WCN - Waste Connections, Inc. Q3 2018 Earnings Call
2018-10-30

Officers and Speakers
Ronald Mittelstaedt; Waste Connections, Inc.; Chairman & CEO
Mary Anne Whitney; Waste Connections, Inc.; SVP & CFO

Analysts
Hamzah Mazari, Macquarie Capital, Inc.
Chris Murray, AltaCorp Capital Inc.
Brian Maguire, Goldman Sachs & Co. LLC
Michael Hoffman, Stifel, Nicolaus & Co., Inc.
Tyler Brown, Raymond James & Associates, Inc.
Noah Kaye, Oppenheimer & Co. Inc.
Derek Spronck, RBC Dominion Securities, Inc.
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Presentation

Operator: Ladies and gentlemen, thank you for standing by. Welcome to Waste Connections' Third Quarter 2018 Earnings Conference Call.

(Operator Instructions)

As a reminder, this conference is being recorded, Tuesday, October 30, 2018.

I would now like to turn the conference over to Mr. Ronald Mittelstaedt, Chairman of the Board and CEO. Please go ahead, sir.

Ronald Mittelstaedt: Okay. Thank you, operator, and good morning. I'd like to welcome everyone to this conference call to discuss our third quarter 2018 results and provide a detailed outlook for the fourth quarter. I'm joined this morning by Worthing Jackman, our President; Mary Anne Whitney, our CFO; and several other members of our senior management team.

As noted in our earnings release, solid waste pricing up 120 basis points year over year plus 140 basis points sequential volume improvement drove better than expected results in the quarter. This price-led solid waste growth, along with continued strength in E&P waste activity, enabled us to overcome the toughest quarterly comparison for recycled commodity values in the year and certain continuing cost pressures.

More importantly, adjusted free cash flow remained strong at over $675 million year to date, or 18.5% of revenue and 57.8% of adjusted EBITDA. Our third quarter performance puts us firmly on track to meet or exceed the increased expectations for the full year we communicated in July.

The pace of acquisition activity remains elevated, as we recently signed our largest deal year to date, a multimarket collection-oriented company with annualized revenue of approximately $175 million, with operations in three states, including two new markets. This acquisition, which is expected to close by year end, along with deals already closed, is expected to bring total annualized acquired revenue to approximately $360 million in 2018.

Rollover contribution from these acquisitions plus price-led organic growth already position us for between 8% and 10% revenue growth and continued margin expansion in 2019, with any additional transactions providing further growth. Moreover, we announced another double-digit percentage increase in the quarterly cash dividend, once again demonstrating that we remain well-positioned to increase our return of capital to shareholders, while continuing to fund above-average acquisition activity.

Before we get into much more detail, let me turn the call over to Mary Anne for our forward-looking disclaimer and other housekeeping items.

Mary Anne Whitney: Thank you, Ron, and good morning. The discussion during today's call includes forward-looking statements made pursuant to the Safe Harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995, including forward-looking information within the meaning of applicable Canadian securities laws.

Actual results could differ materially from those made in such forward-looking statements due to various risks and uncertainties. Factors that could cause actual results to differ are discussed both in the cautionary statement on page 3 of our October 29 earnings release and in greater detail in Waste Connections' filings with the U.S. Securities and Exchange Commission and the securities commissions or similar regulatory authorities in Canada.

You should not place undue reliance on forward-looking statements and information, as there may be additional risks of which we are not presently aware or that we currently believe are immaterial, which could have an adverse impact on our business. We make no commitment to revise or update any forward-looking statements and information in order to reflect events or circumstances that may change after today's date.

On the call, we will discuss non-GAAP measures such as adjusted EBITDA, adjusted net income attributable to Waste Connections on both a dollar basis and per diluted share, and adjusted free cash flow. Please refer to our earnings releases for a reconciliation of such non-GAAP measures to the most comparable GAAP measure. Management uses certain non-GAAP measures to evaluate and monitor the ongoing financial performance of our operations. Other companies may calculate these non-GAAP measures differently.

I will now turn the call back over to Ron.

Ronald Mittelstaedt: Okay. Thank you, Mary Anne. In the third quarter, solid waste pricing growth was 4.5%, in line with the upper end of our expectations, up 30 basis points sequentially and up 120 basis points year over year on a 70-basis-point increase in core pricing and 50 basis points from fuel and material surcharges. Once again our pricing strength reflects the differentiation of our market model, the tone of the underlying economy, and our focus on overcoming recycling headwinds and certain cost pressures, including fuel. Pricing range between 3% in our more exclusive markets in the Western region to upwards of 5% in our more competitive regions.

Reported volume growth in Q3 was slightly negative, at down 10 basis points, reflecting a sequential improvement of 140 basis points from the prior quarter, or about 40 basis points above the high end of our expected range. Looking across our regions, volume in our Central and Western regions were up 1.5% to 2% in the quarter, while Canada and the Southern region were down 1.5% to 2%, due primarily to the impact of shedding lower-quality revenue and a purposeful price-volume tradeoff in legacy Progressive Waste markets.

On a consolidated basis, volume increases of over 100 basis points, driven by the timing of disposal activity and a strong macro environment in certain markets, were offset by the following; about 40 basis points of purposeful shedding; another 40 basis points of tough comps from prior-year disposal activity, including activity resulting from Hurricane Harvey; and about 20 basis points from decreased volumes at the New York City transfer stations due to the Department of Sanitations' marine terminal operations contract that continued to ramp with a third party in Q3.

Some landfill activity that was expected in the fourth quarter occurred in Q3. Therefore, we continue to expect that reported volumes in the second half of the year should total about 50 to 100 basis points better than the first half, with Q3 volumes slightly better than Q4.

Looking at year-over-year results by line of business on a same-store basis in the third quarter, commercial collection revenue increased by approximately 4%, mostly due to price increases. Roll-off revenue increased by approximately 3%.

