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Covanta Holding Corp. (CVA)

Q2 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone, and welcome to the Covanta Holding Corporation's Second Quarter 2016 Financial Results Conference Call and Webcast. This call is being taped and a replay will be available to listen to later this morning. For the replay, please call 1-877-344-7529 and use the replay conference ID number 10089385. The webcast as well as the transcript will also be archived on www.covanta.com.

At this time, for opening remarks and introductions, I'd like to turn the call over to Alan Katz, Covanta's Vice President of Investor Relations. Please go ahead.

Alan Katz
Vice President-Investor Relations

Thank you, Andrew, and good morning, everyone. Welcome to Covanta's second quarter 2016 conference call. Joining me on the call today will be Steve Jones, our President and CEO; and Brad Helgeson, our CFO. We will provide an operational and business update, review our financial results and then take your questions.

During their prepared remarks, Steve and Brad will be referencing certain slides that we prepared to supplement the audio portion of this call. Those slides can be accessed now or after the call on the Investor Relations section of our website, www.covanta.com. These prepared remarks should be listened to in conjunction with these slides.

Before I move on to the Safe Harbor, I'd like to remind everyone that we conduct regular facility tours for the investment community, and are planning on holding the next one in September in New Jersey. Please feel free to reach out to me for additional details.

Now on to the Safe Harbor and other preliminary notes. The following discussion may contain forward-looking statements and our actual results may differ materially from these expectations. Information regarding factors that could cause such differences can be found in the company's reports and registration statements filed with the SEC. The content of this conference call contains time-sensitive information that is only accurate as of the date of this live broadcast, July 27, 2016. We do not assume any obligation to update our forward-looking information unless required by law.

Any redistribution, retransmission or rebroadcast of this call in any form, without the express written consent of Covanta, is prohibited. The information presented includes non-GAAP financial measures. Because these measures are not calculated in accordance with U.S. GAAP, they should not be considered in isolation from our financial statements, which have been prepared in accordance with GAAP.

For more information regarding definitions of our non-GAAP measures and how we use them, as well as the limitations as to their usefulness for comparative purposes, please see our press release, which was issued last night and was furnished to the SEC on Form 8-K.

With that, I'd like to now turn the call over to our President and CEO, Steve Jones. Steve?

Stephen J. Jones
President, Chief Executive Officer & Director

Thanks, Alan, and good morning, everyone. For those of you using the web deck, please turn to Slide 3.

I'll start out with a quick overview of our financial results. Q2 adjusted EBITDA was $82 million, a decline of $1 million from Q2 2015. And free cash flow was a negative $5 million, $35 million higher than in Q2 2015.

While adjusted EBITDA was relatively flat year-over-year, there were a number of drivers in both directions impacting the quarter. Results benefited from the growth in our Environmental Solutions business and New York City MTS contract, and from the 2015 impact of the Durham-York construction expenses on a comparable basis. However, these were offset by the impact of lower year-over-year commodity pricing, accruals for variable incentive compensation, and the impact of our China asset sale.

Free cash flow was impacted by these same factors, but reflected a smaller outflow from working capital than we saw in the second quarter of 2015. These results were in line with our expectations as of our Q1 earnings call, and as such in last night's press release we reaffirmed our guidance for 2016.

We had a solid second quarter. We amended and extended our lease with our Union County client; Brad will provide you details on this transaction.

Our maintenance season went well with spending coming in as we expected for the first half of the year. As we've discussed in the past, the first half of the year represents the heavy part of the annual maintenance calendar.

The waste, energy and metals markets have been trending somewhat favorably compared with where we were at the time of our Q1 call. Overall, there are some puts and takes, but we're in line with our expectations from the start of the year.

Now let's get into some of the details on our markets and operations. I'll start with the Waste business; please turn to slide four. Our North American energy-from-waste same-store volume was flat while pricing was higher by $5 million versus Q2 2015.

Overall, our uncontracted waste pricing has been particularly strong this year driven primarily by two factors. First, we're seeing the benefit of the mix shift from spot waste to profiled and contracted waste. Our Covanta Environmental Solutions group continues to drive more profiled waste into our energy-from-waste facilities.

In addition, our progress in contracting MSW waste supplies over the past couple years, including the New York City MTS contract, has further reduced our alliance on spot volumes. And second, the Northeast waste market continues to firm up and we're seeing improvement in pricing there. Average contracted waste pricing has been escalating about 1% in line with our expectations at the start of the year.

Looking specifically at Covanta Environmental Solutions, energy-from-waste, profiled waste grew 9% this quarter compared to Q2 2015. This includes approximately 15,000 tons of internalized profiled waste from our material processing facilities. Additionally, we're seeing lots of activity within the healthcare industry which includes pharmaceuticals, DEA controlled drugs and consumer product assured destruction. This waste set represents a nice growth opportunity for us in the future.

The integration of the material process facilities and industrial services that we acquired in 2015 and earlier this year is continuing as we execute on the growth and cross-selling opportunities that we expected, so good performances from these investments so far. Also note that the team has done a tremendous job of building out our capabilities on the materials handling side of things.

This past quarter we processed almost 20 million gallons of liquid waste outside of our energy-from-waste facilities. We also managed about 50,000 tons of recycled material that primarily went to third-party sites. The waste handling that we manage at our material processing facilities is a nice recurring revenue stream that's been showing steady growth over the last 18 months.

