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WM - Q2 2018 Waste Management Inc Earnings Call

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OVERVIEW:

Co. reported 2Q18 diluted EPS of $1.01. Expects 2018 adjusted diluted EPS to be $4.05-4.10.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Waste Management Second Quarter 2018 Earnings Release Conference Call. (Operator Instructions) And as a reminder, this conference is being recorded. I would now like to introduce your host for today's conference, Mr. Ed Egl. Sir, you may begin.

Edward A. Egl - *Waste Management, Inc. - Director of IR*

Thank you, Amanda. Good morning, everyone, and thank you for joining us for our second quarter 2018 earnings conference call. With me this morning are Jim Fish, President and Chief Executive Officer; Jim Trevathan, Executive Vice President and Chief Operating Officer; and Devina Rankin, Senior Vice President and Chief Financial Officer. You will hear prepared comments from each of them today. Jim Fish will cover high-level financials and provide a strategic update. Jim Trevathan will cover price and volume details and provide an operating overview, and Divina will cover the details of the financials.

Before we get started, please note that we have filed a Form 8-K this morning that includes the earnings press release and is available on our website at www.wm.com. The Form 8-K, the press release and the schedules of the press release include important information.

During the call, you will hear forward-looking statements, which are based on current expectations, projections or opinions about future periods. Such statements are subject to risks and uncertainties that could cause actual results to differ materially. Some of these risks and uncertainties are discussed in today's press release and in our filings with the SEC, including our most recent Form 10-K.

Jim and Jim will discuss our results in the areas of yield and volume, which unless otherwise stated, are more specifically references to internal revenue growth, or IRG, from yield or volume.

During the call, Jim, Jim and Divina will discuss our earnings per diluted share, which they may refer to as EPS, or earnings per share; and they'll also address operating EBITDA, which is income from operations before depreciation and amortization; and operating EBITDA margin. Any comparisons, unless otherwise stated, will be with the second quarter of 2017. Net income, effective tax rate, EPS, income from operations and operating EBITDA for the second quarter of 2018 have been adjusted to enhance comparability by excluding certain items that management believes do not reflect the fundamental business performance or results of operations.

These adjusted measures, in addition to free cash flow, are non-GAAP measures. Please refer to the earnings press release notes and schedules, which can be found on the company's website at www.wm.com, for reconciliations to the most comparable GAAP measures and additional information about our use of non-GAAP measures.

This call is being recorded and will be available 24 hours a day, beginning approximately 1:00 p.m. Eastern Time today until 5:00 p.m. Eastern Time on August 15. To hear a replay of the call over the Internet, access the Waste Management website at www.wm.com. To hear a telephonic replay of the call, dial (855) 859-2056 and enter reservation code 2373399. Time-sensitive information provided during today's call, which is occurring on July 25, 2018, may no longer be accurate at the time of a replay. Any redistribution, retransmission or rebroadcast of this call in any form without the expressed written consent of Waste Management is prohibited.

Now I'll turn the call over to Waste Management's President and CEO, Jim Fish.

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

Thanks, Ed, and thank you all for joining us this morning. Our traditional solid waste business once again demonstrated exceptional performance, generating strong free cash flow and earnings growth. In the second quarter, our collection, landfill and transfer station lines of business saw organic revenue growth of almost 5%, which translated into income from operations and operating EBITDA, each growing nearly 7%. Overall, we generated EPS of $1.01. Our strong operating performance once again produced robust cash flow from operating activities and free cash flow, both growing by more than 19% in the second quarter when compared to the second quarter of 2017. This achievement was in spite of a more than 45% increase in capital spending in the quarter as we accelerate and execute our fleet strategy and address additional airspace needs to accommodate growth.

Given the outstanding performance in the solid waste business and a lower-than-anticipated tax rate, we are increasing our 2018 adjusted EPS guidance to a range of $4.05 to $4.10. We're also reaffirming our adjusted operating EBITDA guidance of $4.2 billion to $4.25 billion and free cash flow guidance of $1.95 billion to $2.05 billion.

While our strong performance from our traditional solid waste business is propelling us forward, as demonstrated by this EPS guidance increase, we continue to see pressure from our recycling line of business, as commodity market challenges persisted in the second quarter. During the quarter, EPS from recycling declined by $0.07 when compared to the second quarter of 2017, largely due to lower demand for recycled materials, following China's import demand. And we are no longer assuming a second half recovery in recycled commodity prices.

Based upon our revised outlook, we are further updating our expected EPS impact from recycling for the full year to be a negative $0.17 to $0.20 compared to the full year of 2017, which is based upon our blended full year average commodity rate of around $68 per ton. This equates to a year-over-year decline in operating EBITDA of approximately $100 million, which is twice the impact we expected in our initial guidance for 2018. Keep in mind, we believe that more than 3/4 of the impact is now behind us. We expect the headwinds to moderate in the second half of 2018 as we continue to take steps to improve the recycling business.

Recycling aside, 2018 is tracking better than our expectations. So I want to spend a couple of minutes on the big picture beyond this year. Obviously, we're not just focused on 2018, we're focused on delivering sustainable growth for our shareholders over the long term. One area of focus is developing and retaining the best workforce in the industry. Many industries are seeing pressure from labor costs and shortages, particularly with regard to drivers and technicians. We're being proactive in attracting and training talents to handle the increase in collection volumes. To that end, we're developing a second driver and technician training facility. By investing more in our frontline employees early in their careers, we've seen an improvement in safety performance and retention, and a second facility will allow us to accelerate and improve the training delivery process to our drivers and technicians. In addition, using technology, we are piloting a program with Caterpillar that allows us to remotely operate equipment at one of our landfills in Colorado. Technology like this modernizes the jobs for our workers, enables us to work more efficiently and provides us with a further opportunity to higher military veterans, which currently make up 8.5% of our new hires. In particular, we see the potential for wounded service members as well as other qualified workers to fill some of these higher-tech, less labor-intensive jobs in the future.