In the U.S., pulls per day increased 1.3% and revenue per pull was up about 2.6%. In Canada, pulls per day decreased by 6.3%, due primarily to the purposeful shedding of lower-quality revenue and an accepted price-volume tradeoff, with essentially all of this decrease offset by an increase in revenue per pull of approximately 6%.

Solid waste landfill tonnage increased about 1% on increases in both MSW tons, which were up about 1.5%, and C&D tons, up 17%, on increases in several markets, including the Northeast, Colorado, Florida, and Texas.

Special waste tons were down about 8%, less than half the year-over-year decrease in special waste tons that we saw in Q2 due to the anniversarying of the Chiquita Canyon Landfill permit changes and a better-than-expected pickup in special waste activity due to the timing of some activities we noted earlier. The remaining year-over-year decline is primarily related to difficult prior year comparisons in certain markets.

Recycling revenue, excluding acquisitions, was about $21 million in the third quarter, down $20 million, or almost 49%, year over year due to the continued declines in both the value of and the demand for recycled fiber, especially recovered mixed paper. Prices for OCC, or old corrugated containers, in Q3 averaged about $88 per ton, which was down 52% from the year-ago period and down 7% sequentially from Q2.

Mixed paper revenue, excluding acquisitions, declined approximately 75% year over year as values remain in the $0 to $5 per ton range. We believe that the flow-through from changes in recycling revenue was similar to Q2, with detrimental margins of approximately 95% due to the combination of lower fiber values and higher recycle processing costs, resulting in an impact of about $19 million in EBITDA and a rounded $0.06 per share of EPS in Q3.

Looking at E&P waste activity, we reported $64.8 million of E&P waste revenue in the third quarter, up 18% year over year, a smaller increase from prior quarters due to the ramp in E&P waste activity we saw last year, but still up 8% sequentially from Q2.

Q4 typically shows a slight seasonal decline in E&P waste activity and we could see that again this year. We continue to see the majority of our activity in the Permian Basin and don't anticipate a meaningful step-up in revenue above our run rate without increased drilling in other basins, most notably the Bakken, or until additional facilities come online.

As noted last quarter, we are pursuing three new projects in the Permian, including two new landfills, plus a fourth project in Wyoming's Powder River Basin, many of which should contribute by the second half of 2019.

Looking at acquisition activity and divestiture activity, as noted earlier we recently signed an agreement for the acquisition of a multimarket collection-oriented company with annualized revenues of approximately $175 million, including two new markets and one tuck-in. This acquisition, which we expect to close by year-end, will add to an already outsized year of M&A activity, bringing total annualized acquired revenues to over $360 million, our third busiest year since the Company's inception.

This heightened pace of acquisition activity is seller-driven, as sellers dictate the timing of acquisition, often the result of dialogue taking place over multiple years. We anticipated this could be a period of outsized seller interest due to three key factors: the strength of their underlying business, clarity around taxes as a result of tax reform, and rising interest rates, which are viewed favorably by many sellers with a focus on reinvesting proceeds. The pipeline for potential additional transactions remains robust, and we believe that these same factors could drive continued above-average M&A activity level over the next few years.

Regarding divestitures, we are on track by year-end to complete the divestiture program that we undertook in connection with the acquisition of Progressive Waste. In Q3 we sold one of the two final markets that we had originally identified, and we expect to sell the final market this quarter. Together these two divestitures total about $27 million in annualized revenue.

And finally, as also announced yesterday, our board of directors authorized a 14.3% increase in our regular quarterly cash dividend, our eighth consecutive double-digit percentage increase since commencing the dividend in 2010. Even with this increase, our dividend remains less than 20% of our expected annual free cash flow, providing tremendous flexibility to fund our growth strategy and further increase the return of capital to shareholders, including opportunistic share repurchases.

And now I'd like to pass the call to Mary Anne to review more in depth the financial highlights of the third quarter and provide a detailed outlook for Q4. I will then wrap up before heading into Q&A.

Mary Anne Whitney: Thank you, Ron. In the third quarter, revenue was $1.28 billion, up $74.6 million over the prior-year period and about $11 million above our outlook. Acquisitions completed since the year-ago period contributed about $61.1 million of revenue in the quarter, or about $48.2 million net of divestitures. Adjusted EBITDA for Q3, as reconciled in our earnings release, was $416.8 million, about $3.8 million above our outlook for the period due to higher than expected revenue, and up $23 million year over year, despite a $19 million hit to EBITDA from recycled commodities relative to last year.

Incremental margins from solid waste, excluding recycling, were approximately 60%, demonstrating the operating leverage resulting from price-led growth and driving about a 60-basis-point margin expansion, which, along with E&P growth, enabled us to fully overcome an estimated 90-basis-point drag from recycling in the quarter.

Adjusted EBITDA as a percentage of revenue was 32.5% in Q3, in line with our outlook, down 10 basis points year over year due to the impact of acquisitions net of divestitures which were slightly margin-dilutive, with solid waste and E&P margins offsetting the decline from recycling, as noted above. Year to date, margins were up 20 basis points and should expand further in Q4 when the headwinds from recycling begin to abate and comparisons get easier.

By way of reminder, our results do not include the meaningful (inaudible) margin benefit others may have had from accounting changes associated with revenue recognition.

Fuel expense in Q3 was about 3.6% of revenue, up 25 basis points year over year. We averaged approximately $2.72 per gallon for diesel in the quarter, which was up about $0.21 from the year-ago period and down about $0.03 sequentially from Q2.

Depreciation and amortization expense for the third quarter was 13.7% of revenue, up 10 basis points year over year due to increased depreciation expense from acquisitions closed since the year-ago period. Interest expense in the quarter decreased by $0.4 million over the prior-year period, to $32.1 million, due primarily to lower total borrowings as compared to the prior-year period as well as the retirement of higher fixed rate notes since the prior-year period. Net of interest income from invested cash balances, interest expense in the period was $30.6 million.

Debt outstanding at quarter end was about $3.7 billion, approximately 26% of which was floating rate. And our leverage ratio, as defined in our credit agreement, declined to below 2.3 times debt to EBITDA on higher cash balances.

