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Q3 2019 Earnings Call

CORPORATE PARTICIPANTS

Daniel Mannes
Vice President-Investor Relations, Covanta Holding Corp.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

OTHER PARTICIPANTS

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Patrick Tyler Brown
Analyst, Raymond James & Associates, Inc.

Brian Lee
Analyst, Goldman Sachs & Co. LLC

Angie Storozynski
Analyst, Macquarie Capital (USA), Inc.

Henry Sou Chien
Analyst, BMO Capital Markets (United States)

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone, and welcome to the Covanta Holding Corporation's Third Quarter 2019 Financial Results Conference Call and webcast. An archive webcast will be available two hours after the end of the conference call and can be accessed through the Investor Relations section of the Covanta website at www.covanta.com. That's http://www.covanta.com/. The transcript will also be archived on the company's website.

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

Daniel Mannes
Vice President-Investor Relations, Covanta Holding Corp.

Thank you and good morning. Welcome to Covanta's third quarter 2019 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.

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 those 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 day this is live broadcast, October 25, 2019. We do not assume any obligation to update our forward-looking information unless required by law. Any redistribution, retransmission or rebroadcast of the call in any form without the expressed written consent of Covanta is prohibited.

The information presented includes non-GAAP financial measures. Because these measures are not calculated in accordance with US GAAP, they should not be considered in isolation from our financial statements which have been prepared in accordance with GAAP.

For more information regarding definition of our non-GAAP measures and how we use them, as well as 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 turn the call over to our President and CEO, Steve Jones. Steve?

Stephen J. Jones

President, Chief Executive Officer & Director, Covanta Holding Corp.

Thanks, Dan, and good morning everyone. For those of you using the web deck, the quarterly results are summarized on slide 3, and I'll begin my discussion on slide 4. During the third quarter we continued executing on our operating plan, generating $125 million of adjusted EBITDA and $22 million of free cash flow. With solid performance in the quarter and line of sight on the remainder of the year, we are affirming our full year guidance of $420 million to $445 million of adjusted EBITDA and $120 million to $145 million of free cash flow.

Taking a moment to provide more context around our results, bear in mind that the adjusted EBITDA of $125 million represents 2% year-over-year growth, even as we've seen 20%-plus declines in the price of many of the commodities we sell. We overcame this headwind because we're able to drive organic adjusted EBITDA growth of 9% in the quarter. The reliability and performance of our fleet of energy from waste assets is critical to our ability to grow organically. During the quarter, we processed 5.5 million tons of waste, an 8% increase over last year. This production includes 2.5% same store tip fee volume growth, as some of our largest tip fee plants continue to run at or near record levels as well as inclusion of the Palm Beach contracts acquired in September last year.

These improved operating results are no accident. Over the last several years, we've revamped our operating and supply chain management and instituted Lean Six Sigma techniques to improve the operations and reduce costs.

Further, we've invested in our plants and those maintenance dollars are paving the way to consistent operating performance. With three quarters of the year complete, we're right on track from a maintenance perspective and we expect 2019 to be another year of record production.

Our primary end-market is sustainable waste disposal and our ability to capture improving waste prices across our EfW fleet has been a key driver of the financial performance. Tip fees were up over 4% in the third quarter on a same-store basis with higher spot prices, effective recontracting, and strong profile waste growth overcoming typically muted contractual escalation.

As I like to say, it's a good time to be a waste company, especially with our assets in the Northeast. And we expect to deliver tip fee price growth of over 4% for the year.

Covanta Environmental Solutions drove 10% growth in same-store profile waste revenue to our EfW plants. This increase was a product of both unit price and volume improvement. In order to facilitate these high-value waste flows into our EfW facilities, we focus on maximizing the volume of material that is internalized through our material processing facilities or MPFs.

The revenue internalized through our MPFs increased by 25% in the quarter as we continue to utilize these complementary assets to service more customers and increase our profile waste sourcing capabilities.

We expect this rate of internalization to grow further over time, supporting our expanding profile waste business. While profile waste comes in many forms, a key area of opportunity is regulated medical waste. During the third quarter we grew regulated medical waste revenue by over 40% as we continue to ramp volumes to our three energy from waste plants that are permitted to accept this waste.

While still representing a modest amount of the overall profile waste revenue, we see very strong growth potential and are working with regulated medical waste collection companies to source more volume. We aspire to be the leading provider of wholesale regulated medical waste disposal services to that industry.

In order to reduce our long-term cost of ash disposal, as well as to become more sustainable while creating new revenue opportunities, we've been developing our first Total Ash Processing System or TAPS. The first TAPS plant is currently under construction at the Fairless Hills, Pennsylvania metal processing facility. While we had expected to be fully operational by the fourth quarter this year, we've extended the construction timeline a bit to optimize the equipment.

This is the first system of its type and an exciting long-term opportunity for Covanta, so we want to make sure we get this first one right. We now anticipate beginning to start up some components later this year before moving into commissioning of the entire system early next year.