Another big area of focus is maximizing return on our disposal network. We have the best-positioned landfills and transfer stations in the industry, and we've started to see increased volumes being disposed at our facilities. We believe that is due to a strong economy and benefits of volumes from third-party haulers choosing our closed end disposal sites. We see an opportunity to leverage the logistical benefits of our disposal network and increase returns on our large investment in that network.

To close, the 2018 story is a good one. Our solid waste business is in great health, outperforming even our own expectations. At the halfway mark for the year, we are well on our way to meeting or exceeding our operating and financial goals for 2018. We could not accomplish this without the greatest employees in the industry. They've been able to deliver strong performance and are confident that they can execute throughout the remainder of the year.

I will now turn the call over to Jim to cover our second quarter operating results in more detail.

James E. Trevathan - *Waste Management, Inc. - Executive VP & COO*

Thanks, Jim, and good morning, everyone. Our traditional solid waste business continues to build momentum. For the fifth consecutive quarter, both price and volume growth exceeded 2%, putting us on track to achieve our full year pricing and volume guidance. Our strong organic growth in the quarter helped drive revenue $62 million higher compared to the second quarter of 2017.

In our collection and disposal business, price and volume increased $135 million, or 4.3%. The strong growth in our collection and disposal business was partially offset by an $85 million decline in revenue from our recycling line of business. Total company operating EBITDA increased $32 million, or 3.1%, and operating EBITDA margins expanded 40 basis points to 28.4% despite a 40 basis point headwind from recycling. Our revenue metrics continued to demonstrate the strength of our underlying solid waste business. Service increases exceeded service decreases for the 18th consecutive quarter, and new business exceeded loss business for the 13th consecutive quarter.

Our churn rate was 8.7% in the second quarter, a 90 basis point year-over-year improvement, and rollbacks improved 40 basis points (technical difficulty) 25.2%.

Turning to internal revenue growth in the second quarter. Our collection and disposal core price was 5.3%, a 60 basis point improvement from last year, and yield was 2.3%, up 40 basis points. Traditional solid waste volumes grew 2.3%, while total company volumes improved 1.8%. This growth was achieved despite the favorable impact in the second quarter of 2017 and through the end of that year when we received additional landfill volumes in Virginia due to a competitor outage. Transfer station volumes grew 4.7%, primarily due to the New York City disposal contract.

Let's go through the results by line of business, begin with collection, where we saw robust growth. Commercial core price was 6.6% for the quarter, with volumes up 3.2%. Industrial core price was 10.9%, with volumes up 3.1%. In the residential line of business, core price was 3.3%, and volumes increased 0.2%. The combined price and volume increases led to collection income from operations growing $47 million and operating EBITDA growing $56 million, with margins essentially flat. In the landfill line of business, total volumes increased 3.6%. MSW volumes grew 1.7%, C&D volume grew 3.9%, and the combined special waste and revenue-generating cover volumes grew 2.5%.

We achieved core price of 3% in the landfill line of business. For the second quarter, our landfill line of business grew income from operations by $23 million and income from operations margin by 50 basis points, while operating EBITDA grew $37 million and operating EBITDA margin rose by 100 basis points.

Looking at recycling. As we discussed on the first quarter conference call, we took further steps to improve our business as we rolled out an approach to address contamination and recover cost for excess contamination. We are pleased with the results so far and expect to see improvement in the second half of the year. We will continue to work on improving the recycling business because it's a service that our customers desire, and our shareholders deserve an appropriate return on invested capital from our recycling assets in any economic climate.

Turning to operating expenses. Total operating expenses as a percent of revenue were 61.9% in the second quarter, an improvement of 40 basis points compared to last year. Operating expenses increased $23 million over the second quarter of 2017. The main driver is labor costs related to volume increases in our commercial and industrial businesses and our bonus for hourly employees.

As Jim mentioned, with the increasing collection volume, we are hiring additional drivers and adding new routes in high-growth locations. When we do this, we do incur additional training cost and lower efficiency as drivers learn their new routes, which increases our labor cost per unit. But historically, these pressures have been short term in nature, and they should provide opportunity for future margin expansion as we fill in those routes and improve efficiency. Labor costs were offset by lower cost of goods sold due to the reduction in recycled commodity prices. Removing the impacts of recycling and the hourly employee bonus, operating expense margin for the traditional solid waste business improved 130 basis points. We are pleased with our progress in the first half of 2018, and we remain focused on disciplined pricing and profitable volume growth to deliver another exceptional year for our shareholders.

I will now turn the call over to Devina to discuss our financial results.

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

Thanks, Jim, and good morning. As you've heard this morning, our strong core solid waste performance drove impressive financial results in the second quarter. These results give us confidence that in spite of recycling pressures proving to be even more significant than we expected just 1 quarter ago, we will achieve our full year EBITDA and free cash flow guidance and exceed our original EPS guidance.

The strong core pricing collection and disposal volume growth that we saw in the second quarter, combined with disciplined focus on controlling costs and optimizing working capital, drove $975 million of cash from operations. This is the best single quarter cash from operations we have ever achieved. We are seeing the expected list in cash flow conversion from tax reform, and when we combine that benefit with our strong operating performance, the results are markedly improved.

Our cash flow from operations as a percentage of revenue grew more than 400 basis points from the same quarter of last year to 26.1%. The incremental cash from operations is being directly invested in the assets that will support and drive continued growth. During the second quarter, we spent $436 million on capital expenditures, bringing our year-to-date capital investment to $836 million, putting us on pace to spend the high end of our full year capital expenditure guidance of $1.6 billion to $1.7 billion. With our strongest return businesses growing at a pace not seen in many years and an economic backdrop that is generally supportive of continued growth, we're making valuable investments in our fleet and our landfills.