One other related note, in Q3 we received an investment-grade Baa2 rating from Moody's Investors Service, which, along with our existing investment-grade ratings from S&P and Fitch, provides us with greater optionality to the extent that we were to consider further diversification of our sources of capital.

Our effective tax rate for the third quarter was 25.7%, or 22.5% net of certain items in the period, primarily related to refinements to the estimates of the impact of the Tax Act. Accounting pronouncements give companies until year end to finalize their estimates related to the Tax Act, and we believe we're now mostly through our refinements.

GAAP and adjusted net income per diluted share were $0.57 and $0.69, respectively, in the third quarter. Adjusted net income in Q3 primarily excludes the impact of intangibles, amortization and other acquisition-related items, fair value changes to equity awards, and the refinement to the estimate of the impact from the Tax Act. As noted earlier, the impact to our adjusted net income per diluted share from recycling was a drag of about $0.06 in Q3.

Adjusted free cash flow in the first nine months of the year was $675.7 million, or about 18.5% of revenue. We remain on track to meet or exceed our upwardly-revised full-year adjusted free cash flow outlook of $860 million, in spite of higher CapEx outlays due to acquisitions and new growth projects that will benefit 2019 and beyond.

I will now review our outlook for the fourth quarter of 2018. Before I do, we'd like to remind everyone once again that actual results may vary significantly based on risks and uncertainties outlined in our Safe Harbor statement and filings we've made with the SEC and the securities commissions or similar regulatory authorities in Canada. We encourage investors to review these factors carefully.

Our outlook assumes no change in the current economic and operating environment. It also excludes any impact from additional acquisitions or divestitures that may close during the remainder of the year and expensing of transaction-related items during the period.

Revenue in Q4 is estimated to be approximately $1.225 billion. We expect price growth for solid waste to be approximately 4.5% in Q4 with volume of approximately negative 1%, about half of which is due to the first full quarter impact of the New York City Department of Sanitation's marine terminal operations contract with a third party.

Adjusted EBITDA in Q4 is estimated to be approximately 31.5% of revenue, or about $386 million, up 30 basis points year over year. Depreciation and amortization expense for the fourth quarter is estimated to be about 14% of revenue. Of that amount, amortization of intangibles in the quarter is estimated to be about $26.5 million or $0.07 per diluted share net of taxes.

Operating income in Q4 is estimated to be approximately 17.2% of revenue, or about $211 million, up 20 basis points year over year. Interest expense, net of interest income, in Q4 is estimated to be approximately $31 million.

And finally, our effective tax rate in Q4 is estimated to be about 22.5%, subject to some variability.

And now let me turn the call back over to Ron for some final remarks before Q&A.

Ronald Mittelstaedt: Okay. Thank you, Mary Anne. Again, we're extremely pleased with our year-to-date performance, particularly given the significant headwinds from recycling and certain cost pressures that we've been able to more than overcome through a price-led growth to drive margin expansion and double-digit percentage free cash flow growth.

Our year-to-date results combined with our Q4 outlook put us on track to meet or exceed the increased full-year outlook we communicated in July. We just announced the fourth largest acquisition in the Company's history, which should close by year-end, and we remain well-positioned for potential continued above-average acquisition activity as we look ahead. In addition, we announced another double-digit percentage increase of our regular quarterly cash dividend.

As we indicated in the preliminary thoughts for 2019 that we provided on our July call, we believe that 2019 is setting up for above-average revenue growth and margin expansion, as current favorable trends for solid waste pricing, E&P waste activity, and acquisition contribution should continue, and the current recycling headwind and most of the reported negative volume growth primarily associated with our purposeful shedding of lower quality solid waste revenues, should abate.

We continue to believe that this should result in an 8% to 10% revenue growth in 2019, with price-led organic solid waste growth of between 4% and 6%, together with an additional 4% revenue growth from acquisitions already signed or closed, plus the potential for additional contribution from deals to be completed by year-end 2018 and throughout 2019.

And consistent with what we said in July, this should drive EBITDA margin expansion of 50 to 75 basis points, excluding the impact of acquisitions and double-digit free cash flow per share growth. But since typical collection-oriented acquisitions have structurally lower margins than our fully integrated operations, the recently signed $175 million revenue collection-oriented acquisition would reduce this expected margin expansion for 2019 to approximately 30 to 50 basis points, excluding any other acquisitions, but on higher revenues.

We expect to have better visibility on this expected margin expansion, any further updates on recycling, and the timing and magnitude of potential additional acquisition outlays in February, all of which will influence the formal outlook for the upcoming year that we will provide at that time.

We appreciate your time today. I will now turn this call over to the operator to open up the lines for your questions. Operator?

Questions & Answers

Operator: (Operator Instructions)

Our first question comes from the line of Hamzah Mazari with Macquarie Capital. Please proceed with your question.

Hamzah Mazari: Good morning. My first question is just on pricing. And the question really is if you believe that the company can surpass prior peak pricing levels. If you go back to '05 or '08 I think you guys were doing well above 5%. It feels like the sector is a lot more consolidated now. Canada pricing probably helps your mix. There's inflation in the system. Maybe help us think about the puts and takes of why or why you cannot maybe surpass prior peak pricing levels as you look out over the long term.

Ronald Mittelstaedt: Well, first off, Hamzah, I don't think we've said we cannot do so. Every cycle is a little bit different. Obviously, as it relates to our business the housing environment was probably almost double what it is currently, which led to different pricing opportunities, as well. But at 4.5% we're approaching the 5% level you just said.

If there's continued cost increases in both labor, fuel, steel, and other drivers that we've seen accelerate throughout '17 and '18 and we continue to see a CPI lift as we've seen throughout '18, then you could well see that reported number being north of 5% in '19 or beyond if the economy continues to stay as hot as it is right now. So there's nothing structurally different in the Company that would disallow it from achieving prior peak.