Now let's move on to Energy. Please turn to slide five. The power markets, particularly in the Northeast, were under significant pressure in the second quarter with mild weather and low regional gas prices continuing to drag on the market pricing. This is similar to the first quarter. Average market pricing for the quarter was $26 a megawatt hour. Given the warm summer we're experiencing in the Northeast and the current forward curves, we expect some improvement in the back half of the year but still consistent with our initial guidance ranges for the full year. Production for the second quarter was in line with expectations.

Given that we've completed our major outage cycle and have a bit more visibility to the full year, we've adjusted our outlook for market volumes down slightly.

We've also continued hedging for 2017 and 2018, as you can see in our energy portfolio detail on Slide 16. For those of you building out your models for next year, it may be useful to know that our hedges for 2017 are an average price of about $36.

Let's move onto the Metals business on Slide 6. We saw continued recovery in the ferrous market in the second quarter compared with the beginning of the year. However, at $220 per ton in Q2, the average price for the HMS #1 Index was still lower than the $236 per ton price in the same quarter last year. We expect the market to pull back a bit from today's prices based on historical seasonality and the strong U.S. dollar. When we factor in the pricing for the first six months of the year, combined with the seasonality effect we expect in the second half of the year, we have revised our full-year pricing outlook for HMS to be between $175 per ton and $195 per ton and would expect our average revenue per ton for ferrous to be between $95 and $110 for the full year.

Over the past year, I've been highlighting the benefit of our centralized ferrous metals processing facility. As we clean the recovered metal, the tonnage tends to be lower since we're eliminating the residue or the ash from the metal, but quality and pricing improve. Also, the processing facility allows us to access markets outside the U.S. to sell our recycled metal, which has allowed us to obtain higher prices. But it also means that we sell in larger quantities or shipments. So there can be a timing impact.

This quarter is a great example of this. Despite the year-over-year decline in the HMS Index, our average revenue per ton was actually up 8% versus Q2 2015 due to better quality. At the same time, our net volumes sold were lower by about 10% due to less ash on the metal, so it brought the tonnage down, and the timing of the shipments in the quarter. Note though that the volume of metal recovered at the plants prior to processing was up year over year.

Non-ferrous volume increased by about 14% versus Q2 2015, driven primarily by investments made to increase recovery at certain facilities. Overall, metals volumes continue to be in line with our expectations.

Pricing for recycled aluminum is down from Q2 2015 by about 12%, but forward curves are holding steady. So we're in a better place than we thought we'd be when we set pricing expectations for non-ferrous metals at the beginning of the year. As a result, we brought up our outlook for the full year non-ferrous price to approximately $650 per ton.

Let's move onto operating expense and CapEx. Please turn to Slide 7. North America energy-from-waste maintenance spend in the quarter, including both expense and CapEx, was relatively flat versus Q2 2015. We've completed approximately 65% of our total full year energy-from-waste maintenance spend. We still expect full year maintenance spend to be between $350 million and $370 million.

North America EfW other plant operating expenses were up 3% on a same-store basis this quarter compared with Q2 2015, generally in line with expectations. For the full year, we currently expect this line to escalate at less than inflation on a same-store basis, driven in part by our CI initiatives. Other non-EfW plant operating expenses are primarily up due to the acquisition of the Environmental Solutions business and a portion of the bonus accrual.

I'll wrap up with some thoughts on our business outlook and an update on a few of the projects that we've discussed in the past. The core North American EfW business continues to run well. Profiled waste and Covanta Environmental Solutions are performing on plan, and we're making progress on realizing the benefits from our Continuous Improvement efforts.

In terms of growth projects, construction in Dublin is now approximately 70% complete. The design and procurement activities are substantially complete, and the boiler steel erection is nearing completion. We also intend to sign additional Waste contracts in the coming months, so we expect to end up with about 90% of the capacity of the plant contracted for by the end of this year.

With rapidly shrinking landfill capacity, the waste market in Dublin is eagerly anticipating this facility coming on line. We still expect to start processing waste in the first half of next year, and are on track for full commercial operations by the fourth quarter 2017.

I also want to provide a quick update on Perth, which we discussed a bit at our Analyst Day and on our subsequent earnings calls. As I've mentioned, we're focused on developing a project that meets our return and risk criteria. To that end, we're working on developing an EPC and technology delivery arrangement that will support construction of a world-class facility at a cost and on a timeframe that is consistent with our criteria.

We're also exploring various opportunities for partnerships, waste supply and power offtake. All that said, there's still a fair amount of work to be done before we're ready to commit capital to this project.

We'll look very closely at this project and every project to be sure that it's the right use of capital to create shareholder value. This is exactly what all of you should expect from us in the area of business development.

Overall, I remain pleased with how the business is running and the opportunities that I see in front of us. We're committed to using capital in smart, strategic ways. We have a strong capital allocation policy that hasn't changed; it allows for a meaningful dividend for our shareholders while allowing us to invest to grow our business. As we said in the past, our board will review our dividend in December. Our goal continues to be to grow free cash over the long term, and when we do grow our dividend as well.

With that I will turn the call over to Brad to discuss the second quarter financial results in more detail.

Bradford J. Helgeson

Chief Financial Officer & Executive Vice President

Thanks, Steve. Good morning, everyone. I'll begin my review of our second quarter 2016 financial performance with revenue on Slide 9. Revenue was $418 million, up $10 million versus Q2 2015. North America energy-from-waste revenue declined $2 million year over year on a same-store basis. Within that amount, waste and service revenue increased by $4 million as continued growth of profiled waste volumes, positive spot pricing trends in the Northeast and contractual escalations drove higher average revenue per ton. Energy revenue declined by $4 million and recycled metal revenue declined by $2 million, both driven by lower year-over-year market prices, as Steve just discussed.