In the metal processing area, as we mentioned in the last couple of quarters, we've recently invested in technologies to further separate the various types of non-ferrous materials we recover. This equipment began operations late in the third quarter and we're now separating higher value heavy metals like copper and zinc from lower value mix non-ferrous scrap.

As we discussed on the second quarter call, we continue to see a soft environment for many of the commodities we sell, and this has not improved over the last three months. On scrap steel or ferrous, after a decline in the second quarter, HMS pricing appeared to stabilize in the third quarter in the $220 per ton range. In October, prices took another leg down with the index reaching $192 per ton. At these price levels, we believe that the markets will see a reduction in scrap flows which should then stabilize prices. That's what these markets do. And longer-term, we expect to see continued domestic demand growth for ferrous scrap as new mill capacity comes online over the next few years. However, while history tells us the prices should find market equilibrium again at prices well above current levels, the timing of the recovery is difficult to predict.

On the non-ferrous side, the largest product we sell volumetrically is scrap aluminum. For much of the year, pricing has softened as China reduced the volume of this product it will accept, and the smelters in the rest of the world have struggled to absorb the excess material. This has led to severe price pressure with the Old Cast index now pricing at $0.37 per pound in October. This is down meaningfully from 2018 when price averaged just under $0.60 per pound. This is another reason why we're investing in technology to separate the non-aluminum components of the non-ferrous stream as they often trade at three or more times the price.

Lastly, on energy, we've recently seen some stability in price, albeit at historically low levels. As you know, we have a formulaic program to hedge our energy exposure to reduce volatility. This has served us well in this market.

I'll conclude my remarks with a brief update on our UK development activities. Rookery and Earls Gate are now well into construction and we continue to progress Protos and Newhurst towards financial close. Those projects are attractive and well structured, and we're actively engaged with our project partners, lenders and EPC contractors to swiftly move the projects forward. The Protos project remains positioned to reach financial close in 2019, while the Newhurst project is right behind with financial close more likely in early 2020.

Further, and as I mentioned in the last quarter, our partnership with GIG goes beyond these four projects. And there are other earlier stage projects that are moving along as well. We look forward to providing more color on these projects as well as our efforts in other geographies when we have reached material development steps.

With that, I'll hand the call over to Brad to discuss the financial results in greater detail.

Bradford J. Helgeson

Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

Thanks, Steve. Good morning, everyone. I'll begin my review of our financial performance with revenue on slide 6. Total revenue for the quarter was $465 million, up $9 million from the third quarter of 2018. Organic growth excluding the impact of commodities contributed $12 million as higher waste prices and strong EfW plant production outweighed lower construction revenue in the quarter. Commodities had a negative impact as we saw a $13 million decline in revenue related to lower market prices for energy and metals.

Transactions added $10 million to revenue in the quarter, with the September 2018 acquisition of the Palm Beach operations and Q1 startup of the Manhattan Marine Transfer Station partially offset by divestitures. Long term contract transitions added $1 million in the quarter.

Moving on to slide 7, adjusted EBITDA was $125 million in the quarter, a $3 million increase compared to the third quarter of 2018. Excluding commodities, adjusted EBITDA improved by $12 million organically, as the benefit of higher waste prices and plant production more than offset higher planned maintenance this quarter. As we look ahead to the fourth quarter and full year I would remind you that we will lap $11 million and $17 million respectively in business interruption insurance proceeds received in 2018. We knew coming into the year it will be challenging to meet our 3% to 5% annual organic adjusted EBITDA growth target given this year-over-year comparison, and this remains the case. However, we expect to be in our target range excluding the impact of insurance proceeds.

The $13 million headwind from commodity prices as I just discussed translated directly from revenue to the adjusted EBITDA line. The net benefit of transactions added $5 million to EBITDA on the quarter as the contribution from the Palm Beach acquisition and Manhattan Marine Transfer Station were again partially offset by divestitures.

For the full year 2019, we continue to expect adjusted EBITDA in the range of $420 million to $445 million. As Steve noted, we've seen a further reduction in metals prices since last quarter's call. We've revised our outlook range for metals revenue by a further $10 million to $20 million compared to previous expectations, as you can see in the appendix to the slide presentation. This reflects lower scrap ferrous and aluminum market prices, as well as a lower average sales price on non-ferrous, given the timing of startup of separation equipment at our Fairless Hills processing facility.

Further impacting non-ferrous sale this year, we historically have recovered mutilated coins and delivered to the US Mint for currency value. However, the Mint has temporarily closed its redemption program this year in response to fraudulent activity, so as a result we're currently holding coins at processed inventory awaiting shipment. In total and all else being equal, these factors in our metals business will likely move us to the lower end of our guidance range, though it should be noted that much of this essentially represents sale timing.