And in fact, if you go back to that prior peak, we had about 55% to 60% of our revenue that was tied to CPI, which tends to be more of a price governor, and now that number is 42%, 43%. So the reality is is we have more latitude in price than we did back in that '05 time frame. So there's really no reason why it wouldn't if the cycle continues at the pace that it is throughout '18.

Mary Anne Whitney: And I guess I would add to that that you saw those prior peaks when fuel was driving a big portion of that and you saw that was our peak pricing following '05 and '06 when you had fuel spikes.

I would also offer that if you look at markets where we are pushing price, you'd see the legacy Progressive markets where we're already averaging about 5.5% price. So we're certainly at high levels on a historical basis. And what we've said is that we don't see anything changing in this environment, and that's what gives us confidence in thinking about '19 and the organic growth expectations that we've already communicated being the 4% to 6% organic growth with that being price-led.

Ronald Mittelstaedt: That's an excellent point, Mary Anne. Thank you. And Hamzah, just for perspective, back then, fuel got to as high as 6% of our cost structure and it's now in that 3% to closer to 3.5% range. So, that's a material differential and yet there is not that big a spread on price. So I think that's an excellent point.

Hamzah Mazari: Great. That's very helpful color. The second question is just on M&A. You've talked about outsized pipeline. You just did a large deal. And maybe just frame for us how do your cash-on-cash returns look like given valuations are high. And then, do you believe there will be any change with the U.S. midterm elections in terms of either a catalyst on M&A or a slowdown on M&A?

Ronald Mittelstaedt: Well, I mean, to your first question, Hamzah, we look for on a cash-on-cash return using an IRR as a proxy, we're looking for a low double-digit, low-teen type return. And that has not in any material manner changed.

Again, on a large stand-alone or large integrated transaction, that multiple has probably moved about a turn and a half over the last three years. But certain of our cost structure has moved downwards. Cost of debt has moved downward. Tax rate has moved downward and other costs have moved downward. So on a return basis you're not seeing any meaningful change over any protracted period of time.

Mary Anne Whitney: Midterm.

Ronald Mittelstaedt: Midterms, look, we're obviously not in the political prediction business. I would say either way, if the Republicans hold the House, illustratively, I think you have more of the same and maybe even a little acceleration, because it just brings uniformity to what's been going on.

If the Democrats take the House I think you also potentially see acceleration, because people see that as a predictor for two years later that there could be a wholesale change and that there could be a reversal of tax law, and then that provides a window of sellers to look to do something with their companies. So I don't think either situation derails the M&A activity at this point in time.

Hamzah Mazari: Okay. Great. Thank you very much.

Operator: Our next question comes from the line of Chris Murray, with AltaCorp Capital. Please proceed with your question.

Chris Murray: Thanks, folks. Good morning. Just turning back to the purposeful shedding, can you talk a little bit about the pace of that? I mean, you did bring in the marine terminal as something to think about. But I would have thought that most of the shedding from particularly the Progressive Waste operations was done. But can you just talk about how should we be thinking about the pacing of that as we enter into '19?

Ronald Mittelstaedt: Yes. Well, number one, most of it is done. That's why it's continued to drop as a percentage as we've gone throughout '18. But not all of it's done. I mean, you've got to remember that the average contract length, whether it be a commercial contract, the average commercial contract is three to five years, the average municipal contract is five to seven years. So we're two-and-a-half years into those contracts, which say that it puts us mostly through the three-year cycle on the commercial and halfway or so through the municipal that we inherited.

So certainly the vast majority is done, and when I would say vast majority, Chris, I'd estimate that to be 75% to 80% done. But there is still -- we come across agreements all the time that come up for renewal that we are looking to either change our approach or change the price if we're going to continue it. Progressive had a lot of business, a lot. And I'm going to tell you in the -- we told you there was $300 million that did not fit our strategic footprint when we did it. There's another $300 million to $500 million that needed to be repriced to continue.

So we're still working our way through. We've probably worked our way 75 -- the $300 million that wasn't strategic, we will have done by this quarter. We said that on the call. There's $27 million that remains, and that should close here actually any day. And then we're probably 75% through the other basket.

Chris Murray: Okay. So, along those lines, I guess there's two pieces of this question. I mean, first of all, what's the reception that you're getting from some of those Progressive customers who you are going back looking for price increases? I mean, are you actually able to keep those customers or are you seeing increased churn in them? And then I guess the second piece of that is also how -- have you changed your approach to how you think about pricing those customers just even as the market has changed?

Ronald Mittelstaedt: Well, I mean, first off I would tell you that we retain the vast majority of those customers. I mean, it's a little different by geography and it depends how much price change that we've got to go through. But we retain the vast majority of those customers, whether that's a renegotiation on the commercial collection contract or if it's a rebid on municipal. I mean, again, our retention rate is north of 85% on rebid municipal contracts. So we're retaining the vast majority of those.

As far as have we thought differently about how we approach price, I would say that the whole sector has thought differently about how we approach price. And what I mean by that is, look, we are materially changing how we're pricing recycling to these municipal customers, and that is having to stand on its own, that's having a much higher cost for the processing of it. It's shifting commodity risk to the municipal customer or the end user. And all of that is affecting price in the approach.

And I'd say the entire sector is doing that. I mean, there are hundreds right now -- in fact, came out yesterday through our industry, there are hundreds if not thousands of municipal contracts that over the last quarter have been redone by the industry to reflect a dramatically higher charge for recycling or an elimination of recycling. And so that is the biggest change in our approach, rather than anything else.

Chris Murray: Okay. Fair enough. And then just if I may, just looking at your outlook for Q4 '18, what is your expectation then on the additions from acquisitions, both positive and the impact of divestitures? Should we assume that the balance of the $27 million comes out but then just back in to the growth number? I'm just trying to figure out the moving parts on that.

Mary Anne Whitney: Yes, so if you're looking specifically at Q4 just for acquisitions that had already been completed but the rollover impact was, or excuse me, the impact to Q4 was net of about $46 million, so net of the divestitures.

Chris Murray: And should we assume the $27 million is the divestiture in the quarter?