North America EfW contract transitions were a net positive $5 million year over year with a full quarter of benefit from our Fairfax facility now operating under a tip fee contract structure, partially offset by lower debt service revenue.

Outside of North America EfW operations, the Environmental Solutions business was up $14 million compared with Q2 last year, primarily as a result of the acquisitions that we completed in 2015. And the New York City MTS contract is running at 100% service fee revenue from the Queen's North Shore MTS as compared to ramp-up phase in Q2 last year, resulting in a net $6 million increase.

Biomass operations represented an $8 million revenue decline year over year as we're no longer operating any of those facilities as of the second quarter. The China asset swap represented most of the remaining revenue delta.

Moving onto Slide 10, adjusted EBITDA was $82 million in Q2 2016 compared to $83 million in Q2 2015. Commodity prices have remained a drag on year-over-year comparable results, with lower energy and recycled metal prices in the North America EfW portfolio reducing adjusted EBITDA by $6 million on a same-store basis. Contract transitions added $4 million to adjusted EBITDA in the quarter, primarily related to the Fairfax transition.

New business, including the New York City MTS contract and acquisitions in the Environmental Solutions business, together added $6 million to adjusted EBITDA in the quarter. The loss of EBITDA contribution from

China following the asset swap was $6 million in the quarter, while results compared favorably to last year's spend associated with construction and startup costs for the Durham-York facility, which totals $10 million.

As we've discussed previously, our results last year fell short of our targets, driven by significantly lower commodity prices and the Durham-York startup delays, which reduced employee performance based variable compensation to zero. So on a year-over-year comparable basis, the normal accrual for employee variable comp this year negatively impacts reported EBITDA.

Turning to Slide 11, free cash flow was negative $5 million in the second quarter compared to negative $40 million in the prior year. This favorable difference in free cash flow in the quarter was primarily driven by working capital timing with a larger outflow experienced in Q2 2015 than we recognized this year. I'll note that full year guidance implies a significant improvement in free cash flow in the back half of the year, but that trend is typical of the seasonality of our business and is very consistent with the pattern of free cash flow that we reported last year.

Turning to Slide 12, our growth investment outlook is down slightly for the year on lower anticipated spend for facility enhancements to support containerized waste deliveries under the New York City contract. We've invested approximately $20 million in organic growth projects in the first half of the year, primarily related to metal recovery systems and some investments in new equipment for growth in the Environmental Solutions business. Installation of the new emissions control system at the Essex County facility and construction of the Dublin project are on track with our outlook for anticipated spend this year unchanged.

As Steve mentioned, the Dublin facility construction is progressing well. As a reminder, we expect to invest total capital of about €500 million in the project, of which approximately 75% is project financed.

Turning to Slide 13, I'll discuss our balance sheet and leverage ratios. Net debt increased in Q2 to just over $2.6 billion versus $2.3 billion as of the start of the year, resulting from further drawdown of the Dublin facility project debt, seasonal revolver borrowings, and a little over $100 million of debt that came onto the balance sheet in connection with the long-term lease extension at the Union County facility that Steve mentioned.

Let me spend a minute on the financial statement impact of this transaction. In the second quarter, we executed an amendment of our operating lease for the Union facility, including a lease extension from 2031 to 2053. Given the extension, we're now required under GAAP to account for the arrangement as a capital lease. At June 30, this brought $104 million of lease liabilities onto our books as well as corresponding assets. The capital lease is a non-recourse obligation of the Union project subsidiary, therefore it's included in the project debt line.

In addition to the balance sheet changes, we'll recognize an annual benefit to adjusted EBITDA of about $8 million as the lease payments move from operating expense to the depreciation and interest expense lines. The annual cash lease payments are unchanged, so the impact to cash flow available to distribute to shareholders isn't material. The most important takeaway here is that we completed a very long-term extension at a facility that we don't own, which is a strong cash flow generator and is located in one of the most attractive waste markets in the country.

Turning back to the consolidated balance sheet, the net debt-to-adjusted EBITDA ratio at the end of Q2 was 6.2 times. Given the Union lease transaction and the continued drawdown of project debt to fund the Dublin investment, we expect leverage to remain elevated at or around this level until next year when the Dublin project becomes operational and begins contributing to earnings and cash flow.

With a full-year contribution from Dublin, we expect leverage to return quickly towards five times net debt to adjusted EBITDA, all else being equal. Over the long term we will target leverage of approximately four times, as we've discussed in the past.

The calculation of the leverage ratio covenant under our senior secured credit facility was 3.4 times at June 30 versus the covenant limit of four times. We expect this quarter to represent the high water mark on this ratio, with lower ratios by the end of this year and into 2017.

I'll note that the balance sheet at June 30 does not yet reflect the proceeds from the China asset sale. The second step in this transaction, the sale of our stake in Sanfeng Environment to CITIC is still awaiting Chinese Ministry of Commerce approval, which we anticipate receiving by the end of the year to allow completion of the transaction and receipt of the proceeds of just over $100 million. Approximately half of these proceeds will be used immediately to reduce revolver borrowings, while the remainder will either be used to fund new international investments or, if not, to further repay debt.

To close I'll reiterate that given our visibility to increase long-term cash flow from our investments, particularly the Dublin projects, I'm very comfortable with the amount of leverage that we will have on the balance sheet over the next 12 months. We're in a strong position to grow free cash flow and reduce leverage consistently over time. As we find additional attractive growth investment opportunities, we'll continue to fund those with debt financing to the extent that those opportunities are accretive to recurring cash flow, dividend coverage and long-term balance sheet strength.