We generated $621 million of free cash flow in the second quarter, an increase of $101 million, or nearly 20% from 2017. Year-to-date, our free cash flow was $1,044,000,000 million, putting us well on our way to achieve our full year guidance of $1.95 billion to $2.05 billion.

We remain committed to a capital allocation plan that prioritizes return of value to our shareholders and accretive growth through acquisition. In the second quarter, we paid $200 million in dividends and bought back $300 million in shares. We've allocated over 90% of our 2018 free cash flow to dividends and share buyback in the first half of the year.

In the quarter, we completed another $21 million in accretive tuck-in acquisitions, bringing the total for the first half of the year to $269 million. This represents about $200 million of annualized revenue acquired in 2018.

Our continuous improvement mind-set is helping in our diligent approach to managing SG&A costs. SG&A was 9.8% of revenue in the second quarter, which is in line with the prior-year period. This is a particularly strong results when you consider the margin impact of the revenue decline from commodity prices as well as a $9 million accrual in the quarter for legal matters. This charge increased our SG&A costs as a percentage of revenue by 30 basis points and negatively affected EPS for the quarter by $0.02 per share.

As Jim mentioned, the primary reason for raising our EPS guidance is the strong performance of our traditional solid waste business, and that includes managing SG&A. Our employees are focused on making sure that every dollar that we spend on SG&A is invested in providing exceptional customer service, driving continued revenue growth or improving efficiency in our back-office and support functions. We've seen good discipline in eliminating unnecessary spending, and we expect these benefits to continue even as we invest in technology to improve our business.

Our adjusted effective tax rate for the second quarter of 2018 was 23.2%. We now expect our adjusted full year 2018 tax rate to be about 24%. I want to take a moment to recognize our tax professionals who do an outstanding job in tax planning. In the second quarter, we recognized a $0.09 benefit from tax planning and a settlement of outstanding audit. We excluded $0.07 of this benefit from our as-adjusted EPS, but the entire amount represents real value that our team worked hard to capture for our shareholders. They identified an opportunity, worked with the IRS and generated a win for Waste Management.

Looking at our financial metrics. Our debt-to-EBITDA ratio, measured based on our bank covenants, remained at 2.4x at the end of the second quarter. Our weighted average cost of debt for the quarter was about 4.1%, and 17% of our total debt portfolio is at variable rate.

We delivered solid performance in the first half of 2018, and the outlook for the remainder of the year is strong. Our traditional solid waste business performance once again overcame the recycling headwinds to generate a healthy increasing both cash and earnings. We appreciate the hard work of the Waste Management team this quarter and look forward to continued success in the second half of the year.

With that, Amanda, let's open the lines for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Brian Maguire of Goldman Sachs.

Brian P. Maguire - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Congrats on the solid results in the core business. Just wanted to dig into that a little bit more. Just what surprised you the most about the results in the MSW business so far in the year to give you the confidence to kind of raise the EPS guidance despite the recycling headwinds? Is it the landfill part of the business, pricing, retention? Just maybe any comments about what areas are surprising you the most.

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

Brian, I don't know that anything really surprised us. We've seen this coming for a couple of quarters now. We have maybe -- if there was a surprise, it's the fact that with a steeper downturn as we've seen in recycling over a short period, that solid waste has been so strong that it's been able to completely eclipse that. And so if there is a surprise, it's that. To get a bit more specific about the individual pieces, certainly, the landfill business has been good. I mentioned a bit of it there in my script, and Jim as well. It was -- the volumes that we've seen have been -- I'm not sure I would call them a surprise, but they're certainly a welcome addition to several years ago where we weren't showing really any volume improvement. It's not been that long ago that every quarter we talked about strong core price and yield, but always had to answer questions about core volumes. So the fact that these individual lines of business are showing 3.2% in commercial and 3.1% in roll-off, those are strong. If I -- maybe I had to pick one surprise, it's residential -- Jim kind of stressed it, but it's -- residential is now actually positive. It's -- I'm going to call it positive. It's only 0.2%, because it's been negative for a long time.

Brian P. Maguire - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay. That sounds good. Just switching over to the recycling and, obviously, every month or every week it keeps changing the news coming out of China. The latest sort of news is they might ban all imports, first they said maybe by 2020, now maybe sooner. And I know you guys have been looking at ways to try and change the business model in the U.S. One idea or concept we've heard in the industry is that they may look to import more with, I guess, they're calling recycled pulp, where you can take some of the paper and run it through the front-end of a pulping process here in the U.S. and send it over there, and you kind of get around the restrictions and could be a win-win for everybody. I've heard some rumbling that some of waste guys were looking at that business. Is that something that you would be interested in getting into, whether it be through a partner in the paper or pulp industry, but some way to stimulate more demand for recycled paper domestically by either restarting some old mills or trying to develop some kind of a recycled pulp market to China?

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

Yes. I think we look at a business that's fallen off the table like recycling has over such a short period. We're looking at every single option to improve it, whether it is, as you suggest, vertical integration or whether it is bringing really radically different technology to our recycling facilities. Or in the short term, what we're doing -- and maybe I'll boil down the math equation a little bit this way, recycling basically is a -- there's 3 things going on here. And so we've seen, obviously, the commodities really fall off to the tune of about $45 is our expectation for the year, which equates to $0.18, right in the middle of the range we gave. The other pieces are the processing costs have gone up 12% to 15% year-over-year as tempted to meet these contamination limits. And transportation costs have gone up because we're not really importing much to China anymore, it's going to places like India and Vietnam, which are longer length of haul. And then the offset to the cost piece has been this short-term approach, which is a 3-phased recycling improvement plan. So what you're talking about is a little bit longer term, and we're going to look at both short-term fixes and long-term fixes to make sure that this recycling business gets on solid footing.

