GATX Corporation

2017 First Quarter Conference Call April 20, 2017

Operator:

Good day, and welcome to the GATX First Quarter Conference Call. Today's conference is being recorded. At this time, I'd like to turn the conference over to Mr. Chris LaHurd. Please go ahead, sir.

Chris LaHurd:

Thank you. Good morning, everyone, and thank you for listening to our 2017 First Quarter Earnings Conference Call. With me today are Brian Kenney, President and CEO; and Bob Lyons, Executive Vice President and CFO.

As always, some of the information you'll hear during our discussion today will consist of forward-looking statements. Actual results or trends could differ materially from our forecast. For more information, please refer to the risk factors discussed in GATX's Form 10-K for 2016. GATX assumes no obligation to update or revise any forward-looking statements to reflect subsequent events or circumstances.

Before I get into the numbers and provide brief commentary on the quarter, I'd like to remind everyone that our Annual Shareholders' Meeting will be held on May 5. It'll be in downtown Chicago at the Northern Trust building, which is at the corner of LaSalle and Monroe. The meeting begins at 9:00 a.m. Central Time and slides from Brian Kenney's presentation will be posted to our website at www.gatx.com.

Earlier today, GATX reported 2017 first quarter net income of $57.5 million or $1.44 per diluted share. This compares to 2016 first quarter net income of $69.3 million or $1.66 per diluted share. 2016 first quarter results included a net gain of approximately $1.5 million or $0.04 per diluted share from the exit of Portfolio Management's marine investment.

I'll very briefly address each segment and then we'll open it up for Q&A.

Rail North America's fleet utilization increased to 99.1% at the end of the first quarter and our renewal success rate was 72.4%. During the quarter, the renewal rate change of GATX's Lease Price Index decreased by 32.6% with an average renewal term of 29 months. Generally speaking, market lease rates for both tank cars and freight cars were flat sequentially, so first quarter '17 compared to fourth quarter '16.

As we indicated in our earnings release, certain rail industry metrics have stabilized. However, railcar oversupply, a sizable manufacturing backlog and low fleet utilization among some competitors continue to constrain our ability to increase lease rates. Switching over to the service side of Rail North America, over the last few years, GATX has invested heavily in the services we offer to our customers. These investments have been successful, further differentiating GATX from our competitors, which has most recently been proven by our ability to displace competitors' railcars across car types and industries. The secondary market for railcars in North America remains robust, Rail North America's remarketing income was approximately $21 million during the quarter.

Within Rail International, the European tank car leasing market remained stable. GATX Rail Europe is seeing steady demand across the fleet with utilization at 95%, and Rail International's investment volume was approximately $18 million during the quarter.

American Steamship Company’s sailing season started in late March and we're off to a good start on the Great Lakes. As anticipated, coming into 2017, all 10 vessels are in service.

Portfolio Management's results were driven primarily by solid performance of the Rolls-Royce & Partners Finance affiliates.

GATX was active under our share repurchase authorization during the quarter, buying back nearly 425,700 shares for a total of approximately $25 million.

Those are the prepared remarks, and I'll hand it over to the operator so we can start Q&A.

QUESTION AND ANSWER

Operator:

(Operator Instructions) And we'll take our first question from Prashant Rao with Citi.

Prashant Rao:

Good morning, guys. Thanks for taking my question. I wanted to start just kind of broadly. I mean, we've seen some strong demand on rail volumes, in particular, pocket sand kind of stands out there. And then we're hearing about rates improving year-over-year and then sequentially across rail -- across car types we're seeing some stability. I wanted to ask broadly, in the market, where else are you maybe seeing some strengthening in demand that might be a precursor to lease rate improvement? And sort of related to that, the correlation across lease rates, how does it compare in this recovery versus past cycles?

Brian Kenney:

Sure, I can take that. It's Brian. So first of all, I would disagree with you. I'd say it's not widespread at this point. Small cube was one of the bright spots in the quarter, maybe the only bright spot in the quarter from a pricing perspective. So although sequentially, rates were -- absolute rates were flat in the quarter versus the fourth quarter, if you look versus a year ago, especially on the tank car side, rates are down over 34% on average and pretty flat on freight year-over-year. So outside of small cube is where you definitely saw an increase in utilization in the industry and increases in lease rates. The rest of it is just bumping along at this point in time. So we're not seeing strength. We're still seeing a ton of idle cars out there.