So with that, operator, we'd like to open up the line for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] The first question comes from Tyler Brown of Raymond James. Please go ahead.

Patrick Tyler Brown
Raymond James & Associates, Inc.
Q

Hey. Good morning, guys.

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President
A

Good morning.

Stephen J. Jones
President, Chief Executive Officer & Director
A

Good morning.

Patrick Tyler Brown
Raymond James & Associates, Inc.
Q

Hey, so I want to ask a couple of questions on the Waste side. So first off, nice traction on the uncontracted pricing, but when we look at uncontracted pricing up, say mid-single digits, maybe $5 year over year, how much of that is specifically attributable to the swapping of the low value waste? And then how much of it would be, call it, spot market pricing? I guess how strong is that northeastern disposal market?

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

Yes, Tyler, it's Brad. So, on a same-store basis, spot pricing is up about 6% in our markets where we have the open capacity in the second quarter year over year. In terms of the magnitude of the dollar difference though, I'd still say that more of it is coming from the mix shift that Steve talked about. That's profiled waste. That's the biggest piece, but also it's additional contracted volumes to a lesser degree, but additional contracted volumes that are effectively kicking out lower priced spot waste at a couple of the facilities.

Patrick Tyler Brown
Raymond James & Associates, Inc.

Q

Okay. Now, that's great color. And then just switching really quickly to the contractual side where obviously the vast majority of your tons sit, but you talked about in the presentation about 1% escalation. I assume most of that's tied to CPI but I am kind of curious about two things. Number one, how much of your contracted volumes do come up for bid over the next, say, three years? Do you view that an opportunity?

And then number two, your solid waste peers have made a push to move towards alternative indices. Is that something that you might consider and if so when?

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

Yes. So taking the tender of the contracts first, as you know, we signed up a number of contracts covering a large portion of our supply just given the timing of it a lot of that came together at the end of 2014. So, we're pretty well focused on the merchant plants here where we're talking about tip fee contracts. We're pretty well contracted for at the level that we would expect to be over the next three years. I think after that two year to three year timeframe is when you will see contracts really coming back up and that's primarily in the Boston and Philadelphia markets.

Patrick Tyler Brown
Raymond James & Associates, Inc.

Q

Okay, perfect. Yes, that's great. And then just lastly real quick on the ferrous side of metals; again, great job improving the quality there. You've talked about Fairless, but are there other plans to maybe buy additional facilities to move towards kind of a regional metal recovery – kind of an idea of moving to regional yards, I should say?

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

Yes, and actually Tyler, let me – you moved on to Metals. Let me answer the second part of your Waste question and then I'll maybe hand it over to Steve to take the Metals question. The vast, vast majority of our contracts are tied to – well, they're virtually all tied to some form of inflation index whether that's consumer or what's really more prevalent is a producer price type index in terms of being a basket between labor costs, materials costs and in some cases regional consumer prices.

We are actually looking at – I know some other companies are in the waste industry – we are looking at potential alternatives to end up with an escalation that better matches for better or worse over time the actual escalation of power costs, adding to the extent that we are able to start to reflect that in our contracts obviously given what I just commented on a minute ago, that's going to take a while to roll in given the length of the contracts.

Patrick Tyler Brown
Raymond James & Associates, Inc.

Q

Yes, okay.

Stephen J. Jones
President, Chief Executive Officer & Director

A

Tyler, Steve here. On the ferrous system at Fairless Hills, we're looking to replicate that in some other places, so down south, because we've got a lot of metal in the Florida market and then coming up further into the northeast. So we're looking at that right now. The other thing we're doing is at Fairless is looking at a non-ferrous cleanup system. Right now all the non-ferrous goes into kind of one pile and we get the lowest common denominator when that pile gets priced out, so doing more cleanup on the non-ferrous part of the recycling that we do is also in the works, and we'll get rolling on that here shortly.

Patrick Tyler Brown
Raymond James & Associates, Inc.

Q

All right, guys. Thank you.

Stephen J. Jones
President, Chief Executive Officer & Director

A

Thanks, Tyler.

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

Thanks.

Operator: And just a reminder to please ask one question and one follow-up and then you can return into the queue. The next question comes from Andrew Buscaglia of Credit Suisse. Please go ahead.

Andrew E. Buscaglia
Credit Suisse Securities (USA) LLC (Broker)

Q

Hey, guys. Thanks for taking my question.

Stephen J. Jones
President, Chief Executive Officer & Director

A

Hi, Andrew.

Andrew E. Buscaglia
Credit Suisse Securities (USA) LLC (Broker)

Q

Can you just talk a little bit about your free cash flow, you're in about a $10 million deficit so far and through the first half of the year, and that's consistent with last year – actually doing a little bit better it looks like. But can you just talk about it? I know historically we do get a ramp in the second half, but can you just talk about some of –

where some of that comes from? I know if you look before last year, it seems like the first Q1 and Q2 are – you do a little bit better, but what gives you that confidence in the back half that we can make this up?

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

Yes. It – so setting aside to the extent that we have in a particular year, we've had this historically, setting aside a receivables or payables tied to a large construction project, so more on an ongoing basis, it's really as simple as it's our production. And whether the plants are up and running or whether they're down for maintenance and then the actual costs incurred on maintenance, because that's the line that is the most variable seasonally.

And it's really as simple as in the first quarter and really the first half of the second quarter, a number of the plants are down, so we're generating less revenue, and that's then rolling through in the receivables line into the rest of the second quarter. And then the inverse happens with maintenance where we're spending the majority of our maintenance within a relatively concentrated time period, and then the payables related to all that work flow through in the second quarter and a little bit into the third quarter.