Brian P. Maguire - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Okay. And just related to that one, last one for me. Just within the surcharges bucket at $32 million, any of that related to recycling fees that you could call out and kind of success you're having trying to implement those fees on your traditional customers?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

So that surcharge line in our IRG table is specifically related to fuel. All of the behavior associated with the 3-phased approach that Jim mentioned is included in the recycling commodity price line.

Operator

The next question is from the line of Hamzah Mazari of Macquarie.

Hamzah Mazari - *Macquarie Research - Senior Analyst*

The first question is just around the comments on having sort of the best-positioned assets on the disposal side. Jim, maybe if you could frame for us, does that -- are you just referring to that you have further room to push disposal pricing and historically sort of it wasn't done? Or is there anything else around either bidding of future contracts where you can maybe bid better and leverage that asset positioning?

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

Yes. Hamzah, I think it's probably a bit of both, but certainly the former. We certainly would be looking to price those assets accordingly. I mean, they are -- those assets do have a finite life to them. And so with assets that are as well positioned as ours, we need to make sure that we price them accordingly. When we look at our MSW pricing, we've done pretty well for the last 4 quarters in kind of the 2% to 3% range. But I think, aspirationally, I'd like to see us in more kind of the 2% to 4%, maybe even the 3% to 5% range.

Hamzah Mazari - *Macquarie Research - Senior Analyst*

Okay. And then just secondly, you touched on technology, you touched on some of the autonomous equipment at the landfill. Maybe high level, if you could frame for us how many technology projects are you looking at? And any high-level view as to how much that can take out of your cost structure, either efficiency or structural cost takeout? And I know they're in pilot stage, so anything you can share qualitatively or quantitatively would be great.

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

Yes. I would tell you that the benefits of technology is -- particularly as we think about customer-facing technologies, our digital team is doing a fantastic job. They've just rolled out an open-market residential tool. The benefits on the cost side are kind of the secondary benefits. The primary benefits are differentiating ourselves from competitors and giving us an opportunity to gain a bigger slice of the pie. So as a result, I would say, we haven't fully quantified that second piece that you're asking about. There would be some benefits. I mean, it's -- as you think about a customer-facing tool, it is -- it's more efficient for the customer to -- and less costly, by the way, for the customer to go through an app than it is to go through a call process because the call process takes longer. But with that said, we're very pleased with the job that our call centers do. So maybe a way for us to, as we think about turnover in case -- in the case of our call center help mitigate that a bit. But the primary benefit of technology is going to be getting us a bigger slice of the market share pie. And I think the technologies that we're looking at, Hamzah, are both on kind of the traditional technology side, which we've talked about customer-facing type technologies. But also, what I mentioned in my prepared comments, and that is, we're just beginning this partnership with Caterpillar. And that will be -- that will involve operating -- remotely operating a piece of heavy equipment. And those are in this case from -- we'll be operating it from several thousand miles away to this landfill in Colorado. It's the very, very first step in this, but we're excited, Caterpillar is excited. I believe it's something that Caterpillar has done with other customers and other industries. But this is, I think, the first foray into our space, so we're excited about that.

James E. Trevathan - *Waste Management, Inc. - Executive VP & COO*

Hamzah, maybe I would add to that. The birth of robotics that we've talked about at a site, it's in the pilot stage. The landfill automated heavy equipment, all really cool, sexy stuff, and really good future. But what we've done just the last few years with onboard computers, it's an older technology. But we have computers on all those sites. And as we've had the commercial and industrial and residential for the first quarter volume increases, it's helped us with reroutes, it helps us manage efficiency of those new routes that are coming on with that volume growth, and it's also helping us as we use those tools on a truck to provide lead opportunities where their service increased opportunities from our current customer base. So there's some technology that's helping us with, as Jim said, that differentiated view from a customer perspective that's in existence and helping us every quarter.

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

Last point, Hamzah, that I really want to hammer home and that is -- I mentioned it, but this really starts to redefine the job that is the operator job today. I mean, we have 17-ish percent turnover in that job today. So that means we turn over -- internally, we turn over almost all of our operators in a little bit more than 5 years. This starts to redefine it. As you think about a kind of a gaming chair with a remote -- kind of a remote operation and basically a joystick there operating a piece of heavy equipment, that's much different. And potentially, we're more able to not only attract, as I mentioned, wounded vets, but also attract folks that may not otherwise be interested in working on the face of a landfill, but may be very interested in working in an air-conditioned room, sit in front of some screens with -- in a leather chair.

Hamzah Mazari - *Macquarie Research - Senior Analyst*

That's very helpful. Just last question, I'll turn it over. On the volume side, is the 90 bps improvement in customer churn a sustainable figure going forward? I know there's a floor to customer churn at some point, maybe at 7%. But any view there?

James E. Trevathan - *Waste Management, Inc. - Executive VP & COO*

Yes, Hamzah, I -- we're very happy with that result in Q2, but if you look back, we've had 11 straight quarters now with single-digit churn rate. So it has been sustainable, and we've done very well in that regard. Part of it is all of the focus on just service delivery to a customer, part of it some of the technology that we've talked about. We're doing very well. And I do expect further improvements. Maybe that's just old school seeing opportunity, but I think that number can continue to improve, not as dramatically as it could when it was a double-digit number, but it can continue to improve, and we expect that.

Operator

Our next question is from the line of Noah Kaye of Oppenheimer.

Noah Duke Kaye - *Oppenheimer & Co. Inc., Research Division - Executive Director and Senior Analyst*

Jim, just to pick up on one of the areas you highlighted at the beginning of the call around developing and retaining best employees. And I guess, this really gets to the question of managing costs as well. What kind of an environment do you see the industry and in terms of overall cost inflation now? How much for things like labor and maintenance that are more specialized? And what is the ability of the company to kind of recover that and continue to get margin expansion through price, not necessarily just focusing on this quarter, but looking over perhaps the medium term?