We're seeing low utilization in competitors' fleets. And until some of that excess capacity is soaked up, we will not see pricing increases. So our initial forecast coming into '17, I would say, still holds. As far as the last downturn, I'd say most car types are still near or below the low point in lease rates experienced in the last downturn; that's especially true for tank cars. Once again, the exceptions there are small-cube covered hoppers and probably grain.

Prashant Rao:

All right, thank you. And I should have maybe specified that I was speaking sequentially and not year-over-year in terms of the improvement. So speaking about the guidance, the reiteration $4.40 to $4.60, I think you -- the [inaudible] you provided, it's sort of expecting sequential earnings decline this year. But given the -- how strong the quarter was, do you think the cadence to that might be a little bit more pronounced in terms of the deceleration? Or how should we be thinking about that?

Robert Lyons:

Sure. Prashant, it's Bob Lyons. The first quarter, obviously, was strong. A big driver of that was the remarketing income that we posted in North American Rail, just over $20 million. We're still anticipating for the full year that our remarketing income on that front will be in the $35 million to $40 million range. So we got more of that in the first quarter, front-end loaded. So if you look at earnings throughout the course of the year, then the progression -- let's remove remarketing from the equation for a second -- because as you know, that can be pretty lumpy. We would expect that quarter-to-quarter earnings would decrease slightly throughout the course of the year.

Prashant Rao:

Okay, that's very helpful. Thanks for the time, guys. I'll turn it over.

Operator:

And we'll take our next question from Allison Poliniak with Wells Fargo.

Allison Poliniak:

Good morning.

Chris LaHurd:

Good morning.

Allison Poliniak:

Just touching on the competitive environment. Obviously, the lease rate environment is fairly competitive and you talked relative to history. But obviously, there's been an influx of financial players into this market. Is there some irrationality going on? Can you maybe touch on how some of these new competitors are impacting that? Or is it just indifferent at this point?

Brian Kenney:

As far as new competitors, not really. If you talk to our salespeople, they're not worried about competing against anybody in the market including the new competitors. As far as whether competitors are rational or irrational, I'd say they're acting pretty rational. They're extremely aggressive on every new car opportunity, on every existing car opportunity, but that's not unexpected given the oversupply in the market. So I wouldn't characterize competitive behavior as being irrational. What was irrational was when they placed their new car orders, especially in terms of car types and the volume of those cars. So that was irrational. But what they're doing now is pretty rational. And the new money coming into the market hasn't really affected the competitive nature once those fleets are invested in.

Allison Poliniak:

That's great. And then just talking on the remarketing income -- obviously, you're keeping to your guidance of $35 million to $40 million. Are you seeing sort of a slowdown in the interest in those assets? Too early to tell? Maybe comment a little bit on that as well as pacing?

Robert Lyons:

No, not necessarily a slowdown in the interest. We had roughly $46 million last year in remarketing, another year -- this year, of $35 million to $40 million. Given the overall competitive -- or the overall challenges in the marketplace, it's still quite strong. We're seeing good interest again from a number of different buyers. But I would say the buyer list probably isn't as deep or as aggressive as it was a couple of years ago. But that's still in the $35 million to $40 million range. It's a very solid year.

Allison Poliniak:

Great, and then just lastly -- and obviously from an industrial standpoint, a lot of interest and we're seeing a broader recovery, I understand that. As you stand today, I mean, are you feeling more comfortable? I understand lease rates aren't really moving it. But are you kind of more comfortable that we're at the bottom here and we could be at an inflection at some point later this year, potentially?