Mary Anne Whitney: No. So, $27 million was the total annualized revenue associated with those divestitures. So what I gave you, that was a net number, it's about $3 million in divestitures. So that's net of about $50 million in acquisition contribution.

Ronald Mittelstaedt: And that does not assume that for the transaction that we have announced last night and talked about this morning, that does not assume that that closes in the quarter. That assumes that that closes in January 1.

Chris Murray: All right. Fantastic. Thank you, guys.

Operator: Our next question comes from the line of Brian Maguire, with Goldman Sachs. Please proceed with your question.

Brian Maguire: Hi. Good morning, everyone. Hey, Ron. Just wanted to follow up on that transaction. I'm just hoping to get a little bit more details on it. Don't know if you could talk about what new states it gets you into, but would assume since you're getting into them, probably a little bit lower margin since you won't have internalization of tons. But just as you think about those markets, do you think there could be opportunities to acquire some disposal assets and bring some of those tons in, or any other kind of tuck-in opportunities you might get there? And then could you also just talk about whether these are franchise markets or not and just kind of what you're seeing in terms of acquisition opportunity in the franchise versus open markets?

Ronald Mittelstaedt: Sure. Well, first off, Brian, we really can't provide a lot more on the deal specifically out of respect to the sellers, who have not fully met with all their employees yet and their customers. So we don't want to get over our skis and interrupt that process, because that's a very sensitive process with both employees and customers. But what I will tell you is that this deal is in a competitive market footprint, not a franchise market footprint. So I will tell you that.

I will tell you that in two of the three market areas there is internalization opportunity available for us. One of them is a market we have a strong presence in and this becomes a tuck-into. And we have disposal assets in that market. And the other one we have adjacencies to in the market and potential internalization opportunity longer term.

So this transaction comes on at more of what I call a typical very strong collection margin in that 25%-type range. That's a pre-synergy number and a pre-internalization number. We will improve that over time. But it's an outstanding private company, one of the probably arguably the 10 largest private companies remaining in the industry, extremely high quality of assets, phenomenal market position, number one or two in most of their markets, and very high management quality. Again, this is akin to a group that we did a couple of years ago in terms of asset quality and market position and management quality. So, that's really all I can say about this transaction specifically.

The second part of your question was regarding our franchise transactions. Without getting into specifics I will tell you in our backlog there was a greater percentage of franchise transaction building than we have had in a while, in several quarters. And I would expect us again over any period of time, let's just use '19 as an example, I would expect us to close some of those based on our historical hit rate. And that will keep us in that approximately 42% range of exclusive versus nonexclusive markets.

Brian Maguire: Okay. Very helpful. Thank you. Just one more just to switch gears back to recycling. Ron, I know you were at an industry conference not too long ago giving kind of a view of how that business model needs to change over time. I think the bottom line of it was I think you said costs need to come down to basically make the current levels of recycling prices economical in addition to getting some fees.

Just wondered if you're seeing any progress on getting your costs lower. I know some of the others in the industry have talked about some gains there quarter over quarter. And then, as it relates to fees, can you talk or maybe quantify if possible how much dollar amount of fees you're getting? I guess, that's within the 0.5% of surcharges, but maybe just kind of break out how much of that's coming from recycling fees and where you think that could go.

Ronald Mittelstaedt: Yes, well, first off, on the fee portion of recycling, that's been a pretty de minimus piece of the price so far. It's been about 20 basis points of the core price in the current quarter. So that would be the number that's been achieved so far. I would expect that to continue to accelerate as we go forward. Again, this is a long process. This is a multi-year process. But I think both us and the industry is starting to make quite a substantial improvement to these discussions and to actually getting contracts redone.

As far as cost, I don't know if -- that may have been taken a little out of context. I mean, the reality is is the cost for processing recycling is just going up. It's not coming down. That number has moved, I'm going to round, that number has moved from $75 to $100 a ton when we could export the majority of it to China to, when China said you cannot do that, that number has probably moved to $120 to $150 a ton, and in some markets north of that. And the reality is is we're having to slow down processing, we're having to add labor, we're having to add equipment.

Now, I think that cost will come down again over time as we get nonrecyclable material out of the single screen as we renegotiate municipal contracts. So as we get glass, as we get junk mail, as we get magazines, as we get certain plastics back out of the negotiation with these municipalities, and that is happening, that will bring that cost structure back down over time. But I would expect us to make some progress on that in '19 and really start to see that beyond that because, again, these are protracted negotiations.

Brian Maguire: Okay. Thanks very much.

Operator: Our next question comes from the line of Michael Hoffman, with Stifel. Please proceed with your question.

Michael Hoffman: Thank you. Thanks for taking the questions, Ron. A couple of housekeeping, very quick, Mary Anne. Tax rate assumption for '19?

Mary Anne Whitney: Down slightly from '18, more like 21.5% to 22%.

Michael Hoffman: And percent of that that would be cash taxes?

Mary Anne Whitney: Percent of that that would be cash taxes, the way to think about it is in the

75% to 80% range.

Michael Hoffman: Okay. And then can you remind us what your variable rate debt interest rate is, so we can understand what a 0.25 point move means?

Mary Anne Whitney: Yes, we're at about 3.4%.

Michael Hoffman: Okay. And then, just to be clear, the 4.5% for the fourth quarter, 4% of that's the solid waste business, 0.5% is fuel. You price fuel, you don't surcharge. So just so we're -- that's how to think about it?

Mary Anne Whitney: Well, we do have fuel surcharges. As we said, in Q3 they accounted for 50 basis points of the total price that we reported. As you know, in some of our competitive markets we utilized fuel surcharges. There was more of that actually in legacy Progressive business, so in Canada and some other parts of the country we had more of it. And then in our CPI-linked markets we typically have a lag and recapture that in price the following year.

Michael Hoffman: Okay. And then on volumes, I just want to be -- you have positive volumes in the business model ex all the shedding. So if you created a waterfall and started with the minus point 1 and work backwards on add back this for shedding, add back this for divestitures, and we're at X, I'm assuming it's at a 1-something number in total.