Turning to slide 8, free cash flow was $22 million for the quarter as compared to $85 million in Q3 last year. While adjusted EBITDA was $3 million higher in the quarter, working capital and restricted funds were a net cash outflow in Q3 and lower by $63 million compared to the cash inflow in Q3 2018. The two largest components of this were the final payment of holdback and dispute settlement amounts related to the construction of the Durham York plant which we had previously accrued for and a shift in the timing of interest payments on high yield bonds following last year's refinancing, which reduced cash interest payments in Q3 last year.

Our full year guidance for free cash flow is unchanged and these items were always contemplated in the range. Therefore you should expect a sizable improvement in working capital and free cash flow in the fourth quarter, which is a fairly typical seasonal pattern for us.

Now please turn to slide 9, where I'll review our growth investment activity. Over the first nine months of the year, we invested just over $40 million in growth, most notably equipment to support the startup of the Manhattan Marine Transfer Station. Year-to-date, we have spent a little under $5 million on TAPS. But with equipment now being delivered and installed, we anticipate increased spend in the fourth quarter with further spend in 2020 as we complete construction.

In the UK, we have spent $10 million year-to-date which primarily represents our investment in Earls Gate, where we fully funded our proportion of the equity, as well as preconstruction site work primarily at Rookery.

A couple of reminders here. First, our equity investment in Rookery was bridge financed at the project level and net of the premium and cost recovery received from our partners at financial close, we anticipate a remaining funding requirement from the parent company of about $40 million in 2022.

Second, this forecast does not yet include our equity investments in Protos and Newhurst until they reach financial close. We'll provide more specifics on the amounts and timing of funding requirements for those projects at that time.

Please turn to slide 10 where I'll provide an update on our balance sheet. At September 30, net debt was $2.5 billion, up about $30 million from Q2. Our consolidated leverage ratio was 6.0 times, unchanged from June 30, and the senior credit facility covenant ratio was 2.4 times. Our available liquidity under our revolver was nearly $400 million.

During the quarter, we issued our first series of tax exempt green bonds primarily to fund spending on TAPS and our energy from waste plants in Pennsylvania. With a 20-year term and 3.25% coupon, these unsecured bonds represent very attractive long-term funding that further enhances the cost, tenor, and flexibility of our capital structure. We now have over $500 million of corporate tax exempt bonds like this outstanding, and we'll look to tap into this market in the future as an efficient means of funding domestic investment.

Before I turn it over to Q&A, I'd like to hand it back to Steve for some concluding comments.

Stephen J. Jones

President, Chief Executive Officer & Director, Covanta Holding Corp.

Thanks, Brad. I want to take a moment and reiterate a few things. Operationally, the year is going well, and our investments in our plants and people are yielding the growth we expected. The benefits of these investments are evident in our operating performance over the last several quarters. In the US market, we continue to benefit from a very supportive waste environment with strong volumes and declining alternative disposal options, which is driving waste pricing at our irreplaceable assets. I also remain very excited about our progress on several growth initiatives. TAPS remains a major opportunity to improve our profitability and sustainability with broad-based opportunities throughout the fleet.

On the development front we're well on our way to reaching our initial target of four plants in the UK, and we see broader opportunities in international markets as well as growth in the US.

With that, operator, let's move on to Q&A.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Michael Hoffman from Stifel. Your line is open.

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thank you very much for the questions. And, Steve, I hope you feel better.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Yeah, I know. I was going to say something when I first started off. Last Friday, I couldn't speak at all, so this is an improvement. So, thanks for that.

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Brad, can I just get a clarity on the guidance? So I understood that you – $420 million, $450 million remains. If you were able to sell the mutilated coins, you'd still be at the midpoint, is that what you were saying?

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

A

Well, I think the mutilated coins is one of a few issues that are impacting us on the non-ferrous revenue line. Of course, the first one is the underlying commodity prices. The second is our progress on increasing the average sales price by separating it – Steve alluded to this, the heavy metals, generally speaking, from the lights, so the scrap aluminum, and then another piece of it is the mutilated coins. So, I wouldn't – I certainly wouldn't pin it all on mutilated coins, but it was significant enough relative to where we thought we were going to be that it was worth mentioning.

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. But if you could sell the mutilated coins, would you be telegraphing we're in the lower half?

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp. A

Yeah. The mutilated coins alone wouldn't move us back up to the middle.

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

Move up again. That's right.

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

Okay. Okay. That's what I was trying to understand.

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp. A

Yeah.

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

Okay. You have a target of $250 million in free cash over a 5-year period and $15 million a year is supposed to come from US domestic leverage and $45 million comes from the UK, and that's assuming you do the $130 million this year. That's the midpoint of your guidance. Is there anything that's – you look out and the business model under the conditions you're now living with, this lousy commodity environment and the like that would preclude you from doing the $15 million a year on average to get that $75 million in place? It would seem the UK part seems reasonably good.

