GATX | GATX Corporation

2013 Third Quarter Conference Call **October 24, 2013**

Operator:

Good day, everyone. Welcome to the GATX Third Quarter Conference Call. Today's conference is being recorded. At this time, I would like to turn things over to Ms. Jennifer Van Aken. Please go ahead.

Jennifer Van Aken:

Thank you, Farrah, and good morning, everyone. Thanks for joining us for the Third-Quarter Conference Call. With me on the call are Brian Kenney, President and CEO of GATX Corporation and Bob Lyons, Executive Vice President and Chief Financial Officer. I'll give a brief overview of the results provided in our press release earlier this morning and then we'll take questions.

As a reminder, any forward-looking statements made on this Call represents our best judgment as to what may occur in the future. We have based these forward-looking statements on information currently available and disclaim any intention or obligation to update or revise these statements to reflect subsequent events or circumstances.

The Company's actual results will depend on a number of competitive and economic factors, some of which may be outside the control of the Company. For more information, refer to our 2012 Form 10-K/A for a discussion of these factors. You can find this report as well as other information about the Company on our website, www.gatx.com.

Today, we reported 2013 third quarter net income of $53.8 million, or $1.15 per diluted share. This includes a benefit of $2.8 million or $0.06 per diluted share from Tax Adjustments and Other Items, which are detailed on Page 11 of the press release. This compares to 2012 third quarter net income of $53.8 million, or a $1.13 per diluted share, which includes the benefit from Tax Adjustments and Other Items of $18.2 million, or $0.38 per diluted share.

Year-to-date 2013, we reported net income of $116 million, or $2.45 per diluted share, including a benefit of $4.5 million, or $0.09 per diluted share from Tax Adjustments and Other Items. Year-to-date 2012, we reported net income of $107.6 million, or $2.26 per diluted share, including a benefit from Tax Adjustments and Other Items of $0.7 million, or $0.02 per diluted share.

At the end of the third quarter, GATX's North American fleet utilization was 98.5%. The renewal rate for railcars in the Lease Price Index remains strong at 34.3% above expiring lease rates and lease terms were 63 months on average for renewals in the quarter. The renewal success rate in North America was nearly 80%, reflective of the continued solid demand for tank cars.

During the third quarter, we sold our 37.5% interest in AAE Cargo, a European freight car lessor. GATX's wholly-owned business, GATX Rail Europe, which currently owns a fleet of approximately 22,000 railcars, will now be able to independently pursue freight car opportunities. GATX Rail Europe's utilization was 96.3% at the end of the third quarter and the market is stable. We are investing in new railcars and scrapping older equipment as customers are interested in fleet modernization.

American Steamship Company continues to operate 13 vessels and performance is consistent with expectations. ASC moved 20.2 million net tons of cargo year-to-date 2013 compared to 20.9 million net tons moved in the same period of 2012. ASC's performance for the remainder of the year will be partially dependent on weather conditions on the Great Lakes.

The Portfolio Management segment had a solid quarter, benefiting from strong performance and asset remarketing by Rolls-Royce and Partners Finance, our spare engine leasing joint venture with Rolls-Royce. We've also seen improved results from certain ocean-going vessels.

Investment volume was nearly $200 million during the quarter and nearly $670 million year to date. In North America, demand remains strong for railcars delivering under our multi-year supply agreement. We are now allocating cars in mid-2015.

Asset remarketing activity increased during the quarter as expected and year-to-date results are consistent with the same period of 2012.

As noted in the press release, we continue to expect 2013 full-year results to be in the range of $3.20 to $3.30 per diluted share, excluding the impact from Tax Adjustments or Other Items. So with that overview, let's go to your questions. Farrah?

QUESTION AND ANSWER

Operator:

Thank you. (Operator Instructions) We'll hear first from Justin Long with Stephens.

Justin Long:

Overall, would you say that things played out in line with your expectations in the third quarter or were there any areas where you saw surprise in either direction? Also, as you look at the outlook for the fourth quarter, reiterating guidance, but it looks like we'll see an -- or you anticipate a sequential decline in earnings? Is that mainly a function of timing with remarketing or is there something else that's driving that?