Mary Anne Whitney: Well, as we said, if you look -- the cleanest way to look at it is those markets which don't have that noise in it. So you saw 1.5% to 2% in our Western and Central regions, which again I think that's pretty indicative. Certainly franchise markets we have all the business. In our Central region, we have high market share. So that's indicative of the underlying strength. And really all the noise is in those other markets. So I think it's fair to say it's certainly north of 100 basis points in the underlying volumes we're seeing.

Ronald Mittelstaedt: Yes. And, Michael, those two regions -- neither of those two regions had any legacy Progressive operations brought into them. So, that's the other reason to use those as those are legacy Waste Connections markets. So that shows you where there's no shedding what underlying volume is.

Mary Anne Whitney: I think the other thing to keep in mind though, Michael, I would just make it clear that we're okay with a purposeful tradeoff of pushing price harder and continuing to do that and we're okay with losing some volume. Given the cost pressures we see in the business that we've seen in '18 and we expect to continue seeing in '19, I wouldn't expect that trend to change.

Ronald Mittelstaedt: Yes, I mean, that's a good point, Mary Anne. And I would say to that, look, if you told us we can have 3% price and 1.5% to 2% volume, or 4.5% price and 0% to 0.5% volume, we're taking the second one all day long. You're not moving margins up with 2.5%, 3% price, as is evidenced lately.

Michael Hoffman: And I get that. I was more -- the lead-in to that was your volumes are telling us the U.S. economy is just fine, that those two markets where things are at 1.5%, 2% it was more a statement about what's the business climate, not what's the right combination of mix.

Ronald Mittelstaedt: Yes, no, I mean, again, I think that is a fair statement, Mike, though we are not seeing really anywhere that there is any underlying economic contraction or anything going on. Are you seeing that year-in and year-out now in the sixth to seventh year of expansion of some of these waste streams such as special waste or even C&D, that the magnitude of the increase quarter-over-quarter, year-over-year, is stepping down a little? Yes, of course you're seeing that. I would expect that. Nothing's telling us that it's contracting.

Michael Hoffman: And then last one for me. Is there any apparent negative knock-on consequences? I'm making it too complicated. Are sellers having an above-average expectation post the GFL purchase of Waste Industries, given what they paid?

Ronald Mittelstaedt: Well, look, certainly when you have a large, very visible deal that comes on at what appears to be a very, very high multiple, such as the GFL-Waste Industries deal, it gets sellers' attention, no question. And that has the potential to change the conversation. But at the end of the day we're going to pay what we're going to pay. That has always worked for us.

We've been through many cycles where there are buyers, whether they be private-equity backed or companies wishing to go public or whatever it is, we've seen this. And they do large transactions at a very visible multiple, and it has some short-term effect on a few deals. But it has never inhibited our ability to get deals done. You just saw us announce the fourth largest deal we've ever done. And we didn't pay within 5 to 6 turns of the GFL multiple of Waste Industries. So it's not going to affect what we're going to do.

And the reality is is that's a very good deal for GFL, makes strategic sense for them, I'm sure. Waste Industries is an exceptional company that bring a lot of needed infrastructure to GFL. So we're not going to begrudge them for doing a deal that made a lot of sense for them. I mean, we probably couldn't have got to within $1 billion to $1.1 billion of those numbers on that valuation. I mean, it's a material knockout punch. We understand why someone like Waste Industries would do it. It makes all the sense in the world for them, and it probably makes all the sense in the world for GFL.

But I don't expect you to see that become a normalized number for them. If it is, then they have a different cost of capital that no one else in this business appears to have, and which isn't true. So this is just a one-off deal, and it makes sense for both parties.

Michael Hoffman: Okay. And I saved one last one. In 2019, given there is good economic environment, would we see a swing to in a quarter where you're positive, even if it's a tenth on volume because the structure of the economy is so good and you've gotten through the shedding?

Mary Anne Whitney: Well, one thing to keep in mind is we'll have the impact of the DOS contract ramp, as we said. The first full quarter we see is Q4. So you should expect that 50-basis-point headwind at least fully through Q1 and Q2, and then starting to abate in Q3 and Q4 or in Q3. So you have to factor that in.

Also, I would just reiterate that we're not approaching this to necessarily report positive volumes. We're going to accept that purposeful price-volume tradeoff. So I'd be reluctant to say that there's a point in time at which we know when we'll report positive next year. We continue to believe that the underlying economy should lead us to volumes at an underlying basis in the U.S. to 1% to 1.5%, slightly weaker in Canada, and I would encourage you just to think about it that way.

Ronald Mittelstaedt: Yes, (inaudible).

Michael Hoffman: Okay. Yes. That helps.

Ronald Mittelstaedt: That's a fair answer.

Michael Hoffman: Okay. Thanks.

Operator: Our next question comes from the line of Tyler Brown, with Raymond James. Please proceed with your question.

Tyler Brown: Hey. Good morning, everyone. I'm a little under the weather, so I apologize. But nice quarter. Hey. Ron, if I could pry a bit, on the large transaction can you just talk about maybe what region geographically the operations are in broadly, maybe West, Northeast, South, etc.?

Ronald Mittelstaedt: No. But what we've said is they're not exclusive markets. So that tells you it's not west of Colorado.

Tyler Brown: Okay. Okay. Okay. That's helpful. And then maybe if I could turn a little bit to the E&P side, can you talk a little bit more about the activity in the Permian? I mean, the DUC well count is really moving higher. Takeaway capacity is very constrained out of that market. But at this point, do you think that $60 million in revenue is a good run rate into '19? And maybe specifically what is in that 8% to 10% guide for E&P specifically?

Ronald Mittelstaedt: Yes, I think, first off, there is not an assumption in that guide of an acceleration in either Q4 or in our '19 preliminary thoughts. I mean, we're assuming the E&P waste business stays approximately the same, which is that today it's a $240 million, $250 million run-rate-type business for us on a revenue basis. So, to your number, Tyler, we're assuming it stays around $60 million in revenue in Q4, and with some normal seasonality in 2019 stays around those numbers.