Brian Kenney:

Well, inflection point from pricing is unlikely to happen till we work through that backlog. And if you look at -- specifically our earnings guidance, we're already sitting there at 99% utilization, and I'm saying it's going to be very hard to get pricing power until that idle fleet has been worked through in the industry. So yes, you could see an inflection point, but it really wouldn't impact our earnings. And what's going to need for that inflection point to happen, we've had a couple of quarters where car loadings have been up sequentially year-over-year. You see railroad velocity decreasing. All of that's good stuff. It just needs to hang in there and show a positive trend for a number of quarters. And then you'll see that excess idle inventory start to come down. But as far as impact on our earnings in '17? Unlikely, until that backlog is worked through.

Allison Poliniak:

Great, thank you.

Operator:

And we'll take our next question from Matt Elkott with Cowen.

Matthew Elkott:

Good morning, Thank you for taking my question. Speaking of the backlog, guys. I know that you have about 2,000 to 3,000 frac sand cars in your fleet, if I'm not mistaken, that are fully -- I think there are over 15,000 frac sand cars in the OEM backlog. So I was wondering, do you guys have any small-cube covered hoppers on order with the OEMs? And if so, does the strong recovery in frac sand demand warrant pulling forward delivery dates? And if you don't have any on order, are you considering adding to the -- to your current fleet?

Brian Kenney:

We don't have any on order that I know of. Certainly, nothing material. I'm not sure about the number you threw out for what's in the backlog -- assuming that's accurate. We are hearing some -- we'd probably more describe it as rumors about those being pulled forward. Certainly, the small-cube covered hopper market has definitely increased in the first quarter. What you're seeing is drill rigs increasing and you're seeing profit intensity per rig, so -- increasing dramatically. So way more sand being used in each well, and there's a lot of forecast out there that's saying that frac sand could exceed the record 2014 levels in 2017. So that's why you saw lease rates almost double in the quarter. That's why you see near 100% utilization in the industry. We have a much longer-term view on the small-cube covered hopper. In fact, most of our small cube covered hoppers are in other commodities, not just in the frac sand. So this recent increase in demand and increase in utilization doesn't really change our long-term view of the car and it wouldn't cause us to do anything different strategically as far as ordering.

Matthew Elkott:

All right. Even though there is -- it seems like the demand for cement as well has been on the rise, so you would think that frac sand helps with the cement and overall improvement in industrial markets. Still, you don't necessarily -- are not tempted necessarily to materially add to your fleet at this point?

Brian Kenney:

Well, we consider -- we always look at it, but you have to realize that there are lot of -- so what happened was there's a big backlog in the industry, all designated for the energy boom. So that collapsed. People started repurposing their orders. So we have to see what happens here with this backlog over the next year or so. If a lot of that gets repurposed back into sand, I don't know what will happen with this recovery. So of course, we watch it. It's just that we're careful about investing in the trend.

Matthew Elkott:

Got it. That's very helpful. Just one more quick question. I believe you guys on the fourth quarter call, you noted that utilization could decline in -- a bit in 2017. Do you still expect that? And also, given the sequential improvement in utilization, I was wondering if you would have seen a modest improvement in rates had utilizations remained flat from the fourth quarter?

Brian Kenney:

Yes. So utilization did pick up in the quarter, not a lot and not unexpected. Really, when we talked about a couple of points drop potentially in utilization in our fleet in '17, it was in reference to the fact we have a lot of coal cars coming up for renewal in '17. That does happen later in the year, so we're not backing off that. We still may see a slight decline in utilization. Having said that, you're right, we did see, like I said, a slight uptick in the quarter. It went a little better on a couple of renewals than we thought. That could be the first quarter effect of railroad velocity decreasing and car loads increasing. But once again, we're 99% utilized. There's not much more room to go and there's too many idle cars in the industry and utilization is too low at our competitors to really push pricing at this point, except for cars like small cubes.

Matthew Elkott:

Thank you very much.

Robert Lyons:

And just a follow-up on that. I'd point you to the LPI. The negative 32.6% is a pretty good reflection of how challenging it remains on the pricing front.

Matthew Elkott:

It was a modest deceleration from the fourth quarter, though, as far as the decline.

Robert Lyons:

Sure, but it's actually -- we came in at the year expecting the LPI to be down about 30% on a full-year basis. So it's right in that area. And again, pretty good reflection of the pressure -- continued pressure.