Once we hit the summer months, where we are now, the plants are basically running full out. And so it's as simple as collecting on those receivables in the third quarter and into the fourth quarter and from a cash basis recognizing that the lower ongoing expense that we see during the non-maintenance season.

Andrew E. Buscaglia
Credit Suisse Securities (USA) LLC (Broker)

Q

Okay. Yes. That makes sense. That's helpful. Kind of turning to your uses of cash, I know you talked about leverage, that's gone up, because you resigned a facility. But what are your allocation priorities at this point? I mean, are we – are you comfortable? It sounds like you're comfortable at this level of leverage. Has anything changed with regards to that?

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

No. Nothing at all has changed. I think the ratios where we are today have been impacted by what commodity prices have done, but by and large where the ratios are today, and certainly in terms of the drawn debt that we have, that was all part of our plan. I think given the condition of the debt markets here over the last few years, it just made overwhelming sense for shareholders to be funding the incremental growth investments with debt. And that's obviously with the expectation that when those investments come on line and start to contribute, that ultimately it's going to strengthen the credit profile of the company. So given the nature of the underlying cash flows and the contracts of the business, six times is really not an issue for us.

That being said, as we've talked about in the past, we would like to run at a lower level on an ongoing basis, so over time we'll target four times. We haven't put a specific date out there as far as when we might get there. There are a number of factors that play into that, including potential new investment opportunities, but that's really what guides the thought process.

In terms of our capital allocation, the dividend is an implicit commitment to our shareholders. So our capital allocation in terms of where we make additional investments and the way we run our business is really with an eye towards defending and growing the underlying cash flow that supports the dividend. Beyond that, the capital allocation becomes opportunistic, whether it's growth investments, which we would hope to continue to make, and then as we've done at different points in the past, we've bought back stock.

I think increasingly once the large investments we've been making come on line, I think you'll see debt repayment – it's always been a part of the capital allocation thought process, but obviously we've been in an investment phase where we've been drawing debt to fund that. So I think as we go over the hump on that, if you will, I think you'll see debt repayment become part of the equation more significantly than it has been.

Andrew E. Buscaglia
Credit Suisse Securities (USA) LLC (Broker)

Q

All right. Very helpful. Thanks, Brad.

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

Thanks.

Operator: The next question comes from Michael Hoffman of Stifel. Please go ahead.

Michael Hoffman
Stifel, Nicolaus & Co., Inc.

Q

Thanks for taking my questions.

Stephen J. Jones
President, Chief Executive Officer & Director

A

Sure.

Michael Hoffman
Stifel, Nicolaus & Co., Inc.

Q

Steve, on the guidance side, is it fair to characterize the re-affirming is at the midpoint with a positive bias?

Stephen J. Jones
President, Chief Executive Officer & Director

A

I'd say we're at the midpoint. I think there is maybe somewhat of a positive bias because we've had some better performance on some of the commodity pricing, but generally the midpoint's still a good number to use.

Michael Hoffman
Stifel, Nicolaus & Co., Inc.

Q

Okay. And then can you bring us up to date on how you see the progress in the Lean Six Sigma efforts? And where we could look at on the income statement that, that progress is coming through?

Stephen J. Jones
President, Chief Executive Officer & Director

A

Yes. So we've got 40 active projects that we're focused on right now, areas of outage optimization and maintenance. You can imagine that's a big number in our cost of goods sold that gets a lot of attention. Stable operations, which is basically the idea of having optimal set points for various situations at our plants, so it's this idea of having the best operator on the board all the time and you take some of the decision-making out of the operator's hands.

We're also looking at efficiency around the use of reagents. And then profile waste integration into the facilities. You saw we've had good performance in profile waste, but it still takes us too long to get a profile waste customer kind of approved to get them into our plant.

So we're working in those major areas. And again, we've kind of tried to highlight where we can get the biggest bang for our efforts, and so we're doing that. The $10 million that I mentioned is kind of scattered throughout the P&L, so it's hard to look at one line and track it. We do track the projects themselves. So, for example, in the last couple of days we've got a listing of various projects and an estimate of what the benefits would be, but we're really – so what – I mean when you sit back, we're trying to build a CI program that's going to provide benefits for years to come.

So we've hired on a few people, so that's caused our cost to go up a little bit, kind of an SG&A standpoint; but those folks will pay themselves back fairly quickly here. And we're starting to look as we get into next year what projects then go into the P&L so that we have an active project with – an active program that's going to continue to roll out for a number of years.

So I'm pretty pleased with where we are so far. And like I said, there's a number of different areas and that's why I highlighted that – the types of areas that we're looking at where you can start to see some of the benefits.

Michael Hoffman Q
Stifel, Nicolaus & Co., Inc.

Okay. And then Brad, through the P&L, as you've mentioned some of this information on Environmental Solutions and the bonuses, where should we be – one, how much should we be adding year-over-year to 3Q, 4Q? And where in the P&L for incremental bonus accrual and incremental cost related to Environmental Solutions?

Bradford J. Helgeson A
Chief Financial Officer & Executive Vice President

Yes, so the cost and revenue associated with Environmental Solutions from a business line breakout standpoint, referencing the exhibits to our press release, that all flows obviously into the other line – the other column within North America, so outside of the EfW business hitting the Waste revenue line there and primarily the other plant operating costs line so that's part of what you see rolling through and driving some of the increase year over year on that. The bonus is really spread into two lines. It's in actually that same line item. It's the other plant operating expense in the other column as well as the G&A line. And that total impact year over year is an accrual of about $30 million.