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp. A

Yeah. So, the short answer is no. I mean, I think the underlying drivers of the target when we originally put it out and the components of our strategic plan are unimpacted by commodity prices. I mean, production and profitability in the plants. It's growing the metals recovery, ash management capabilities with TAPS, growing Covanta Environmental Solutions, profiled waste, regulated medical waste, I mean there are a number of initiatives that we're focused on, none of which are impacted by commodities. And that's what underpins the $15 million, the shift that you referenced.

And then of course on top of that, we're looking to grow our portfolio, focus immediately is in the UK, but we have our eyes out over the horizon on other international markets as you know. And then, ultimately opportunities domestically. So, all of that is unchanged.

I think as regards to the $250 million specifically, commodities obviously impact our results. And so, I think we do have to recognize that if commodity prices are materially lower than where they were when we set the guidance as they are today, on the order of probably $50 million, when you step back, that's going to impact our results. And all else being equal, probably the best way to think about it is it just makes the path to $250 million a little bit longer.

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

Okay. But you'll still get to the $250 million? It's not that you're permanently lowering the number. It's going to take you longer.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Yeah. That's exactly – this is Steve, Michael.

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Is that what you're saying? Just to be quick. Okay. Okay.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Yeah. This is Steve. Yeah. That's what we're saying.

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

And some of it depends on when does the commodity environment snap back to the mean, right? We're not sure and everybody on the call can take a view on that, obviously, but that's an important consideration when you start to think about the time it takes to get to $250 million.

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. I have two kind of high-level housekeeping-type questions. You have a peer company that has not had particularly good press lately, one around a landfill expansion for ash, and the other air pollution equipment. Can you contrast why you're different?

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Yeah. So – yeah, we saw those too. If you look at – let's take the second one first, air pollution equipment. I think out of our 40 facilities now, we have two facilities that don't have baghouses. And so – and this other company is I think dealing with issues around not having a baghouse in a particular facility. I think that's what you're referencing.

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yes.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

We're in the process now of determining when we're going to add baghouses to the two facilities. So, it's limited in number and we'll think about – it will present lumpiness in the year that we decide to add the baghouses. But as a general matter, our maintenance isn't really going to vary much from the inflationary bogey that we put out there. So, we've got a good handle on air pollution control from that perspective. With respect to – the first part was again?

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Ash, they got denied a permit...

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

On the ash. So, yeah. They're I think they got denied...

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Q

...for the landfill ash...

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

...at Putnam. Yeah. We have multiple – and most of our plants that we were responsible for the ash, we have multiple options in order to be able to get our ash put into an ash landfill or ash monofill. So, we're not particularly worried about that. I think we've got really good programs in place to be able to back up what we need to do from an ash standpoint.

And then the other side of that is TAPS, right? So, one of the reasons we're interested in TAPS, and I use the words financially and sustainability – and from a sustainability standpoint in my prepared remarks is that TAPS allows us to reduce the volume of ash that's going to go into an ash monofill. So, we're very excited about what's going on in Fairless Hills right now, and that will help us to reduce – even if we had issues which we don't, that would reduce the volume of ash that needs to find a home.

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Q

All right. And then last for me, Brad, can you tell us what the hedging rate we should be using for 2020 at this point?

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

A

In terms of price?

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Yes.

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

A

Yeah. I think it's a little – we'll lay all that out in February, so it's a little early to – because we're still hedging for next year to put a specific number on that though. I think a reasonable expectation would be that it's going to be modestly lower than the hedged rate overall for this year.

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Q

But the emphasis is on the word modest.

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

A

Yes, I would – I think that emphasis is appropriate.

Michael E. Hoffman
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. All right. Thanks.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Thanks.

Operator: Your next question comes from the line of Noah Kaye from Oppenheimer. Your line is open.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Thanks. I want to ask you a question around operations and in particular increasing the plant throughput. You've got 2.5% same-store volume increase growth this quarter. And just broadly, I think this is an area you've talked about, getting stable operations and improves uptime.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Yeah.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

I mean, I think about 500,000 ton increase in the tip fee plant, that's a $25 million to $30 million bump in revenue. So, I guess the question here is really can you give us a sense of how much of the fleet is operating close to permitted capacity? How much cushion you have under permits to increase throughputs? Would you need to seek expansions to permitted capacity as you improve through lean operations? Just how much runway you see for the sort of stable operations, lean operations to drive higher throughput?

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Well, maybe I'll start with this and then Brad can jump in. So, stable operations, first off, we're not using in all our plants yet. We know we picked our biggest plants. So they are the ones that actually came through this quarter.

So the reason you see this 2.5% same store growth is these big tip fee plants, think places like Essex for example or Hempstead.

They're operating really well at this point and that's because we've been using stable operations which is basically you've heard me talk about this before. It's as if you had your best operator on the board 24 hours a day, 7 days a week and so that's working well. We will get more leverage from stable operations as we move it out to some of our other plants which are a little smaller in size.