Bob Lyons:

Good morning, Justin. It's Bob. I'll take these questions. Really, in the third quarter, no material difference from what our expectations were. The LPI continued to perform very strong utilization, strong both in North America and in Europe and generally stable performance, both within Portfolio Management and American Steamship. So I'd say little in the way of surprises here in the third quarter. It continues to be a very good environment. And you hit the nail on the head with regards to the fourth quarter. With guidance, where it's at, at $3.20 to $3.30 per share, that would indicate a slight decline from the third quarter income but really, that's all primarily driven by remarketing.

Justin Long:

Okay, thanks Bob -- that makes sense. And, you know, one of the things that you mentioned was demand for the tank cars in North America remaining strong. I was wondering if you could provide a little more color on what trends you're seeing in terms of long-term tank car lease rates right now? And are you seeing any divergence in the lease rate trends between the crude tank car market and the non-crude tank car market?

Brian Kenney:

Yes, Justin. I'll take that -- it's Brian. And yes, we are, but generally, taking a step back, it's still an extremely strong tank car market. If you look at most of our major tank car types, they're at or near full utilization and at or near record lease rates. And the only exception in the quarter, to your point, was in the crude-by-rail traffic -- so those cars that serve the crude market. There was a development in the quarter on that and if you look at weekly petroleum carloads, they were down somewhat from the May peak. The slowing growth in demand there has been met with the accelerating new car builds that we've been talking about for quite some time. If you even look at the spreads of WTI to Brent, they've narrowed throughout the year, really starting in -- at a very high like $18 spread in July of 2012 and down to almost no spread in September of this year and that drives a lot of that crude-by-rail traffic.

You saw some pipeline de-bottlenecking in 2013, so there has been a lot of developments there, but as far as rates that we're seeing -- I think most of the rates that have come down that, that people have been asking about are those short-term lease rates, the six months, the two-year rates that have come down substantially. But remember, we never played in that business anyway because we thought that was a little ridiculous. So we've been pushing terms long and trying to lock in those rates for a very long period of time. Now, having said that, we saw rates for this car type come down a little bit in the third quarter, say about 10%, but to put that in perspective, the rates for those cars are up about 500% in the last three years. So we're still very positive on the tank car market and rates are still at or near record high.

Justin Long:

Okay, great -- that's helpful color. One last one I had on the regulatory front. I know it's still very hard to predict what happens, but what do you view as the probability that we see a required -- or required retirement of the DOT-111 flammable liquid cars? And if that's the case, would you consider making an order to replace the 7,000 cars or so you have in that category or would you hold off at this point just given where asset prices are in the market?

Brian Kenney:

Okay, well, there's a couple of questions there. So the question about whether we anticipate a retrofit or change the new car design or a phase out of DOT-111 cars, you sized it. I think the right way. But for other callers on there, you've got to remember that the DOT-111 is more of a designation and it encompasses a multitude of car types that carry different kinds of commodities. It's really applied -- that DOT-111 designation, applies to almost two-thirds of the tank car fleet in North America. So, the real focus of the industry and the regulators, especially in the wake of these accidents, is not all those DOT-111 cars, but specifically the large general service tank cars that transport these flammable liquids. And that's about 65,000 industry-wide and you're right about 7,000 in our fleet.

Now, as far as whether we anticipate a retrofit or phase out -- on September 5, I don't know if you saw this, but PHMSA issued an advanced notice of proposed rulemaking and they're seeking public comment on the various petitions over the last few years. They all seek to further enhance big transportation of these hazardous materials and tank cars, specifically these DOT-111 cars. So yes, we would expect some kind of rule to enhance the safety will be enacted. But, as far as what it could be, as you said, it's just too early to tell and there is a lot of different possibilities. So, our reaction is going to be on whatever is implemented and whether it makes sense for GATX. So, we'll have to look at what the proposed or what the final rule is, if any, and determine if it's still feasible to implement for our fleet and if it's not, we'll take that car out of service. So, as far as ordering new cars, we have our existing order out there. As far as further orders, we really have to see what that final rule is before we can even react to that question. (multiple speakers)

In the end, we have to make sure that these flammable commodities are transported safely. And that's what we're focused on and that's what the industry is focused on. So, from our perspective, any rule that makes the transportation of that commodity safer in the broadest sense makes perfect sense to us. So, we support any rule with a design change that makes new or existing cars safer and give the industry a decent amount of time to implement that change. So, by a reasonable amount of time -- I mean long enough to not drive this flammable liquid traffic off the rails and onto a less safe mode of transportation, like the highways. But we are 100% behind making these cars safer.