Now, in the second half of '19, we do have two new facilities -- excuse me, three in the Permian coming on that will step that up some relative to the approximate $60 million run rate. And it will take it to a $65 million to a $70 million run rate, all things being even, just through those new facilities initially in the second half of '19.

Tyler Brown: Okay.

Mary Anne Whitney: And I would just add, Tyler, as we said before, when you talk about takeaway constraints or competition in the Permian, we don't see a step-up in activity beyond where we are right now without other basins coming to play, because what we know is, in addition to the permits that we're pursuing and have received in the Permian, other companies are doing that, too, and there is increased competition.

So we think about 55% of our E&P revenue is in the Permian right now, and we see it's hard to get beyond kind of that level for the Permian. So, again, it takes most specifically the Bakken coming to light to bring us anywhere near prior peaks.

Ronald Mittelstaedt: And to give you some exact perspective on that, Tyler, I mean today in the Permian, what we define as the Permian in both Texas and New Mexico, there are 10 landfill permits or sites. We have four of those. And there is expected to be five new permits by the end of 2019. We are two of those.

So we're 4 of 10 permits today. We will be 6 of 15 permits at the end of '19. So it stays at the 40% number on a permit basis and more than that on a share basis. So we're not anticipating any share degradation. In fact, we believe we'll take that share higher as we bring on these additional sites.

Tyler Brown: Okay. And that, it really kind of speaks to my other question. I mean, to be very blunt here, I mean, do you worry that this market's going to get oversaturated with disposal capacity in the near to intermediate future?

Ronald Mittelstaedt: I mean, the potential always exists, Tyler. Again, look, you have to understand that this business is a volume-driven business. And to your original comment, it's also affected by the takeaway capacity from a pipeline basis and also a trucking basis of both water and solids. And those latter two are very constrained.

If crude moves up that drives volume and it pulls down the radius because of fuel and transport costs that the material can travel. So you have to assume, look, for it to get much more competitive, it only does that if volumes increase materially. That happens if takeaway capacity improves, trucking capacity improves, and crude pricing moves up. So we're not overly concerned about that.

Tyler Brown: Okay. Okay. And then maybe my last one. So, Mary Anne, I was looking through the Q this morning. I think at this point you're down to one fuel hedge. Maybe you could argue that you are as exposed to fuel as ever. Now I'm going to use air quotes here. I mean, I know that you have a natural hedge from E&P and you've got the fuel surcharges. But is there any change in strategy to your fuel hedging? I'm just curious. And do you think that the surcharges are robust enough to offset any potential rise in fuel?

Mary Anne Whitney: No. Good question, Tyler, and I know you and I have talked about this before. As you may know, we do a combination of financial hedges that you'd see in the Q and then fixed price contracts out in the field. And we already have about 23%, 24% of our fuel locked for '19 at the field level, and it's actually below where the aggregate hedges are this year. So we're mindful of that and continuing to look at local hedges. And so, again, you won't see this in our Q.

Tyler Brown: Okay. Excellent. Yes. I appreciate it. Thanks, guys.

Operator: Our next question comes from the line of Noah Kaye, with Oppenheimer. Please proceed with your question.

Noah Kaye: Good morning. Thanks so much for taking the questions. Talking about CapEx, elevated this year, but we understand part of that is going to build out the E&P assets run that you were talking about earlier. How do we think about CapEx as a percentage of sales heading into '19, and when does that kind of CapEx spending for the E&P assets start to trail off?

Mary Anne Whitney: So the E&P, the increase that we talked about, the $35 million in incremental CapEx, most of that will be spent this year. Some of it we'll look continue to look at the timing of that as projects continue. But there will be some -- if a third of it rolled over I wouldn't be surprised. And then beyond that I would think in terms of the 10.5% of revenue as a good proxy for what you should expect CapEx to be in '19.

Noah Kaye: Okay. Great. Second question, you've entered multiple new markets with this deal and others so far year to date. And congratulations on the acquisition. With those entries, how would you now characterize the size of the potential revenues that fit your footprint?

Ronald Mittelstaedt: The size of potential acquisition opportunity revenues?

Noah Kaye: Yes, potentially acquirable revenues.

Ronald Mittelstaedt: Yes, I'd tell you, no, it's in that $3.5 billion to $4 billion range. Again, we've acquired, I'm rounding, $360 million so far year to date. So the year will probably be a $400 million a year or more thereabout. But, again, that $3.5 billion to $4 billion is growing organically at 4% to 5%, and it puts us in states where we didn't have visibility on other deals that we now do. So it really hasn't changed that much.

Noah Kaye: Okay. Perfect. Thank you so much.

Operator: Our next question comes from the line of Derek Spronck, with RBC. Please proceed with your question.

Derek Spronck: Great. Thanks for taking my questions. Just on pricing, you're pricing to more than offset some of the cost pressures and the headwinds from recycling. Is the competitive environment remaining rational, and in that regard, as you're pricing to offset some of these cost pressures how are your customer retention rates trending?

Ronald Mittelstaedt: Well, overall, customer churn rates are down. So that would tell you that retention rates are improving. I think that is indicative of how strong the economy is and that everybody, publics and privates, are faced with similar cost pressures, whether it be driven through recycling, or labor, or fuel, or steel, or anything else.

And you have to understand, again, the public companies have similar cost structures, similar investor expectations, similar balance sheet structures. So they're going to be similarly rational. The private companies, they actually have a disproportionate burden right now in the cost structure relative to the public companies. Number one, they operate typically on lower margins. Number two, they have a disproportionate amount of their cash flow derived from commodities, usually 3x to 4x what the public companies have. That is gone.

So they have a real material cost pressure to them that they haven't seen in quite some time. And we are seeing privates be very aggressive in raising price. So you sort of have the perfect storm for both public and private together having differential reasons to raise price.