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

So the rate that we're seeing is kind of still in that 3% range, and our turnover of employees has stayed relatively constant. Hard to know whether that is driven by things like this new training center that we're bringing on or whether there is -- I'm sure as we get closer to the end of the year, there's an allure of the 2000 that becomes kind of closer and closer and feels more and more real to them. So I think that's going to start affecting turnover, but we haven't seen that yet. And clearly, whether that means that turnover would have been higher and it actually is having an effect or whether it's not having an effect at all, and I'm not sure we're able to tell. But I think longer term, Noah, and that really is the big question, not only as a company, but I think as an industry, we're looking at how do we provide a job that is an attractive career for folks. For us, it means providing an excellent form of training. We've seen that's -- the drivers that -- when we rolled out our first training center, the drivers and technicians that went through that training center had a markedly lower turnover in their first year to 1.5 years. And that is really the critical point for us with turnover. Once they hit kind of year 2 or year 3, I guess, that seem -- there seems to be some magic to that. They seem to stay for their careers. But that first couple of years is really critical. And so adding another training center, we think, will help that. We think doing some things as we mentioned with Caterpillar and a little bit farther down the road on the collection side of our business and additionally in recycling, those types of technologies bringing to our business will help. But for right now, I would characterize it this way, we're seeing some local pressure, but not anything that expands across the network, and we address it locally. By the way, we've been seeing local labor pressure for several years. This isn't something that's just cropped up in the last 12 months.

Noah Duke Kaye - *Oppenheimer & Co. Inc., Research Division - Executive Director and Senior Analyst*

Right, right. And then on recycling, the company is no longer assuming a price reversion. If the ban is implemented, do you think we see another leg down on prices? And then how should we think about any potential decrementals or incrementals? Because if I got my maths right, your decrementals were maybe mid-40s, and that's lower than other peers in the industry. It would seem that there may be an opportunity to improve that even further through some of the initiatives that you have highlighted around improving processing costs and rationalizing the cost structure.

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

Yes. I would -- I'm not a prognosticator, but I would tell you that if I were asked to place a bet on this, I would tell you that we're closer to the bottom. And so there's probably more upside potential than downside. As I mentioned, we didn't put any upside in the remainder of the year, so we're basically flat line in commodity prices from this point through the end of the year. But here's the silver lining to all of this: because we've taken a conservative approach with this $0.17 to $0.20 and because solid waste has been able to completely overcome it, there could be some upside for the remainder of the year. We certainly think that in 2019, as we think about this expense reduction effort and the 3-phased recycling improvement plan really not being rolled out in earnest until May, that if all things remain equal, recycling could be a tailwind for us in 2019. And if we are closer to the bottom of commodity prices, then it would in fact be a tailwind because we really didn't get much in either of those improvement plans in -- certainly in the first quarter and even into April and May.

James E. Trevathan - *Waste Management, Inc. - Executive VP & COO*

And Noah, I might add to that. You opened with the China impact. Just so we're clear, we sent less than 5% of our volume in the first half of this year to China. So it's -- we found other outlets, and yes, it's affected cost and transportation -- both the commodity price and transportation cost. But what China does next is not a significant impact, given the fact that we found other outlets, both domestically and internationally. So with less than 5% of our current fiber going to China, I'm not sure how that impact would be huge for us in the future months or quarters.

Operator

And our next question is from the line of Tyler Brown with Raymond James.

Patrick Tyler Brown - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Devina, so I just wanted to make sure I understand it. But if my notes are correct, so year-to-date, you've seen about a $0.15 drag in recycling. You're guiding to a $0.17 to $0.20 for the full year, which implies that you really aren't expecting much of a back-half drag, even though I thought peak commodity pain would be in Q3 and -- even at current prices, but it sounds like you're not assuming any change in price. So what is -- what's going on in the back half the short-term fixes that are really softening the drag? Or am I thinking about this all wrong?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

You've got that part of it right. The one piece that I would correct is from a commodity price perspective, the pressure that we saw on a year-over-year comp basis was much heavier in the first half of 2017 and 2018 on a year-over-year basis than it will be in Q3 and Q4. So that's part of the reason that the incremental up to $0.05 from the current year-to-date impact of $0.15 that you noted at the high end is so much less than what we've already experienced in the year. And then as Jim has mentioned, our efforts on both cost reduction and our particular interest on contamination fees with our customers should provide lift over and above what we've already experienced, given the delay in execution in some of those in the current year. With regard to solid waste, I think that the big picture there is that if you only have $0.05 of impact in the back half of the year relative to the $0.15 of impact that we've had from the recycling line of business and solid waste is more than overcome that $0.15 drag, that tells you that there's a lot of lift that will come from solid waste in the back half of the year. And then on top of that, we'll have some lift from the lower tax rate that we have provided.

Patrick Tyler Brown - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Right. Okay. And then on the tax rate, real quick, how should we think about next year?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

I would tell you that our -- the only item that I don't see continuing into 2019 is the current quarter $0.02 benefit that we had from tax planning activity. Aside from that, there are impacts as we start to see some roll-off impact of the low income housing tax credit investments and renewable energy tax credit. But we're looking at those, and it's too early for us to say specifically. But about that 24%, 25% is reasonable at this point in time for our current outlook for 2019.

Patrick Tyler Brown - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Okay. And then Jim Trevathan, I'm curious about the application on the hours of service exemption. So can you talk a little bit about the reasoning behind that move? Is that really a way to cope with some of the tightening in frontline labor?

James E. Trevathan - *Waste Management, Inc. - Executive VP & COO*

Yes. Are you talking about the yield issue?

Patrick Tyler Brown - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Yes.