Brian Kenney:

Yes. And the fact that absolute lease rates are relatively flat over the last couple of quarters. That's essentially what we baked into our guidance coming into '17. So that was not unexpected.

Matthew Elkott:

So you would -- given you expect the LPI to be down 30% or so in 2017 -- I don't remember the exact convo. I thought you said 30% or more?

Brian Kenney:

Yes. Correct.

Matthew Elkott:

Okay, got it. And then I was just looking at the historical average renewal terms that you guys had over the past 10 years or so. I don't know if there's any significance to this. Probably not much, but this is the third consecutive quarter where you've had decade-long lows in average renewal terms. And I was just looking back at history of 10 years, I don't see any 3 consecutive quarters where you had an average term, the first -- the same average lease term, and second, a cycle low.

Brian Kenney:

That's correct.

Matthew Elkott:

Do you foresee changes to the -- when can we expect that term number to start picking up?

Brian Kenney:

You could expect terms to start to pick up as we see rates start to pick up and then -- and we come incented to lock those rates in for a longer period of time. Right now, as I said, since most of those rates, especially on tank cars, especially on energy-related tank cars, are very low even compared to the last downturn. We're just incented to stay short.

Matthew Elkott:

Great. Thank you very much, I appreciate it.

Operator:

And we'll take our next question from Justin Long with Stephens.

Justin Long:

So I think last quarter you talked about around 15,000 cars this year coming up for renewal. Is that still a good number to use? And is there any color you can provide on how many of those cars are tank versus non-tank?

Chris LaHurd:

Yeah, Justin. Coming into the year, we said approximately 15,100 cars with lease expirations across 2017. And you can assume that those cars expire ratably. So we're a quarter of the way through that number. As far as tank versus freight --

Bob Lyons:

I'd say, coming into the year, there's probably a little bit more on the freight side than tank. I mean, the fleet overall is 50-50 mix, but more freight than tank. And also the coal car element there is important to keep in mind because we're staying very short on coal, given the very depressed rate. So we'll see more of those cars than in a normal environment.

Justin Long:

Okay, great. That's helpful. And you mentioned it earlier, but some of the leading indicators are starting to get better for railcar demand. But I believe last quarter you talked about it, probably taking multiple years before the market gets back to equilibrium. Is that still your view today?

Brian Kenney:

I said it was unlikely to happen in '17. I still believe that to be the case. Correct.

Justin Long:

Okay. Do you think there's potential that we get to that equilibrium in 2018, if the current trends hold?

Brian Kenney:

Sure, potentially. But we need these current trends to pick up and hold.

Justin Long:

Got it. And then one quickly on the guidance. So I know the EPS range was reiterated for 2017. But were there any components within that guidance that have changed meaningfully relative to your expectations at the start of the year?

Robert Lyons:

Justin, no, not really. The first quarter very much played out as we had expected. And the outlook for the balance of the year, we still feel very comfortable with what we laid out back in January. No notable trends or contributors occurred in the first quarter.

Justin Long:

Okay. And maybe I'll sneak one last one in. I know you've been paying close attention to some of the railcar fleets that could come to market at some point, and we've had some come to market recently. But I was curious when you look at that list of potential buying opportunities. Could you speak to the percentage of fleets that have a meaningful amount of exposure to the energy market? And correct me if I'm wrong, but is the strategy still to avoid any opportunity as it relates to M&A that has a meaningful amount of energy-related exposure?

Brian Kenney:

Got to be careful about commenting on any individual situation, of course. You could say that at the right price, any car works, but am I thrilled about taking on dramatically more energy or legacy energy exposure? No.

Justin Long:

Okay. And in terms of just – Sorry --

Brian Kenney:

That's all the help you're going to get there.

[Laughter]

Justin Long:

Okay, fair enough. I'll leave it at that. I appreciate it.

Bob Lyons:

Thank you.

Operator:

(Operator Instructions) We'll take our next question from Mike Baudendistel with Stifel.