So this will be a path that will continue for some period of time. I would say on how we operate from a permit standpoint, we try to operate at the limit of our permits all the time. And so and with the waste market the way it is right now which is a great waste market, there's plenty of waste out there, so we can we can operate at the limit of our permits.

The issue or the benefit you saw particularly in this quarter is we had less downtime. So, we were able to – we always have some downtime on our plants. Because of stable operations we were able to limit that downtime if you look at this past quarter. And that's what we're expecting stable operations to do as we move forward.

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

A

Yeah. I would just add as it relates to the permits, what we're seeing at a few of our big plants, the permit limitation is now relevant to the production whereas in the past it hasn't been. So in those situations, we'll look to see if there is flexibility for us to modify the permits, if the plant is sustainably operating at a higher level.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

Okay, that's very helpful. And then on the TAPS facility, the first one that you're standing up, I think you've talked in the past about turning around the 20% unlevered IRR and that type of project. I guess, just how long do you need to see that facility operate before you would get comfortable enough in the returns to put capital into additional plants, and just give us an idea of how long you think it might take to put the processing capacity in place to cover the full fleet?

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

The plants – we're going to start to commission some of the aspects of the plant later this year, and then kind of full commission next year, and I mentioned that in my prepared remarks. I think the plant needs to run for I'd say a couple of quarters in order to make sure everything's working the way we expected it to. This is not new technology, so I'm not particularly worried about the technology risk to it, this technology has been used in other industries. So we're putting it – it's novel if you will as it relates to our industry, and the ramp-up in and the size is bigger than it's been used in some other places.

So that's what we're going to need to test out over these, let's say couple of quarters. We also want to make sure that the sands and the aggregate that we produce gets de-wasted, which is effectively, it's got to go through a testing process in order to then be used in DOT-approved road waste. So, can be used in other applications before then and so that's going take a couple of quarters to work that out.

And then quite frankly right now, we're in discussions with clients and also looking at our own plants on – when we roll out the next TAPS projects. So, they're going to move. The long lead time item, I mean, you saw it on the

Pennsylvania TAPS and the one that Fairless Hills was permitting. So, we're in the process now of lining up the resources to get the permitting well underway. So, that's the leading indicator and so we'll start that process even as we're waiting these couple of quarters to see how the Fairless Hills TAPS operates.

How long it will take to roll out over the whole fleet? I'd say probably two, three years, something like that, and probably on the later end of that timeline. Again, the pacing item is going to be permitting. So – and as you saw in the first one, it was a little variable depending on the state.

Noah Kaye
Analyst, Oppenheimer & Co., Inc.

Q

That is very helpful. Thank you.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Sure.

Operator: Your next question comes from the line of Tyler Brown from Raymond James. Your line is open.

Patrick Tyler Brown
Analyst, Raymond James & Associates, Inc.

Q

Hey. Good morning, guys.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Good morning.

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

A

Good morning.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Good morning, Tyler.

Patrick Tyler Brown
Analyst, Raymond James & Associates, Inc.

Q

Hey. Hey. Great job on controlling the controllables. But I do want to come back to HMS. Can you guys give us any color on what's exactly going on in that market? Do you think that it's being influenced by the US-Turkey relations, or do you think it's destocking at domestic mills? Just any additional color there.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Yeah. It's probably a little bit of both. The noise around Turkey – and then that's recent is – and you saw the leg down in October on HMS number one index, it could have some impact from the Turkey situation. We certainly think there's destocking going on. We saw some – and to go take a look at Nucor's comments, there's been some comments out from other companies that generally they think we're at the bottom and now we're going to start to move back up again. We'll see how that – we'll see how that plays out. I think as a general matter, we'll continue to reclaim all the metal that we can. The alternative for us unlike some other folks is we have to pay to get rid of it. Pay to put it in, stay in the ash and then we have to pay to get rid of the ash. So, it makes a lot of sense for us to kind of collect the metal and then we'll see where the HMS index comes out. But it does feel to me that we're kind at and around the bottom and it's going to start moving up from here.

Patrick Tyler Brown
Analyst, Raymond James & Associates, Inc.
Q

Okay. And then, Brad, on free cash. So, I just want to kind of get to the bottom of this restricted cash benefit. So, I see that the flows from restricted funds was increased I think this quarter to $15 million to $20 million for 2019. So, wondering if, number one, you can just talk about what's going on there. But maybe, two, if you can talk, is this a cash flow that will be recurring in 2020 and beyond?

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.
A

Sure. Well, there's really two pieces to it. So, I'll take the first one and this explains the increase. We had – so, a movement in a restricted account under one of our service fee contracts with a client earlier this year. And so really the increase in the range accounts for that. Essentially you had cash come out of restricted fund. It went right back out the door through working capital. So, essentially net neutral, it's just and that's why you saw an offsetting change to the guidance range for working capital change. It's just in and out. And that was about $5 million.