James E. Trevathan - *Waste Management, Inc. - Executive VP & COO*

We -- it is. I mean, right now, we're operating under the requirements just as they're written, but we did file that exemption. Most -- about -- over 90% of our routes are less than -- have been less than 100-mile radius, so there are several people that are part of that exemption request (inaudible) the industry other short-term type haulers. And whether that happens or not, I'm not sure yet, Tyler, but we filed the exemption, and things are looking good. But we're living with the standards today and operating as if it won't happen, but we sure expect it.

Patrick Tyler Brown - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Okay. And then maybe my last one here. Just, Devina, going back to the margins. So you had a 40 basis point improvement in margins year-over-year this quarter. I think you mentioned that recycling was a 40 basis point drag. Is that correct? And was that -- did that have any impact from maybe the shedding of some of the lower-margin broker tons?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

You're exactly right, that included the 40 basis point impact from the recycling line of business. Brokerage impact did, actually, positively, so the MRF business was a drag of 70 basis points in isolation. So the 40 basis points that you mentioned for recycling is inclusive of the mix in business between brokerage and MRF.

Patrick Tyler Brown - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Okay. So solid waste was up, call it, 80? But was there any benefit from rev rec in there?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

So solid waste in -- by itself was around 50 basis points actually. There are some other gives and takes. The rev rec standard implementation as well as some other changes in our pass-through revenues had a total impact of 50 basis points. But we also had the hourly bonus plan, which was a negative 50 basis point.

Patrick Tyler Brown - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Okay, okay. So it was up core, core, core is what I'm trying to get at?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

Yes.

Operator

Our next question comes from the line of Michael Hoffman of Stifel.

Michael Edward Hoffman - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Group Head of Diversified Industrials Research*

I wanted to look at the mix of EBITDA as you thought about the beginning of the year and where we are today because, I think, if I have parsed this correctly, you were looking at approximately 7% growth in solid waste-driven EBITDA with a down recycling at the beginning of the year, but now we're really looking at probably more like 9% growth in solid waste to EBITDA versus the revised outlook for recycling. Have I parsed that correctly?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

You have.

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

Yes.

Michael Edward Hoffman - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Group Head of Diversified Industrials Research*

Okay. So that's the power that you've been talking about. And does the acceleration of that in what you just alluded to, Devina, going into the second half is that you're expecting that to be on a first half versus second half basis even better? Is that right? If I split the 9% in halves, it's greater in the second half than it is in first half?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

Well, the one piece that I would remind you about though is Q1 was particularly strong because of the fuel tax credit. So we have had some of the benefit in the first quarter with solid waste because we're talking about on an EPS basis, comparing the $0.15 that had to be overcome to a $0.05 detriment from the recycling line of business. But on the EBITDA line, at $1,061,000,000, the level of growth that we've seen should provide us confidence to hit somewhere between $4.2 billion and $4.25 billion of EBITDA growth, which would be full year growth of around 5% on a consolidated basis.

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

I think, Michael, what we're really saying is that as the recycling headwind moderates in the back half of the year and solid waste stays as strong as it's been, then you really do see that lift coming in the back half. I'm not sure whether I would say it's solid waste getting even better than it is. Solid waste is as good as it's been in over a decade. It's just that the recycling comps get easier in the back half.

James E. Trevathan - *Waste Management, Inc. - Executive VP & COO*

(inaudible) get a little bit easier in the second half, the solid waste comps, landfill volumes, for example, the comps (inaudible).

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

Yes, there is a little bit of -- you have some tougher comps with landfill because of the storms. And we're in the middle, by the way, of the tougher comps for the Virginia plant -- Cummins plant went down last year and so we were beneficiary of some of their volume. But that started in Q2, so we're seeing those tougher comps already for that plant. Obviously, as we get into particularly Q4, we'll see a bit of a storm comp difficulty year-over-year.

Michael Edward Hoffman - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Group Head of Diversified Industrials Research*

Okay. And again, back to that analysis, am I right that the solid waste business then is going to have margins up something around 120 basis points gross and its 50 for rev rec, so it's kind of 70 basis points is what we're seeing out of solid waste ex rev rec?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

Well, the solid waste year-to-date has been around the 50 to 70 basis points of growth, and that's ex rev rec and ex the hourly bonus. And so that's how we're looking at it. And what we are expecting as a continuation of that performance and then, hopefully, some upside as Jim Trevathan mentioned earlier when we think about the labor cost inflation that we saw in the second quarter because of training hours and the incremental routes, as we start to see those routes gain better efficiency through the rest of the year, we would expect some upside on that margin expansion in the collection line of business in the back half of the year.

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

Yes. Michael, I mean, the big contributors into the tractors -- I mean, you've kind of hit on it, but the big contributors into tractors when we think about EBITDA margins are the recycling business, solid waste, rev rec and the hourly bonus. And it's really -- everything else is kind of small, but those are kind of the big 4, with kind of a couple of working for us and a couple working against us.

Michael Edward Hoffman - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Group Head of Diversified Industrials Research*

Okay. So I've heard you all talk in the past about $1.5 billion -- I'm following up on Devina's comment about labor, $1.5 billion of direct labor. Talk about, if you can, things you're doing to try and reduce that number and the timing of it, given these training efforts and focus on the labor retention and the like. What can we see that do over the next 12 to 24 months, that $1.5 billion?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

Well, some of what we've talked about is automation in the fleet, particularly in the residential line of business. That's been a big step forward for us, and it continues to be something that we're focused on. In addition to that, I think it gets back to the onboard computers and the efficiency in our routing and fleet structure and optimization of that part of our business. And that's provided benefit for us -- substantial benefits for us over the last several years. The second quarter impacts that you saw really are volume and growth-related. And as we take up our routes, we've increased our route structure by almost 1%, which is impressive given over 3% volume expansion in both commercial and industrial collection volumes. So the focus really from a labor perspective is ensuring that we flex as we see volume growth and we find ways to use automation and technology to improve the working environment. And that doesn't just impact direct labor cost, but it also impacts safety and risk management costs as well.