Mike Baudendistel:

Thank you and good morning. I wanted to ask you -- you had in your press release -- you said you displaced some of your competitors' equipment that caused the utilization to pick up a little bit. Are you just doing that through offering a little bit more attractive lease rates than your competitors are? Or just anything else that's helping you to win some of that business?

Brian Kenney:

No, it's just -- no. Why are we keeping utilization so high? I mean, we are the price leader, both on the way up and the way down. So we don't use -- lose a deal solely on the lease rate. But honestly, we offer superior customer service. So we don't have to offer the lowest absolute lease rate. We have great long customer relationships, and our cars tend to stick in general. And more importantly, our utilization -- our high utilization is due to the fact that we've invested wisely in terms of car type commodity and lease term. And that's really what drives the utilization more than anything else versus our competitor.

Mike Baudendistel:

Okay. And then I just also want to ask you on the railcar sales. It looks like on a per car basis, that was higher in the more recent quarter just based on the gains you're realizing per car. I mean, is there anything specific there in terms of mix? Or is that sort of a trend that you continue?

Robert Lyons:

That number can bounce around in terms of the gain per car pretty materially quarter-to-quarter. Compared to the fourth quarter, it's up dramatically. Compared to the first quarter of 2016, it's not. So it really does come down to the mix, the cars and the carrying value, the age, the term that they're on. So there's a lot of different factors that play into that, and it -- there's no notable trend there.

Mike Baudendistel:

Okay, yeah. And we've heard from other companies that there's clearly some international interest in buying railcars and taking ownership interest of railcars. Is that something that you're experiencing as well?

Robert Lyons:

Well, our European platform obviously is very important to us, as is our growing presence in India. And we like those markets long-term for sure, those continue to be good areas, particularly in Europe, to put capital to work. So, no change in strategy there for us at all.

Mike Baudendistel:

Okay. And has there been any change in industry dynamics in -- per GATX Rail Europe, with Greenbrier making investments there and potential for consolidation there that you see?

Brian Kenney:

No. No, I mean, Europe continues -- as you know, our fleet is over 60% dedicated to the petroleum market and that's been an unsettled market for a couple of years. They're doing great to keep utilization high. But in terms of their manufacturing situation or their investment philosophy, no, it's irrelevant -- their entry into the market.

Mike Baudendistel:

Okay. Thank you, that’s all I had.

Operator:

And we'll take our question from Gordon Johnson with Axiom Capital.

James Bardowski:

This is James Bardowski on for Gordon, thanks for tanking my questions. I just have a couple. You had a pretty -- relative to last quarter -- pretty decent rebound in your renewal rate. Could you just give a little color on what's driving this?

Brian Kenney:

Yeah, pull that apart a little bit. It is better than we expected. We said last year we were in the mid-60s as far as renewal's best percentage. We said we expect that to slide a little bit especially because of all the coal cars coming up for renewal. You're right, we did do better than expected in the first quarter. And that variance is due to higher freight car renewal success than we expected. And actually, it was just a couple of large transactions where we did better-than-expected that drove that metric higher. If you look at the tank car side, that was still in the low-60s right where we predicted it. So a little bit of an unusual effect there just from couple of transactions, and we really haven't changed our outlook for the year.

James Bardowski:

Right. On the coal cars, clearly, freight has been on the rise fairly recently. And then you also mentioned that you have a lot of renewals for those batch of cars coming up this year. What's your exposure as -- I guess, as specific as you can get. What's your exposure to coal? And of the roughly 15,000 cars coming up, can you tell us how many are coal cars?

Chris LaHurd:

Sure. So our total coal car fleet is about 6,300 cars. Lease expirations on coal cars is about 3,400 cars. And those all predominantly are coming in the back half of the year.

Robert Lyons:

Yeah, the other thing I'd point out to is we talked a little bit about this at year end. Those won't be – regardless, really what happens to the rates on those cars, they're not a big driver to our overall 2017 financial performance because the lease rates on those cars that are coming up for renewal, those 3,000, are already very low, extremely low. So they won't be a big driver to any type of revenue variance even if there's continued pressure or what have you on those cars in 2017.