The other piece is one that it has been more permanent and will go away next year. So, for the last few years we've been receiving on an annual basis cash distributions from a trust related to the ownership structure of the Delaware Valley facility. Those cash distributions concluded earlier this year. So all else being equal, you should expect the restricted fund line maybe plus or minus in a quarter. But on a sustained basis, it should be essentially zero over time.

Patrick Tyler Brown
Analyst, Raymond James & Associates, Inc.
Q

Okay. Okay. That's helpful. And then maybe on the working capital side and I know it's early, you probably haven't done all your budgeting but is that – so I think that's positive this year. Is that something that is recurring as well maybe into 2020 or even beyond that?

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.
A

Yeah. I guess I'd probably say a couple of things. One, as you know, we've talked about several times, working capital efficiency is a long term initiative.

Patrick Tyler Brown
Analyst, Raymond James & Associates, Inc.
Q

Sure.

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.
A

And we've gotten a lot of value out of that over the last few years and that's AR collections primarily but it's also AP management. So I would hope that we're going to continue to get efficiencies over time.

That being said, in this business working capital can be lumpy quarter-to-quarter, year-to-year. And ultimately out over the long term and this isn't necessarily a comment specific to 2020, but over the long term it's probably appropriate as a modeling assumption to assume that working capital isn't going to be a persistent $10 million, $20 million benefit to us indefinitely.

Patrick Tyler Brown
Analyst, Raymond James & Associates, Inc.

Q

Okay.

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

A

That will ultimately – the opportunity will reduce over time. So, as far as 2020, again it can be lumpy and so we're just not really in a position at the moment to put a finer point on it.

Patrick Tyler Brown
Analyst, Raymond James & Associates, Inc.

Q

Yeah. Yeah. No, that's very helpful. And then maybe on the total EfW maintenance spend, so I think this year you guys are looking for [ph] $415 million (00:35:06) at the midpoint. And I think maybe 30% of that is attributed to maintenance CapEx. But I'm curious, is that an exchange or should we just grow that maintenance spend and assume that it's about 30% is maintenance CapEx or is that the right way to think about it?

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

A

My response to that unfortunately is going to sound a little similar to my response on working capital. I mean, it can be lumpy and it could move up and down and particular at year-end. For maintenance, and Steve alluded to this earlier, really what we look at is an underlying trajectory of what's the annual spend now and going forward that's going to be required to maintain these plants and keep them at peak operating condition. And that's a spend that is going to – plus or minus going to grow with inflation or inflation plus or minus over time.

In a given year, the profile of spend is subject to the long-term maintenance plan. And then that's – okay, much of it is more weighted towards expense versus capital and also what is the aggregate spend. So I guess in summary of all that, you can't necessarily look at 2018 and extrapolate – or sorry, 2018, 2019 and extrapolate to what would that mix be in 2020.

Patrick Tyler Brown
Analyst, Raymond James & Associates, Inc.

Q

Okay. Okay. Interesting. Okay. And then my last one. So, Steve, with these two plants without baghouses...

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Yeah.

Patrick Tyler Brown
Analyst, Raymond James & Associates, Inc.

Q

...are these large tip fee facilities?

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Yes. Yeah. Both of them are. They've been...

Patrick Tyler Brown
Analyst, Raymond James & Associates, Inc.

Q

I mean...

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

They use a different technology. And so these are plants that we own and we're looking at – okay, what do we want to do? The other technology, non-baghouse technology is called ESP. It works just fine, but baghouses are becoming more popular at this point. So, we're looking – as I mentioned, we're looking right now at, okay. What do we want to do? What's the timing on changing out to a baghouse rather than ESP?

Patrick Tyler Brown
Analyst, Raymond James & Associates, Inc.

Q

I see. Okay. Okay. I appreciate the time. Thanks, guys.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Sure.

Operator: Your next question comes from the line of Brian Lee from Goldman Sachs. Your line is open.

Brian Lee
Analyst, Goldman Sachs & Co. LLC

Q

Hey, guys. Good morning. Thanks for taking the questions. Maybe just going back to free cash flow topic for a moment. Brad, it seems like the free cash flow is obviously much more 4Q-weighted than it has been in past years. I know you've talked through some of the moving pieces here. But can you kind of walk us through again a little bit of the dynamics driving that this year versus the cadence we've seen in past years? And then that steep ramp that you do need in 4Q to hit the full-year target, kind of how de-risked do you see that being right now?

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

A

Yeah. So, we actually have had precedent historically for the free cash to be heavily weighted in the fourth quarter and we saw that a couple of years ago. And I mentioned this earlier. Really the driver is going to be working capital based on how we see the rest of the year playing out.

Brian Lee
Analyst, Goldman Sachs & Co. LLC

Q

And from a de-risk perspective, do you see that as being pretty solidly in hand at this point? I know you're taking the EBITDA guidance down to the lower end. How are you kind of thinking about where you're settling out from a cash flow perspective?