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

And, Michael, one -- a couple of additional items just to add color. Completely agree with Devina on her points, but most of our efficiency gains over the last couple of years have come at the beginning, at the end of our route structures, using the new tools that we've rolled out. We started early this year with a project, looking at the middle of the route. We've rolled out some tools that allow a route manager, a district manager to clearly see the efficiency, the timing versus the plan for every driver, and they see that real time. And we've just begun that effort that lets us target some of the time opportunities in the middle of the route. And that will help. That's -- it's a longer-term project, just given the number of routes that we have on the street. But that will help. The bigger issue is that, as we've talked about, we had a later seasonality impact in Q2 than in previous years. A lot of our volume growth on the collection side of the business came in that May and June period. And I love 3% commercial and industrial volume growth. I'm not sure, Michael, I remember that happening in a quarter at the same time where both of them did. So we overwhelmed some of our larger-growth districts with a lot of volume and, therefore, as we've talked about, Jim and I both mentioned that earlier, with new drivers, with new route structures, with new training, it's underway with a little bit overtime to handle that structure as we get our arms around that and manage that growth. You'll see margin expansion on that collection line of business closer to where we expect it in the second half of the year.

Michael Edward Hoffman - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Group Head of Diversified Industrials Research*

Okay, great. And then, Devina, 2 for you quickly. The CFO upside, how much of that was working capital versus operating leverage in Q...

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

Yes. In the first quarter, we -- or I'm sorry, in the second quarter, we had about $15 million of benefit from working capital, but most of that actually related to the fuel tax credit benefit that we got in Q1. We got the cash for that in the quarter. On DSO and DPO, actually, we continue to make progress on DPO and got an incremental day, but we saw DSO slide. And so net-net, that was actually a bit of a detriment to us. We continue to be focused on both pieces of that equation, and there's upside from the performance we've seen so far in the first half of the year and the second half of the year.

Michael Edward Hoffman - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Group Head of Diversified Industrials Research*

Okay. So then this upside to 26% is really operating leverage. That's the other point to be made.

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

So the 26% really -- the other thing I would say there is, we elected not to make a federal tax payment in the second quarter, so we moved from our base of around 22% to 26%, a 400 basis point improvement. I would say more normalized, we should look for that improvement to be more like a 200 basis point over the course of the full year.

Michael Edward Hoffman - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Group Head of Diversified Industrials Research*

Okay. That's good to know. And then on the EPS, the $0.05 to $0.08 incremental change, how much is tax and how much is operating leverage?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

So we view tax and recycling really is offsetting each other, and the entire upside is operating leverage.

Michael Edward Hoffman - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD & Group Head of Diversified Industrials Research*

Okay. And then last for the operators. Force majeure, is that an option for this recycling issue at this point?

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

It's an option, but it's not an option that we prefer. We think we're making good progress taking the approach that we're taking at this point.

James E. Trevathan - *Waste Management, Inc. - Executive VP & COO*

Michael, we've talked to most, if not all, of our largest franchise and residential contracts. That's where more than half of our MRF volume comes from. And they get very clearly -- whether it's news media that's exposed them to the commodity issues and contamination issues, they see it. Whether they want to accept it in the short term is a question, but we have some of them with the restructuring plans already in place. So I don't see us going to force majeure, but as Jim said, it's always an option. We'd rather work through with our customers on a positive basis and with absolute clarity of what's going on in the market that they see. And not just from our standpoint, but they see across North America and then change the contracts accordingly. We think that's the best approach.

Operator

Our next question comes from the line of Jeff Silber of BMO Capital Markets.

Jeffrey Marc Silber - *BMO Capital Markets Equity Research - MD & Senior Equity Analyst*

Wanted to go back to some of your earlier comments about the new training facility that you're building, if we can get a little bit color on that. Is this something from an operating expense? Is there going to be CapEx? Is it included in your guidance? What time frame should we be seeing at?

James E. Trevathan - *Waste Management, Inc. - Executive VP & COO*

Jeff, there is capital. We've not -- capital is part of the equation, with property and building we're looking at, whether we look at internal locations or external locations. But we're going to move out West. We've got 1 center in the East and covers really well all the training. But remember, we do training today at the local level. So from an operating cost perspective, I'd like to see it go down over the long term so we get more efficient with training because right now it's done where we don't have capacity to utilize more the training center. We do it locally, we just don't do it as efficiently. We also think we do it more completely and more comprehensively as well when we centralize that training. We give them a full perspective of what the company expects, and we also include route managers and technicians that are part of this so that the message is consistent and clear and aligned across the whole company rather than just a localized training operation. So it improves retention, it improves our safety results, and we expect it to improve efficiency as well. We're excited about it (inaudible) be until next year when it opens.

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

But that capital is included in our outlook at the high end of the $1.7 billion.

Jeffrey Marc Silber - *BMO Capital Markets Equity Research - MD & Senior Equity Analyst*

Great. Just wanted to confirm that. I appreciate that. And then just a couple of numbers questions. I don't think you mentioned in your remarks the percentage change on the average commodity cost, both on the cost side and the volume side. Is that something we can get?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

We'll get back to you.

Jeffrey Marc Silber - *BMO Capital Markets Equity Research - MD & Senior Equity Analyst*

Okay. Appreciate that. And then finally, what share count is embedded in your adjusted EPS guidance for the year?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

Around 432 million shares.

Operator

Our next question comes from the line of Corey Greendale of First Analysis.

