Yes. The first thing I'd say is, we believe that environmental sustainability and economic sustainability needed to be tightly linked. So that's why we're so passionate about restructuring the business model for recycling, because over time, we're long on recycling and we want to be a major player in that space. But it has to have really attractive financial returns for us to continue to invest there, and we're seeing that absolutely in given markets over time.

So the market is moving there in a positive direction. I think you'll see things like landfill gas energy projects over time, a place we meet, or place we further invest to meet the sustainability goals, and we put out ambitious goals for 2030. We don't have all the ticks and ties and all the plans to achieve every one of those items built out yet, because they're ambitious goals and they're more than a decade off. But we feel really good that we're going to do those in a responsible way, value creating way. So that, not only is the environment winning, but the shareholders winning as well.

Chuck Serianni

And this isn't a one-time investment either that you're going to see all of a sudden pop into our CapEx, right? This is something that we've been doing over time, and it's already baked into our cost structure. So there won't be any big blips on the radar relative to our investments in these areas.

Noah Kaye

I think that's helpful. Thank you. Maybe a little bit more near-term. Just want to understand based off of the M&A that you completed year-to-date, what is kind of the rollover revenue contribution to 2020? And is that basically what's assumed in this preliminary outlook?

Chuck Serianni

Yes, it is. So we're about 70 basis points of revenue rolling into 2020. And then you get on top of that the revenue associated with the $200 million of investment where we're saying we're going to make in 2020.

Noah Kaye

But – so – does – in other words, is your outlook assumes both of those and you assume some contribution from next year's M&A as well?

Chuck Serianni

That's right.

Noah Kaye

Okay.

Chuck Serianni

The 70 basis points rollover, plus the revenue impact of the $200 million of investment.

Noah Kaye

Okay. Okay, that – that's helpful. And then, you are – you kind of defined expectations for the recycling headwind for next year as well around $20 million. Are your processing fees now covering most of your third-party volumes? Is there further improvement opportunity there, or is it really now all about redoing the municipal contracts and improving the technology? What are the levers to pull that could maybe reduce this headwind assuming a constant commodities environment?

Chuck Serianni

Right. So I think that we made really good progress in terms of the pricing initiatives and in converting to the processing fee. Right now, the processing facilities themselves are – continue to be profitable. And we continue to look at that profitability in those fees, so that we can get what we consider to be an appropriate return on this facility. So, we've got a little ways to go in that regard. And then we still have conversations that we need to have with our municipalities to get them to convert over to these processes.

Jon Vander Ark

Yes. And we're marching into City Hall every day. And I think the good news is a lot of conversations in flight and the nature of the conversations is turning, I think a year ago, it was staff pushing back on us. And now we are here staff inviting us in saying, I want to make sure that recycling is sustainable in my community. Let's go on to gather to talk to the elected officials, because ultimately, we need to get more pricing to the curb to make this sustainable for the long-term.

Noah Kaye

Yes, makes sense. Thank you very much.

Operator

At this time, there appear to be no further questions. Mr. Slager, I will turn the call back over to you for any closing remarks.

Donald Slager

Thank you, operator. In closing, we are pleased with our third quarter performance. Through the relentless operational execution of our employees, we achieved strong pricing, 60 basis points of underlying margin expansion and continued grow – growth of both earnings and free cash flow. The momentum in our business is strong. The economic backdrop remains supportive of continued growth in 2020.

As always, we will continue to manage the business to create a long-term value for all stakeholders, including our employees, customers, communities and shareholders. I want to thank all of the Republic employees, everyone on our team for their hard work, commitment and dedication to operational excellence and creating the Republic way. Thanks for spending time with us today. Have a good evening, and please be safe.

Operator

Ladies and gentlemen, this concludes the conference call. Thank you for attending, and you may now disconnect.