Justin Long:

Okay. I'll pass it along. Thanks for the time today.

Operator:

Next up, we'll hear from Bascome Majors with Susquehanna.

Bascome Majors:

Good morning, guys. I wanted to follow-up on the crude oil tank car lease rate question earlier. I was hoping you could point out if there's been any differentiation in what you're seeing in rates both on the long and short term between the coiled insulated cars and the Bakken-style cars in the marketplace?

Brian Kenney:

They are both down, but once again, it's in the context of -- we would have loved to have that rate, even six months ago. So yes, they've come down somewhat, but really the most of the noise around dramatic decreases in lease rates have to do with those short-term leases that people are doing in the industry.

Bascome Majors:

Okay, and with the backlog as big as it is today and a lot of those still going to that market -- what is your sense, if you have it, by basin or sort of the supply-to-demand balance today and where that goes over the next six to 12 months?

Brian Kenney:

Well, as you probably know from listening to our prior calls, we've been somewhat of a contrarian about the crude-by-rail market for a while over the long term. So, forgetting about what happened in the quarter and whether that's really a change or a temporary lull, I mean longer term, if you look at crude-by-rail, it's 700,000 barrels a day in the U.S. this year. And there's projections that could double by the end of 2014. But to your point -- there's so many tank cars being delivered, and I think it's now 80% or more of the backlog of orders out there in the rail market are tank cars and something close to 60,000 being delivered over the next few years, with most of them earmarked for this service.

But we've been saying for quite some time that we think there's eventually going to be an oversupply, as these cars are delivered and as these pipelines come online. I don't know exactly when that's going to be, but our perspective is this market will be over-served. So that's why you've seen us take the strategy we have of maintaining a very diverse fleet, using the strength in crude cars which has caused a short supply of all tank cars to further diversify our fleet and lock-in these rates for a long period of time. So, the point to remember for GATX is we have less than 2,000 cars in crude service and that was an intentional move on our part. So, I think we're in pretty good shape given the trend that we saw coming, anyway. What I can't answer is that, that has already flipped at this point in time or whether it's a temporary lull, but it's coming eventually.

Bascome Majors:

Alright, I'll cut it off at that. Thank you.

Operator:

Moving on, we'll hear from Art Hatfield with Raymond James.

Art Hatfield:

Morning, everyone. I want to ask the question with regards to your lease book. It seems to me -- and help me if I'm off-base here, but as I think about your lease book and what's gone on with your renewal terms over the last couple of years, it seems to me that the best rates you have are locked up long term and the worst rates you have are locked up short term. So, if I think about GATX's lease portfolio, regardless of what goes on over the next year or two in the tank car market, particularly related to crude-by-rail, do you theoretically have a very strong set-up for good pricing growth over the next couple of years, particularly on your renewal side? Am I thinking about that right?

Brian Kenney:

Yes, you're thinking about that right. I mean, there's always the risk that if there's a rapid decline in the market, there's more of a utilization risk, right? Because we do have cars coming up for renewal every year. It's not like we've locked up the entire fleet, but we've locked up a significant portion of it, especially on the tank car side at very high rates, almost record rates for very long periods of time. So, yes, directionally you're right, but there's always that utilization risk and nothing's perfect, but we certainly work towards that goal, so yes.

Bob Lyons:

The point -- I'm sorry, Art. The point I'd add on that, just to follow-up on Brian -- if you think about the fleet rollover over the course of the last few years and you assume that 2014 with -- as we do, we'll still be in a positive, very positive rate environment. We will have rolled close to 80% of our lease portfolio at a very attractive rate except for those cars we've targeted for the shorter-term, like coal or certain cars that remain challenged. We're keeping those short and we'll get another shot at those in a better environment. So, we have locked down a significant amount of cash flow.

Brian Kenney:

To even get more specific, if you look at the tank car side, because there's been a lot of questions that you've already heard about rates and have they peaked, are they coming down? Even if rates don't move up from here and actually come down from here, we're still going to see revenue increases because that expiring rate is still pretty low and doesn't really change much next year. So, we're going to have revenue increases even if rates have peaked at this point in time.