Michael Hoffman Q
Stifel, Nicolaus & Co., Inc.

Spread relatively evenly, of course, per quarter?

Bradford J. Helgeson A
Chief Financial Officer & Executive Vice President

Yes, there is some lumpiness on a comparable basis just given the timing of when we had taken the accruals down last year. So you'll see a little more of a delta in the third quarter and less of one in the fourth quarter so on a full year basis it's 30 and that's the number we talked about in the beginning of the year.

Alan Katz
Vice President-Investor Relations

A

Michael, I can help you with the model offline.

Michael Hoffman
Stifel, Nicolaus & Co., Inc.

Q

Okay. And then I guess the last question would be for all of you, at what point given that the momentum has now shifted towards the more of a tailwind than a headwind on commodities, electricity, the tip fees do we get to a quarter or year-over-year growth in profitability? 1Q?

Stephen J. Jones
President, Chief Executive Officer & Director

A

It's hard to get. You know we're just starting to make turns here on commodity pricing. So I'd give us some more time to be able to tell you that. It's hard to – you know, the visibility is just starting to change now, so I'd be guessing at this point. So, give us some time to think about that question.

Michael Hoffman
Stifel, Nicolaus & Co., Inc.

Q

Okay. Thank you.

Stephen J. Jones
President, Chief Executive Officer & Director

A

Sure.

Operator: The next question comes from Al Kaschalk of Wedbush Securities. Please go ahead.

Al Kaschalk
Wedbush Securities, Inc.

Q

Good morning. I wanted to follow up on the Environmental Solutions group, in particular the comments about the Northeast market. I guess the broader question, Steve, would be as you think about growth there and change in mix, how much capacity – or how much is available from a tonnage perspective in that market that you can continue to, I won't to say tinker with but provide some better mix on the results going forward? I don't know if you could just maybe gauge that a little bit.

Stephen J. Jones
President, Chief Executive Officer & Director

A

I don't have an exact number right now, Al. We've got years of – this isn't something we're going to hit a constraint with any time soon. So we've got quarters and years of growth in the profiled waste business. And one of the things we're doing – that's why CI is important in this area. We're looking at how we can take more and more profiled waste into the plants. And so – and then part of it is permit issues. So if we run into permit issues, we'll work to amend our permits. But I don't see it hitting the – if what you're getting at is do we hit a constraint fairly quickly here, I think the answer to that's no. But we can give you a better idea with a number offline if you'd like.

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

Yes. And Al, I'll just add a little bit to your reference to the Northeast. I just want to make sure when you're looking at where we have uncontracted capacity and kind of lining that up with the Environmental Solutions opportunity, the Environmental Solutions opportunity really is, it's probably obvious, but that's concentrated in areas where you have heavy generation of industrial and manufacturing waste streams. So that's really – if you look at our map, that's really Pennsylvania out through the Midwest. So it's our Indianapolis plant, it's our Niagara plant, and increasingly looking at opportunities in Pennsylvania as well as some other areas. But I guess the point is that we don't have significant amounts of industrial wastes of the type that we're specifically targeting now in the Boston area. So I just want to caution people who may be thinking about it in these terms that, okay, if you have two million tons or three million tons of excess capacity it's just a matter of filling that up. It isn't quite that simple.

Al Kaschalk
Wedbush Securities, Inc.
Q

All right. But the point is that the nature of the business there not being uncontracted or non-contracted depending on how we reference it, is that it's just shorter duration. In other words, it's not long-term commitment or it is?

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President
A

That's right. It ends up being – it's evergreen type business. It's much more similar to what you would see in one of the traditional integrated waste companies as opposed to our business historically, which is 10-year or 20-year municipal contracts.

Al Kaschalk
Wedbush Securities, Inc.
Q

Right. And then my follow-up, Steve, the progress on Dublin sounds good. I guess I just want to take a step back here, and is the objective and the preferred, given the market conditions here, is the preferred method to have 100% of that business contracted? Or given market dynamics and the hunger for facilities, would it be prudent to steer some of that into an uncontracted basis to take advantage of it?

Stephen J. Jones
President, Chief Executive Officer & Director
A

We'll leave some of it uncontracted out. We're in the process now of finalizing some other contracts. So we announced two contracts where we signed 60% of the capacity. We're looking to firm up another 30%. So when it's all said and done, about 90% of capacity by year-end. And maybe that's probably where we'll sit for a while. We'll start to look at shorter-term contracts. That 90% capacity is termed out for a while, so – and so we'll look to go a little shorter term on kind of the remainder at that point. And then we'll do – there's a lot of things that we're doing here in the U.S., you start to look for profiled waste and we're already getting inquiries in Ireland about bring certain types of profiled waste that have a higher tipping fee into the plant. So we'll keep some of that capacity available for that.

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President
A

And Al, to clarify, when we talk about 50% contracted or 90% contracted, what we're referring to is the committed waste volumes under those contracts. So we need a little bit of flex in there for weekly, monthly, seasonal movements in waste streams. And what may end up happening is if we say we're 90% contracted, it may end up being that we end up filling the plant entirely with the waste that's brought with those customers. It's just that we couldn't necessarily commit to 100% of the facility just given the operational flexibility that's needed.

Al Kaschalk
Wedbush Securities, Inc.

Q

Right. Thanks a lot for the clarity. And good luck, guys.

Stephen J. Jones
President, Chief Executive Officer & Director

A

Thanks, Al.