The other thing is you have -- I think everybody's system is at full capacity. There's not -- people don't have parked roll-off trucks and boxes and spare front loaders just sitting around. I mean, due to the ongoing strength of the economy, systems are full. So, all of those things lead to a lot of legs under the table of supporting why price is growing, is sustainable, and churn rates are dropping.

Derek Spronck: Okay. That's great color. Thanks, Ron. And just quickly on your M&A opportunities, how would you classify the quality of the M&A opportunities? Are you still finding very strong opportunities from an M&A perspective? I know you said the overall acquired revenue availability is still around $3.5 billion to $4 billion. How about the size of the companies individually that you're looking at and the quality? And then, finally, are you in advanced discussions with any additional companies at this point?

Ronald Mittelstaedt: Well, for the last part, we're always in advanced discussions with a lot of companies. So, that one's an easy one to answer. I mean, look, deals we're closing now or in next quarter or in the first half of '19 we don't just start talking about in this quarter or the fourth quarter. We've been talking about for a long time. So, there is a large amount of deals in our pipeline at various stages of either offer or due diligence to negotiate to offer.

And again, Derek, those companies range from small tuck-ins of $0.5 million to a couple million dollars to companies north of $100 million. So we've got companies of all sizes. And look, again, to have a year of $360 million to $400 million, I'm going to tell you, that means we've made offers on $1 billion-plus of revenue to get to this point of closing. So with an average transaction size of $5 million to $10 million, it tells you we've made probably 100-plus offers this year. That's the type of what a pipeline has to be to get to this end result, and that has not changed, that has grown.

Derek Spronck: And you're still finding good quality opportunities out there?

Ronald Mittelstaedt: Oh, absolutely. I mean, once we can fully talk about the deal that we announced this morning, it's one of the best asset quality deals and market positions we may have ever done. And so, yes, I mean, look at earlier this year. We acquired one of the preeminent companies in southern Virginia, an integrated company that sort of dominates the Norfolk market and south of Norfolk to North Carolina. So, yes, we continue to find very, very good companies.

Again, you've got this sort of I think in seller's minds a window, okay, a window where they have tax clarity that they think could get, might get different in a few years, rising interest rates which hurt their balance sheet but helped them in reinvested proceeds, a very full system through a strong economy, and you have a pent-up amount of deals that didn't get done for many years because the economy was sort of in neutral to low gear.

And so all of those things sort of create again the sort of perfect storm for M&A in our sector. We sort of called this at the beginning of '17. It's played out just about how we thought it might. And I think that it plays out probably through approaching the next election. And then who knows?

Derek Spronck: Okay. No, that's great. Thanks, Ron. Thanks, Mary Anne.

Operator: Our next question comes from the line of Michael Feniger, with Bank of America. Please proceed with your question.

Michael Feniger: Hey, guys. Yes. Thanks for taking my question. Just the first point just to kind of flesh it out, you mentioned when you see how strong the backdrop is, you mentioned how everyone's at full capacity, everyone's incentivized to raise prices with the higher costs.

I'm just curious how you're seeing the supply side of that equation into 2019. You guys have clearly spent some CapEx. Now that's more on the E&P side. But the national players have been spending CapEx, too, on trucks and adding to the routes. I'm curious if you've seen the small, medium-sized guys, are they adding more trucks to the routes and are they aggressively expanding their routes?

Ronald Mittelstaedt: Yes, I think that the reality is, is that where they can get vehicles, where they can get trucks, I mean one of the challenges right now, Michael, particularly for a small- or a medium-sized company that doesn't have pre-negotiated national agreements to buy in large quantities, such as most of the national players have like ourselves, you can be talking about six- to eight-month lead times if you want a new configured truck in a certain way today. That's how backlogged manufacturers are.

And so they have a little bit more of a challenge if they bid a new contract that's going to start in 90 days and they need to get equipment for, that could be a particular challenge right now to some of the smaller to medium-sized players. The large players that's not I don't think going to be an inhibition to doing anything because they have agreements with all the national suppliers on sort of standing orders. I know we do, and certainly Waste Management, Republic, Advanced, and others do as well. But supply is definitely tight for equipment. Yellow iron is even more difficult. Yellow iron lead times are even longer for heavy equipment, for landfills, or transfers, or recycling facilities.

Michael Feniger: That's great. I really appreciate that color. And obviously, we talked about C&D, but with all the things we're seeing with housing right now and you guys have had really strong growth the last six, seven years, I'm just curious if we do see a step-down there from these high levels next year, how do you think that impacts the market in terms of competition? I understand I think it's around 15% of tons for you guys, so it's a smaller part of the business. But just overall how do you think that knock-on effect could play out in 2019 or maybe if it's more of a 2020 event?

Ronald Mittelstaedt: Yes, well, first off to a comment I made earlier, Michael, to give you and investors some comfort, if you go back to the 2005 to 2008 period, the housing industry was averaging 1.8 million up to 2.2 million new housing starts. At that time, C&D or temporary roll-off related to construction was almost not quite double what it is today as a percentage of revenue for us. And part of that is the company has grown, it's diversified geographically and in business lines.

But the other part of it is is we're only back to 1 million housing starts a year, 50% of where we were in 2005 to 2008. So it's just not as big a percentage of the business. It's half the risk -- a little more than half, probably 60% of the risk that it was if you go back a decade.

Michael Feniger: Got it. Thank you, guys.

Operator: (Operator Instructions)

Mr. Mittelstaedt, there are no further questions at this time. I will now turn the call back to you. Please continue with your presentation or closing remarks.

Ronald Mittelstaedt: Okay. Thank you, operator. Well, if there are no further questions, on behalf of our entire management team we appreciate your listening to and interest in our call today. Mary Anne, Worthing, and I are available to answer any direct questions we did not cover that we are allowed to answer under Regulation FD, Regulation G, and applicable securities laws in Canada.

Thank you again, and we look forward to speaking with you at upcoming investor conferences or on our next earnings call.

Operator: Ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation and ask that you please disconnect your line.