Art Hatfield:

Right. And that's my point. So if you start to -- excluding the risk with regards to utilization, if you start to see improvement in the freight car side of things, we could see very strong LPI for the foreseeable future.

Brian Kenney:

Absolutely and that's when people ask me has the railcar market peaked, does it -- do you think it's very strong? It's really -- It's such a car-type by car-type answer and on the freight side, with a little help from the economy, you could really see -- I could actually say our entire fleet is performing very well.

Bob Lyons:

If you think about the LPI numbers that we posted last year and this year and the renewal terms we're getting, we're really getting those despite the fact that on the freight car side of the business, it's been pretty fair market relative to tank, which has been spectacular. We don't feel like we've gotten a lot of help or economic lift on the freight car side.

Art Hatfield:

Okay, just moving over to Europe. Now that you've sold AAE, can you talk a little bit about what your growth strategy over there is and how we may think about kind of how the international side of the business may perform going forward?

Brian Kenney:

Sure. Well, on the tank car side, we think we've been in a growth mode for well over a year-and-a-half now with our multi-year order program over there and we will continue to have, I think, a high level of new tank car orders in Europe for the near future. On the freight car side, yes, we've sold AAE now, but we're going to continue to look at opportunities through ordering of new cars and through potential fleet acquisitions on the freight car side. So we do -- you know, in the kind of market Europe is right now, which is obviously relatively weak, as you know, GATX's strategy generally is to place orders and to try to grow in those kinds of markets anyway because you get more attractive prices so that is the objective over there.

Art Hatfield:

Can you refresh my memory? How big is the European market from a unit standpoint?

Jennifer Van Aken:

In terms of the leased market –

Art Hatfield:

Yes.

Jennifer Van Aken:

-- I think it's about 75,000 to 85,000 cars each of both tank and freight.

Art Hatfield:

Okay and so 150 to 160 total?

Jennifer Van Aken:

Right.

Bob Lyons:

One of the things occurring in the European market that is of significant interest to us and we think is an opportunity, is that there is, much like in North America, there is increased regulatory scrutiny and focus in the European market. So we're seeing a number of mid- or smaller lessors not really reinvest capital back into their business. So we were displacing some of those cars and we think there may be some opportunities there.

Art Hatfield:

Is there an opportunity for ownership to transition from all owned to lease?

Bob Lyons:

Not a significant shift --

Art Hatfield:

Okay

Bob Lyons:

We don't see a significant shift there.

Art Hatfield:

Perfect. Thanks for your time this morning.

Bob Lyons:

Thank you.

Operator:

Next up, we have Steve O'Hara with Sidoti & Company.

Steve O'Hara:

Hi. Good morning. I was just curious, I mean in terms of the new railcar order, when does that go through? I think it's 2014 and what are the plans beyond that? I mean, with tank car prices where they are, would you lean more to -- how do you think about your capital, your CapEx decisions at that time?

Brian Kenney:

Yes, the Trinity order was a five-year order that was placed in March 2011. We started delivering in the summer of 2011 so that really ends at the end of '16 and as far as how we're doing there. Obviously, that's great. We placed all the cars in 2011, '12, '13, '14, and we're halfway through '15, right now. As far as what happens beyond that, we definitely will always want to have a supply of tank cars coming so we can fill our best customers' needs, but in terms of strategically what we're going to do there yet, I don't really have anything to announce yet. I really want to see how it plays out in terms of supply and demand in the tank car market, especially given what we've talked about in the call and the overbuild that I think is out there.

Steve O'Hara:

Okay and then I mean in terms of the -- on the freight side, what are the -- I mean it sounded like I think grain and coal were doing a little bit better. Are there any other areas that are very weak or getting better?

Brian Kenney:

Well, as you said, coal has improved somewhat, but let's not get excited about that. I mean there's still -- what is it, 170 train sets idle in the industry -- so that's down a little bit. And we placed some this year, but all on very short-term leases, and all at relatively low rates. I'd say it's less worse, but it's certainly at a, I wouldn't call it improving dramatically. Now, grain there's some -- if you look at the railroads, they're seeing some improved traffic there, but I think from a lease perspective, with the good harvest this year, you'll really see that start to get better next year.