Operator:

(Operator Instructions) We'll take our next question from Justin Bergner.

Justin Bergner:

Good morning and thanks for taking my question.

Bob Lyons/Chris LaHurd:

Good morning.

Justin Bergner:

So Brian or Bob, my first question is, with respect to velocity in the system, has anything changed from your view sort of 3 months ago with respect to how velocity is going to trend over the course of 2017? I know you made some earlier comments, but just to clarify.

Brian Kenney:

We didn't assume a big improvement. By improvement, I mean, reduction in velocity. And improvement, as far as the lessor goes, would be a reduction in velocity. We didn't assume a lot coming into the year there. It got a little better year over year. So once again, if that continues, that will be a very good thing for the leasing industry. As far as how it will impact our results of '17, not very much. It's more -- if it's a sustained decrease, it will help future years.

Justin Bergner:

Okay. Second question is, with respect to your Rolls-Royce JV, I mean, the affiliate earnings seemed pretty good this quarter. Was there anything you can sort of point to as -- is that either sort of a positive blip? Or is that reflective of improved performance, leasing rates, what have you?

Robert Lyons:

Yeah, it was more driven by the number of instance on lease and the rates on those. We did see a little bit of a tick up in our RRPF contribution quarter-over-quarter. I think one thing to note, first quarter 2016 versus first quarter 2017 for Rolls-Royce, neither of those quarters really had any gains from the sale of engines. So as the year progresses, we will have some of those. So we would expect the quarterly numbers from our RRPF actually to tick up a little bit. But overall, they had a very good quarter. Also a very good quarter at Rolls-Royce from an investment perspective. We saw a lot of opportunities to invest in a new engine. And so we're continuing to grow that portfolio.

Justin Bergner:

Okay. Just thinking about the whole business, were there any parts of the business that particularly positively surprised you in the first quarter? I know you're keeping sort of your guidance unchanged and the components therein, but just relative to your own expectations in the quarter?

Brian Kenney:

No. It's largely right on target.

Justin Bergner:

Okay. And then the final question I had is, in your segment breakout, the Other Interest Income of $3.2 million, what does that relate to? It seems a much larger number than last year. And I was just curious if that was a function of higher rates? Or what's going on there?

Robert Lyons:

That actually has to do with total interest expense overall. It's more the important number to look at. The other kind of where it lays out by segment really is an allocation process. So that's a little bit of excess interest that didn't get allocated to the segment that sits within that other column. But the small amount and really the number to look at is the overall interest expense.

Justin Bergner:

Okay, so outside of the $0.04 gain on the rest of the Portfolio Management disposition, there was nothing sort of unusual or one time in the quarter?

Robert Lyons:

Correct.

Justin Bergner:

Okay and thank you taking my questions.

Bob Lyons:

Thank you.

Operator:

And we'll take our next question from Brian Hogan with William Blair.

Brian Hogan

Good morning.

Bob Lyons:

Good morning.

Brian Hogan:

My question is actually on your ROE. Last year it was in the high-teens. This quarter it was as well. But your guidance, based on my calculations, looks like an ROE of low double digits. And I guess, what are ROEs on your current assets you're putting on? I assume it's much lower than that. And where does ROE go from here? And what is your kind of target ROE over time?

Brian Kenney:

Target ROE over time is that low teens. Once you get into low teens, we think that is attractive to our shareholders. The last couple of years at the peak of the market, it's much higher than that as expected. It is trending down. And to the extent that we put the pedal down on acquisitions or purchasing cars at lower prices in a difficult market, you'll see ROE continue to decrease even more. But that's fine for me over the short term. I really look at it over the long term. And over the long term, anything in the low teens is an excellent return at GATX.

Brian Hogan:

Alright. Thanks for the color.

Operator:

It appears there are no further questions at this time. Mr. Chris LaHurd, I'd like to turn the conference back to you for any additional or closing remarks.

Chris LaHurd:

I just like to thank everyone for their participation on the call, and please feel free to contact me later today. Thank you.

Operator:

This concludes today's call. Thank you for your participation. You may now disconnect.