Ken Wang - *First Analysis Corporation - Analyst*

This is Ken Wang on for Corey. Just a quick one for me. I think this may be the strongest quarterly free cash flow at least for the last few years. Just wondering any change in your thoughts on use of cash going forward?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

We remain committed to balance between the dividend, share buyback and M&A. And what I would tell you is we are really committed to the organic growth part of the equation as well, which is why you've seen a step-change in capital expenditures. And so while you're focused on the strength of free cash flow and how we allocate that free cash flow, we're thinking about it in terms of how we allocate cash from operations. And so capital investment in the core and organic growth is an important piece of that, too.

Operator

Our next question is from the line of Michael Feniger of Bank of America.

Michael J. Feniger - *BofA Merrill Lynch, Research Division - VP*

When we think of 2019, costs are going up with labor pressure, but you're seeing a pricing momentum. Volumes are strong. Recycling headwinds anniversary next year. So can you help us with like the puts and takes on how to think about 2019? What pricing do you kind of need to be able to get, say, like 100 basis points of margin expansion next year?

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

Michael, you've kind of hit on most of them. I do think the recycling has better chance of being a tailwind for us next year because if we assume the commodity prices have come pretty close to bottoming out, then everything that we're doing, as I mentioned, will eventually become a tailwind for us. So recycling, we think, can be a tailwind for us next year. Labor is a question mark because, as you recall, we've got -- we have 2000 our bonus out there this year. We haven't decided what we'll do next year. We know that there will be some -- we think there'll be some labor inflation in the economy. So there's some puts and takes within labor itself that we haven't fully quantified. We do think pricing -- particularly as I mentioned at the landfills and transfer operations, we think pricing is an opportunity for us, not only for '19, but for the remainder of '18, and we will continue to push on that. And then all of those things that primarily Jim went through, efficiency improvements, managing the middle of the day basically for -- through technology, all of those we think start to build some momentum and, ultimately, contribute to the bottom line and to margins. So I would tell you, we're pretty encouraged about -- if I look at the puts and takes for next year, we're pretty encouraged about 2019.

Michael J. Feniger - *BofA Merrill Lynch, Research Division - VP*

And just based on your comments on core waste, it sounds like you have confidence on the cycle. That said, your balance sheet could indicate a different story since it's pretty conservative. Can we get an understanding more on why the balance sheet is conservative at this part of the cycle? Is it goal to not overpay for acquisitions right now? And how (inaudible) balance sheet for that next downturn and maybe shift more towards buybacks and dividends? So if you could just like kind of walk us through and flush that out for us?

Devina A. Rankin - *Waste Management, Inc. - Senior VP & CFO*

So I'll start, Michael, and then Jim can add on. But what I would say is that the conservative balance sheet is a result of really strong core growth. And so we've not done anything in recent years to reduce our indebtedness. In fact, we're committed to ensuring that we're allocating 100% or more of our free cash flow to that combination of share buyback, dividends and M&A. And we're going to continue to do that. With regard to taking a firmer stance or potentially a more aggressive stance on any piece of that, I think you hit the nail on the head with regard to ensuring that we're not overpaying for M&A in this environment. We are interested in ensuring that we continue to look for those acquisitions where the combination of the parts is greater than -- or provides a whole that is greater than those 2 pieces individually. And we'll keep doing that, but we also focus on return on invested capital. And we have to be sure that we continue to deliver the best-in-industry return on invested capital and growth in that return on invested capital over the long term, so we're not going to overpay for M&A.

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

Yes, Michael, she said it right. The only thing I would say is -- by the way, I think our long-term debt balance has been the same since I've been here in 2001. I think we had $9 billion, and we have $8.9 billion now. So she is right, it's really been -- when you think about leverage, it's really been the growth of the business, not really need material changes in long-term debt. But with respect to the dividend itself, what we really have made a real effort to do is mirror changes in kind of that base free cash flow with changes in our dividend. And I think we've done a pretty good job of that. It doesn't happen every year. It doesn't even happen every other year, although recently it seems to have happened every other year. But it's really more a function of when we see established kind of new norms with basically cash flow, that is a number that's gone up dramatically over a period of kind of 6 years from kind of a $1.1 billion up to close to $1.6 billion, $1.7 billion number. And to the extent that, that we believe that has changed again, as I said, we'll try and mirror that with changes in the dividend.

Michael J. Feniger - *BofA Merrill Lynch, Research Division - VP*

Yes, that's great. And guys, just to speak this last one in. I mean, based on all the comps you're seeing on volume and kind of what you're talking about landfill pricing, even not just 2019, but even in the second half of this year, just is there -- has there been any step-change in July that you saw compared to the trends that you witnessed and observed in the second quarter?

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

You mean as far as volume goes, Michael?

Michael J. Feniger - *BofA Merrill Lynch, Research Division - VP*

Yes, yes.

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

Well, so I'll just say it has. I mean, it's kind of a small sample here. But July looks really good so far. In fact, we've talked about July looking as good as most of us maybe with the exception of Jim, who's been here forever. But...

Operator

And at this time, there are no further questions. I'd like to turn the conference over to Mr. Jim Fish for any closing remarks.

James C. Fish - *Waste Management, Inc. - President, CEO & Director*

Great. Thanks, Amanda. So in closing, our theme today really remains consistent with our theme for the year. While we certainly had our challenges in recycling, the solid waste business and the overall macro economy are as strong as we've seen them in a little over a decade. At this point, we don't see any storm clouds on the horizon as we look out towards 2019. Even the recycling business itself becomes a tailwind as we mentioned for next year. And as we bring new technology to our operations, as our digital team makes great strides in rolling out differentiated customer-facing solutions and as we truly focus on providing an unmatched customer experience, we're very excited about what the future holds for Waste Management. I'd like to, again, thank all of our 43,000 teammates who really make this possible, and thank all of you for joining us this morning. We will talk next quarter.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program. You may now disconnect. Everyone, have a great day.