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

Thank you.

Operator: The next question comes from Noah Kaye of Oppenheimer & Company. Please go ahead.

Noah Kaye
Oppenheimer & Co., Inc. (Broker)

Q

Thank you very much. Good morning. Wondered if we could kind of get the lay of the land on the pipeline and the opportunity set for new projects? You know you did touch on Perth. You've given us an update on Dublin. You announced I think back in May progress on the Bedfordshire plant and partnership with Veolia, so maybe if it would be possible to get an update on the timeline there and how the permitting's going? And then just broadly, the opportunity set. Thanks.

Stephen J. Jones
President, Chief Executive Officer & Director

A

Yes. So one of the things I'm trying to do from a business development standpoint is to have a longer list of opportunities. These tend to be long cycle projects and we talked about that at our August Investor Day last year. And so you mentioned kind of what we're looking at right now. I mentioned Perth. So Dublin, 70% complete on construction. We're working hard on some of the additional waste contracts. We still expect to see first fire in the first quarter of 2017 and then kind of full operational capabilities in the fourth quarter. So that's coming along as we expected.

The Perth I mentioned, you know we're really looking at kind of the technical side of that project as the technical package are we taking it – can we take in more waste? Can we produce more power and thereby creating value for the project? We're looking at that pretty closely along with the EPC arrangement to make sure that we have – it's a long ways away to build a plant, we want to make sure we have an EPC arrangement that gives us comfort that our risk criteria is being covered. So we're working hard on that now.

And then you mentioned what we call the Rookery project, which is a little north of London. No real update at this point, except we're working with Veolia to develop that project. There's a couple other potential projects in the UK that we're looking at also. And so we have a bit of a list of different projects that we're working through the process on. Again, I wanted to make sure that we had more of a robust list of business development activity as we move forward. So, that's generally kind of where things are.

If you look to it at other areas of the business, obviously I mentioned the Fairless project and kind of the offshoots from that. So there's opportunities for us to invest in and around our base business and not new energy-from-waste, but existing energy-from-waste, where the returns are pretty darn clear that we'll look to do Fairless-type projects, as I mentioned in down south and then also further up in the Northeast and they'll be good return projects if we can get them where we want them to be.

Noah Kaye
Oppenheimer & Co., Inc. (Broker)

Q

Okay. Great. Thanks. And then just thinking about maintenance spend, the sustainability of the current level of maintenance spend possibly how that interacts with some of the CI work that you're doing now? Does that work give you more confidence that, call it, $110 million range is sustainable longer term? How should we be thinking about that, particularly in the context of certainly upcoming contract transitions?

Stephen J. Jones
President, Chief Executive Officer & Director

A

Yes. You know it's interesting, because again when you start to roll out a CI program, you look for the high value areas, and maintenance in this business jumps right off the page. I mean out of a cost of goods sold of roughly $1 billion, and you start to look at how much both CapEx and expense we spend on maintenance, it's $350 million to $370 million range. There's a lot of work that gets done there, and therefore it's ripe for CI, particularly lean. How do you do operational activities in maintenance more efficiently? And so we're seeing good progress there. It started, we call it wrench time early on, but now we're talking about it as outage optimization. How do we optimize around the outages? How do we also then use vendors at various plants in order to get economies of scale and get leverage across vendors? All that's going on right now.

I would tell you that there's two things that can occur. There's – we can either do more maintenance at the same price or we can – you know, if need be – or you can do the same amount of maintenance and the price will go down and we're starting to see kind of both of those things. With the efficiency, we can decide what we're going to do, so it's really creating a lot of benefits for us so far and I expect this area will create benefits for a number of years to come. It's a pretty high target area for the CI team right now.

Noah Kaye
Oppenheimer & Co., Inc. (Broker)

Q

Understood. And so then just to make sure I'm interpreting what you're saying correctly, you think that the outlook for kind of maintenance trajectory is certainly going to be helped by this...

Stephen J. Jones
President, Chief Executive Officer & Director

A

Yes.

Noah Kaye
Oppenheimer & Co., Inc. (Broker)

Q

... but on sort of on an absolute basis, how do you think about levels going forward?

Stephen J. Jones
President, Chief Executive Officer & Director

A

It's likely to increase at the rate of inflation. Although, you know, the whole idea of CI is to ultimately fight back on inflation and to get ahead of that, so it's still early days; I mean we're in the first -through the first half of the first year of CI, so we'll have more thoughts on that as time goes on but I'm pretty confident that we'll be able to kind of fight back on that inflationary number as time goes on. That's what CI is designed to do. And, again, this area, I think has a lot of potential targets in order to save money.

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

Noah, it's Brad, I'll just jump in with a couple of additional points on that. So we've talked about this in the past just to keep in mind that the capital projects, particularly large capital improvement projects, we've talked about a couple of them that are on deck for us here this year and next year, those will lead to some lumpiness in the CapEx line. You'll see the maintenance expense line have a much more predictable trend to it.

Noah Kaye
Oppenheimer & Co., Inc. (Broker)

Q

Great. Thank you.

Stephen J. Jones
President, Chief Executive Officer & Director

A

Thanks, Noah.

Operator: The next question comes from Scott Levine of Imperial Capital. Please go ahead.

Scott Justin Levine
Imperial Capital LLC

Q

Good morning, guys.

Stephen J. Jones
President, Chief Executive Officer & Director

A

Good morning, Scott.