The good news is there's some, some strengthening in other car types -- small-cubed covered hoppers, which had some weakness, especially last year with some over-ordering. That's seen a nice uptick this year, both from frac sand and service as well as renewed cement demand. The medium cube market's getting a little better -- I think fertilizer is helping there. Autos have been strong throughout this period so there's pockets of strength and things aren't quite as bad as it has been, but I'd say it's far away from being a strong or even strengthening market overall on the freight car side.

Bob Lyons:

And Steve, just -- if you hear reference or a comment about coal being better than anticipated, I just want to be clear that we have been able to keep more cars at work than we anticipated coming into the year. But rates are still very low; hence the reason we're staying very short term.

Steve Barger:

Right, okay. No, that makes sense. All right, thank you.

Operator:

And next up, we'll hear from Matt Brooklier with Longbow Research.

Matt Brooklier:

Just a follow-up question on tank car pricing. I think you did indicate you saw some sequential moderation, the number being roughly 10% in terms of lease rates. Was that just specific to longer-term crude cars or was that for all tank cars, including general purpose?

Brian Kenney:

No, it's just for the cars that serve -- the general purpose cars that were serving the crude market and we did see around that kind of reduction in the quarter. As far as the rest of the tank car types, we did not see reductions in lease rates. Now, starting in the second quarter, actually, those rate increases have moderated. We're not -- definitely not seeing the increases we saw in prior two years but as far as lease rates coming down, that's really refers to the cars that are serving the crude market.

Matt Brooklier:

Okay. I got on the call a little bit late, but if you could provide kind of a current update on the overall tank car market. Potentially, rates for crude cars could have gotten a little bit healthier in October with the spread widening, but just curious to hear your thoughts on that?

Brian Kenney:

No, it doesn't happen in that kind of real-time pattern, but that's -- I'm glad you said that because you know a big appeal of crude-by-rail has been the flexibility it offers refiners and marketers to put their products where they get the best price. So it does depend on that factor, you said, which is that WTI-to-Brent differential, which was huge in the middle of 2012 -- I think $18. It came all the way down to zero or $1 in September of 2013 and has widened out to about $10. So, as far as us seeing any effect of that immediately, no, we haven't seen it yet, but that's one of the reasons I'm not willing to say that our prediction, long-term prediction of oversupply, and a reduction in the crude-by-rail market, I don't know if it's actually here yet, but our long-term view hasn't changed, which is, eventually, it will be oversupplied.

Matt Brooklier:

Okay. And then outside of tank cars and given we're seeing the overall railcar cycle may be a broaden from an equipment, a different -- a varying equipment perspective, specifically on the freight side, is it -- I guess is it the right time now to start thinking about potentially putting in incremental orders for those car types? My question really boils down to your level of conviction in terms of freight car overall market improvement to continue and maybe build in 2014?

Brian Kenney:

Yes, we're seeing some indication of higher freight car backlog in 2014 and actually, a little bit puzzled by that because -- and my answer is probably not going be a satisfying one -- because I'm not going to say freight cars in general. There might be certain freight car types we'd be interested in placing an order for, as things improve here, but as far as a blanket freight car order. For instance, coal cars. You're not going to see us order new coal cars anytime soon. So, I can't be that broad when I talk about freight cars, but on a specific type of commodity for specific customers, sure, we always entertain adding cars.

Matt Brooklier:

Do you guys have a sense for the overall coal car market still feels like we're in oversupply and likely, we're going to have to go through a longer-term phase out of coal cars? I'm just trying to get a sense for how much more supply do we have to go here before maybe we see some lease rate normalization in terms of the number of coal cars that may be have to attrition out of the current population? What is the potential timing for that supply side correction?

Brian Kenney:

Well, there's 170 train sets idle in the industry; that's down a little bit from earlier this year. It's not a lot from March 2012 when I think it was over 300 train sets. So, it has gotten, quote-unquote, better, but when there's 170 train sets idle in the industry, you're not going to see prices or lease rates increase. As far as what it takes, I mean there's a lot of factors. One is economic activity, which hasn't been a help. It's -- high natural gas prices would help, but that hasn't occurred just yet. More normal weather patterns would help, that hasn't occurred just yet, and lastly, the fleet attrition is what you have to depend on until all those other factors come around and that actually is moving kind of slow and if it was just depending on that alone, it would still be a couple of years, I think, before that market got back into balance.