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.
A

Yeah. We feel comfortable with the guidance.

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

Yeah. We're comfortable with that guidance. So, the working capital side as we've showed in the past, whether it's accounts receivable or accounts payable, there is levers that we can adjust in order to get a positive working capital in the fourth quarter.

Brian Lee
Analyst, Goldman Sachs & Co. LLC
Q

Okay. Fair enough. And then just maybe switching gears a bit, I know earlier in the call you mentioned this investing in technology to remove some non-aluminum metals given the higher pricing potential there. Can you maybe elaborate a bit on what goes into that and the potential timing of deploying that? And then just in terms of impact does that really move the needle from a volume perspective, if you're successful? Just trying to get a handle around whether or not that could be a strategy to help on the metals side of the business?

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

Yeah. It's clearly something – it's actually in operation now. So, what we've looked at was – and it's interesting. I don't think some other companies aren't necessarily doing this. I got a note from Steve Bossotti who does our metals management about this yesterday.

This is color sorting. So basically, you're looking at taking non-ferrous and using technology that color sorts in order to take out – in order to split the non-ferrous into its kind of piece parts. And some of the darker non-ferrous metals, so the heavier and darker non-ferrous metals trade at three times the price of some of the other metals.

So, it can move the needle. You don't need a lot of it to make it impactful. And as I said, we're – that – I've been out to see the unit, it's in operation now in the third quarter and we have actually had stockpiled some of our non-ferrous in order to run it through this unit in order to take advantage of its capabilities.

Brian Lee
Analyst, Goldman Sachs & Co. LLC
Q

Okay. Fair enough. Thanks a lot, guys.

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

Sure.

Operator: Your next question comes from the line of Angie Storozynski from Macquarie. Your line is open.

Angie Storozynski
Analyst, Macquarie Capital (USA), Inc.

Q

Thank you. So, I have a bigger picture question. Nobody has really asked a question about your 2020 guidance and I understand that you're not really willing to provide it. But could you at least directionally tell us if you think that if the current commodity price environment were to persist and you would continue to see the pickup in sales and volumes, would we see a year-over-year growth in EBITDA? So that's one. And, two, how should we get more comfortable with your ability to support your dividend given that the commodity prices are weighing on it for cash flow and your net debt to EBITDA is already up 6 times.

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

A

Sure. Hey, Angie, it's Brad. So, on 2020 and you said it at the top, we're not giving guidance for next year whether that's specific or directional but – and I think there are a few sort of building blocks, if you will, when you think about 2020 that I'll mention. One is the underlying rate of organic growth which is sort of all-encompassing for the initiatives that we're focused on, and that's 3% to 5%. Nothing has changed that would impact our view on that.

So that's something you can count on from us when we roll out our 2020 guidance. The other big one of course is commodities. It's a variable that we can't predict. I think if you look at current spot prices and you extrapolate that across calendar year 2020, that's not necessarily our view. But if you did that, that would imply a headwind year over year.

And of course the kind of handy rules of thumb that we've talked about to help people kind of frame what that impact could be are for HMS, for every $25 move, it's about a $4 million to $5 million – on a full-year basis 12 months it's about a $4 million to $5 million revenue EBITDA impact. For Old Cast which is the underlying index for aluminum, every $0.05 is about $2 million to $3 million. So based on what your view is going to be for commodities for next year, that's how it would flow through into an estimate for 2020.

The other question around the dividend, our dividend policy is something that we stand behind. And as we've said many times, the dividend policy is based on what we view as the long-term sustainable cash generation in the business, not based on the cash flow in any particular period or certainly not based on commodities in any particular period. And to the extent that our long-term view is that we're going to be growing cash flow sustainably, that's what supports the dividend. So, I'm not sure how better I can answer it than that.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Yeah. I mean, let me be clear. We're committed to the dividend. We clearly don't see a case where we don't – where we're not going to be able to support that dividend as we look out in time. For us to even consider changing our dividend, we'd have to have a persistent reduction in free cash as Brad mentioned. And quite frankly, we see free cash growing with our – up to $250 million over the next several years, and we talked a little bit about that earlier in the call. So, we think we're in a pretty good place.

Angie Storozynski
Analyst, Macquarie Capital (USA), Inc.

Q

Thank you. And just one bigger picture question, so are you trying to basically change the design of some of your contracts to make them less dependent on commodity prices? I'm asking, well, not only because we have this downturn, but also if you look at the Northeast, you have all kinds of structural reasons why power prices could continue to decline. You have offshore wind, you have this issue in New York ISO about potentially putting a carbon price on power generators. Can you talk us through how you perceive your market positioning from that perspective?

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Yeah. That's a tricky question. The markets clearly are changing. In a lot of respects, it drives our businesses, the waste side of the business. And then the power, and in some respects the byproducts. So one of the things we've been trying to do is figure out how to sell that power, not just into the grid, and very difficult these days to get long-term contracts. We have a long-term contract in Long Island for example. But to get those types of contracts is difficult.