Scott Justin Levine
Imperial Capital LLC

Q

So, I mean, I wanted to ask a little bit about construction work. You know, it seems like Durham's on track. You mentioned, I think in your prepared remarks the CPC technology initiative. I was hoping maybe a little comment just with regard to your thoughts on performing construction work in general, and also I've seen some press involving one of the boilers at Durham-York and some issues from an environmental standpoint there. I was hoping you'd be able to comment on that if that was a potential issue or nothing to be concerned about.

Stephen J. Jones
President, Chief Executive Officer & Director

A

Sure. So construction generally, I mean we're not in business to be a construction company. We'll do construction work as kind of an augment to our opera – sorry, I'm getting a little bit of feedback here from somebody's phone. Yes. Okay. Thanks. So we do construction as part of our operating expertise. So if you look at Pinellas, for example, we're doing construction down at Pinellas at the Pinellas facility, but really that's kind of to augment what we're doing from an operations standpoint.

And if you look at – so Durham-York we were a lot more involved in the construction. We were kind of the general contractor, if you will. I think that model caused us a few problems particularly because we weren't as familiar with

Canadian markets. If you look at Dublin, we're not the general contractor or the EPC. It's a function of having Hitachi Zosen play that role. So going forward – and if you look at Perth, we're looking at a model that's more like Dublin than Durham-York for obvious reasons. Anyway, that's kind of my thinking on construction.

With respect to Durham-York, yes, in May we did some voluntary source testing on both of our units, and one of the units exceeded the in-stack performance standards on dioxin and furans. We shut down the unit, conducted some system-wide equipment assessments and diagnostic evaluation. We tested all the other parameters, which the unit passed on. The dioxin, furan standards were the ones where we ran into some problems.

The other unit, we have two units in Durham-York, the other unit passed with flying colors, so no issues there. It passed all the parameters. So we performed some further tests, and now we want to start back up so we can check out what actually happened as part of this testing. We should get approval from the Ministry of the Environment, that's where the testing sits right now. We've gone through it with the clients, and everybody is onboard to bring that unit back on line, and we'll do some more work on it. But we expect that very shortly we'll get that unit back on line. It hasn't had a big financial impact on us. There's some diversion costs that we're responsible for, for waste not going through that unit, but we're running at 50% capacity now because one of those two units is operational, so not a huge issue.

Scott Justin Levine
Imperial Capital LLC

Q

Got it. Great. Thanks. And then just a quick follow-up, I think you mentioned that the timing of the China sale, Brad, would be towards year end. Is there any potential swing factor with regard to financials of a material nature if that were to fall into, say, early 2017 versus 2016 to be taken into consideration or not really?

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

No, because there's kind of the two steps to the transaction. The first one was the asset swap, and that closed at the end of March. So after that date there's no more P&L contribution. So China is out of the results. It's really just a matter of when we get the cash to redeploy and to pay down debt.

Scott Justin Levine
Imperial Capital LLC

Q

Got it. Great. Thanks.

Operator: The next question comes from Dan Mannes of Avondale. Please go ahead.

Daniel Mannes
Avondale Partners LLC

Q

Hey. Good morning, everyone.

Stephen J. Jones
President, Chief Executive Officer & Director

A

Hi, Dan.

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

Good morning, Dan.

Daniel Mannes
Avondale Partners LLC

Q

Hey. I know it's a little premature and I'm not looking for anything exact as it relates to 2017, but in the context of your discussion about, obviously, the dividend, reducing debt ultimately, can you walk through a couple of things for 2017? One would be maybe the cash flow timing as it relates to Dublin. And then, number two, what are your current committed CapEx for 2017 excluding Dublin, if any?

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

Yes, so Dublin. The contribution will start obviously when it comes online. And just – Dan, you probably understand this – but on this topic, maybe to clarify for people generally, Steve had mentioned that we would target to start processing waste in the first half of next year. Any revenue that we generate from that, whether it's electricity sales or waste processing during the start-up and commissioning phase is netted against the CapEx. And that's all netted within the total capital numbers that we talked about. But, anyway, I just wanted to clarify that, and you gave me a good opportunity to do it.

But – so in terms of operational, what's going to hit revenue and EBITDA from an accounting standpoint, you'll see that starting in the fourth quarter and you really won't get the full year, from a cash standpoint, you won't get a material contribution most likely until 2018.

As far as what else is committed, it's just the items that we have listed on our growth investment outlook in the earnings presentation. There's nothing else that we have that's committed that's out there. I think we'll take whether it's acquisitions in the Environmental Solutions area or whether it's metal systems, the types of organic growth investments that we've been making we'll take those as they come and decide whether they make sense to invest in.

Daniel Mannes
Avondale Partners LLC

Q

Got it. And then just one other follow-up on 2017 as it relates to the capacity markets for power, you know you've been running fairly consistently at this level. When you look forward to next year given I know a lot of the auctions you're in are multiple years in advance, is it fair to assume that your capacity revenue is going to be down next year on a year-over-year basis or am I misreading that?

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

Yes. Not materially, I think you're misreading that.

Daniel Mannes
Avondale Partners LLC

Q

Okay. Got it. Thank you.

Bradford J. Helgeson
Chief Financial Officer & Executive Vice President

A

Thanks.

Stephen J. Jones
President, Chief Executive Officer & Director

A

Thanks, Dan.

Operator: This concludes our question-and-answer session. I would like to turn the conference back over to Steve Jones, Covanta's President and CEO for any closing remarks.

Stephen J. Jones
President, Chief Executive Officer & Director

Again, thanks for joining us in Q2. We appreciate everybody's help and questions and we look forward to continued dialog with all our investors. And we'll talk again in this format at the end of Q3. So thanks so much for your participation.

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