Matt Brooklier:

Okay, that's good color. I appreciate it.

Bob Lyons:

Matt, that's consistent, too, with when we talk about the lease terms on the coal cars. That's one- to two-year type range that we're talking about keeping those short. So we're not anticipating a huge turnaround in some of the factors that Brian just mentioned, so (multiple speakers) continue.

Matt Brooklier:

Got you, okay. That's helpful. Thank you.

Operator:

Next up, we'll hear from Steve Barger with KeyBanc Capital Markets.

Tejas Patel:

Hey. Good morning. This is actually Tejas filling in for Steve. How are you guys?

Brian Kenney:

Good morning

Bob Lyons:

Morning

Tejas Patel:

It seems like a lot of my questions are taken but I just have a last one. You did surprise a little bit relative to our model on the number of cars you sold out of your American fleet. What did you exactly sell? I mean were these coal grain cars? Were these cars that are hot or where you're not really seeing demand?

Bob Lyons:

Right. They -- first of all, the -- we did come into the second half of the year anticipating a very strong remarketing -- level of remarketing activity -- we indicated that at the end of the second quarter. That much of the remarketing income for the year would come in the back half of the year. So we've had packages out for sale. I'd say in general, they've been fairly diversified across car type. This is not a market where anybody would be selling a significant amount of coal cars, for example, but we're -- the package, I think, is generally reflective of the fact that we have a highly diversified fleet. And we continue to seek opportunity to put some of those cars out in the marketplace. They're all attached to leases, all very good equipment and seeing a lot of interest across the board.

Tejas Patel:

Got it and then just one other quick one if I could. It seems like for Europe, your rates are higher, but the margins are, too. Can you just kind of walk through that?

Bob Lyons:

Well, there's a couple of things going on in Europe. One, we're bringing a number of new cars into the fleet and we are more aggressively scrapping older cars out. That's a good thing for income this year, but keep in mind that, that is a potential lost revenue and income in future years, but we're replacing some of our older cars with new equipment. That has an impact on that revenue line. The other thing that's happened this year in Europe is that as we're scrapping those older cars, there's no maintenance required on those as they're coming out of the fleet. So, our maintenance numbers have actually gone down in Europe, which is a benefit of their segment profits.

Tejas Patel:

Great. Thank you, guys.

Bob Lyons:

Sure

Operator:

(Operator Instructions) We'll hear next from Mike Baudendistel with Stifel.

Mike Baudendistel:

Thanks and good morning.

Bob Lyons:

Good morning.

Mike Baudendistel:

I had a question on the safety discussion earlier. If there are additional requirements in your [unintelligible] cars in flammable service that causes you to spend extra capital to retrofit some of those cars with additional safety features -- Is there any mechanism for cars that are already on lease to recapture some of the economics from your customers? Or do you have to wait for those leases to expire and start new leases in order to pass any of those costs along to customers?

Brian Kenney:

No. Yes, it's Brian. It's a great question. Yes, we do have provisions in our standard lease contract that allow us to pass along mandatory modifications. I don't want to give too much details because there's a competitive term, but directionally, the longer the remaining lease term, the higher the percentage of the cost you're going to be able to pass on to your customer. And, as you know, we've focused intently on increasing our lease term over the last few years so we're probably better positioned to pass that cost along than we have been in the past. But, I think your point that about do you have to wait until the car comes off lease? No, you actually -- that's what you don't want that to happen because then you're just subject to market forces and whatever the market bears at the time. So it's better if the car is on lease for a long period as far as your success at passing along any of that cost.

Mike Baudendistel:

Great, that's very helpful. The other question is, I think you said earlier that are the only cars that you're taking delivery of are the ones that are on the Trinity contract -- of new cars?

Bob Lyons:

We've had some others -- during the course of the year and last year, we've had some very small incremental orders for new equipment on top of that, but nothing in a -- very immaterial.

Mike Baudendistel:

Okay, great. That's all I have.

Operator:

We have no further questions from our audience.

Jennifer Van Aken:

Okay, I'd just like to thank everyone for your participation on the call this morning. I will be around all afternoon in case of any follow-up questions. Thanks.

Operator:

Ladies and gentlemen, that does conclude today's conference. Again, we do thank you all for joining.