So one of the things, what we've been looking at is whether we can sell the steam, rather than turn the steam into electrons, is sell the steam directly to customers in and around our plants. We do that in places like Niagara, for example, our Niagara facility. We're looking at other options around that. I've talked to about a few of them on prior calls.

And then on the electrons itself, we got involved in the BGS auction. We're looking at other ways to sell these electrons in a way that's more valuable to our investors. And we look at direct lines for example. So there's a couple of our facilities that are close to other large users of electricity. And can we sell directly to those large users and at the middle price, so we'd be selling it higher than wholesale and they'd be buying it at lower than retail. But to make both parties happy.

So they're the types of things that we're looking at right now. But those business development efforts do take some time has been my reaction because we've been looking at these for a couple of years at this point just because of the way the market has been playing out.

Angie Storozynski
Analyst, Macquarie Capital (USA), Inc.

Q

Okay. Thank you.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Sure.

Operator: Your last question comes from the line of Henry Chien from BMO. Your line is open.

Henry Sou Chien
Analyst, BMO Capital Markets (United States)

Q

Hey, guys. Good morning.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Good morning.

Henry Sou Chien
Analyst, BMO Capital Markets (United States)

Q

Just wanted to – I figured I'd just – I had a question to explore a little bit more the maybe not necessarily explicit guidance, but the one area beyond the organic growth. Like, what are the projects or factors, I guess, that would also impact free cash flow and EBITDA if we think about 2020?

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

A

Well, our big focus – Henry, it's Brad – in the project area is, of course, the pipeline in the UK and that's something that's going to impact us when those plants come online and at least for the first four that we're developing that we've been talking about in the 2022, 2023 timeframe.

Henry Sou Chien
Analyst, BMO Capital Markets (United States)

Q

Yeah.

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

A

When you think about 2020, really, the drivers for us are the ongoing initiatives under the organic growth umbrella, and that's encompassed in the 3% to 5%.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

So, you think about things like waste pricing, metals – additional metals recovery, TAPS, continuous improvement, profile waste, regulated medical waste, Covanta Environmental Solutions, they're all those – all the things that we're undertaking in order to grow the company. And a lot of that is – that's more on the domestic side. Brad mentioned more the international side. And then on the international side – and I'll mention this – we're looking at other projects outside the UK. I mean, there's other – there's additional projects inside the UK that GIG is – was one of the reasons we partner with GIG in the UK. Outside UK, you may have seen some publicity around a project in the Philippines that we're involved in. There's projects in China that we're looking at. There's a lot of energy from waste, new plant activity that's occurring. In places like China, quite frankly, they build these plants very quickly. It doesn't take them three years to build a plant in China. It's half the time. And so, depending on what we do with some of these other markets, that will also flow into maybe not 2020 but not too many years further out from 2020.

Henry Sou Chien
Analyst, BMO Capital Markets (United States)

Q

Got it. Okay. That makes sense. And I guess maybe just for the next 12 months or so, not with that sort of view, any kind of milestones that you're looking at going forward or timing-wise or just kind of regulatory hoops or permit-wise things that you guys are looking out to?

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

A

I think the key milestones, I'm not sure if this is your question, but the key milestones that we're focused on are getting all four of the initial projects in the UK and the construction. So two down, two to go. We're focused on Protos and Newhurst now to get those going. It's getting TAPS up and running. And then as Steve was talking about based on the operational performance of that unit, rolling that out across the fleet. So, I think if we can meet those milestones and build from there we'll be in a really good position and that's where we're focused.

Henry Sou Chien
Analyst, BMO Capital Markets (United States)

Q

Got it.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

A

Yeah. And the other thing I'll mention too, and this is a US comment for new energy from waste. There are opportunities for new energy from waste in the US. We've seen some – there's been some public announcements and some of our clients – some of these are client opportunities, some of them may be tip fee opportunities where we own the plant. So even in the US, I would have told you in the beginning of my tenure, there wasn't going to be a lot of new energy from waste in the US. I think now I'm changing my view a little bit. I think there's going to be opportunities for us here in the US and they'll also be bearing timelines associated with those opportunities.

Henry Sou Chien
Analyst, BMO Capital Markets (United States)

Q

Got it. Okay. Yeah. Look forward to hearing more. Thanks.

Bradford J. Helgeson
Executive Vice President & Chief Financial Officer, Covanta Holding Corp.

A

Thanks.

Operator: There are no further questions at this time. I'll turn the call back over to the presenters.

Stephen J. Jones
President, Chief Executive Officer & Director, Covanta Holding Corp.

Well, we want to again thank everybody for joining us for the call today and we appreciate your ongoing interest and support in Covanta. Have a good day and have a good weekend. Thanks.

Operator: This concludes today's conference call. You may now disconnect.