GATX | GATX Corporation

2016 Second Quarter Conference Call July 21, 2016

Operator:

Good day, ladies and gentlemen and welcome to the GATX Second-Quarter Conference Call. Today's conference is being recorded. At this time I would like to turn the conference over to your host, Chris LaHurd. Please go ahead, sir.

Chris LaHurd:

Thank you. Good morning everyone and thanks for joining GATX's Second-Quarter Earnings Call. I'm joined today by Brian Kenney, President and CEO; Bob Lyons, Executive Vice President and CFO; and Tom Ellman, Executive Vice President and President of Rail North America.

I have some prepared remarks and then we'll open it up for questions. Please note that some of the information you'll hear during our call 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 2015. GATX assumes no obligation to update or revise any forward-looking statements to reflect subsequent events or circumstances.

Today, GATX reported 2016 second-quarter net income of $61.2 million or $1.49 per diluted share. A net income for the first six months of 2016 of $130.5 million or $3.15 per diluted share. 2016 second-quarter results include a net gain of approximately $200,000, with no effect on per diluted share income, and the first six months of 2016 include a net gain of approximately $1.7 million or $0.04 per diluted share. Both the quarterly and year-to-date gain is associated with the planned exit of the majority of Portfolio Management's marine investments.

Despite industry challenges, there were a number of encouraging signs during the quarter. First, Rail North America's fleet utilization remained very high at 98.1% at the end of the second quarter. The minor sequential drop in utilization was predominately due to returned coal cars.

Second, we continue to successfully place cars from our committed supply order with a diverse customer base. We've completed the placement of all 12,500 cars from our 2011 agreement, and already placed approximately 2,350 cars from our 2014 agreement.

And finally, on the expense side, SG&A has decreased year-to-date due to tighter cost controls across our organization.

Our results reflect excellent execution by our team, in the face of ongoing railcar oversupply, reduced car loadings and increased railroad efficiencies. The combination of these headwinds resulted in a decrease of our Lease Price Index by 25.4% and a lower renewal success rate of 62.6%. Energy-related car types certainly had the largest impact on this LPI decrease, but as expected, lease rate pressure is broader-based than just energy at this stage.

From a strategic standpoint, GATX will continue to protect utilization by competing aggressively on lease rates, but will shorten lease terms where possible. We are having success executing the strategy as evidenced by a high utilization rate referenced just a minute ago and an average renewal term of 34 months in the second quarter.

Secondary market continues to remain active. Rail North America's asset remarketing income was approximately $3 million during the quarter, compared to $18 million in the first quarter of 2016. The difference driven solely by timing. GATX will continue to optimize our fleet by leveraging the secondary market, and we still expect full-year remarketing income to be in the range of $35 million to $40 million.

Within Rail International, the European tank car leasing market remained stable. Year-to-date segment profit was down materially from 2015, primarily due to the same factors discussed on our earnings call last quarter; those being last year's higher remarketing income and 2016's purchasing of a large number of wheel sets in anticipation of a change-out program there.

American Steamship continues to face a challenging market with low iron ore demand, but is performing as expected; they're operating two fewer vessels in 2016 compared to 2015.

At Portfolio Management, during the quarter, we had significant residual sharing gains as a result of asset sales in the managed portfolio. As noted in our release, approximately $20 million of these pre-tax gains had not been factored into our previous earnings guidance, so we have adjusted our full-year EPS guidance accordingly. Rolls-Royce and Partners Finance continues to perform well, reflecting strong global demand for aircraft spare engines.

Finally, GATX repurchased more than 443,000 shares for approximately $20 million during the quarter. At the end of the quarter, $230 million remains available under the $300 million repurchase authorization.

Those are the prepared remarks. I will hand it back to the operator so we can start the Q&A. Thank you.

QUESTION AND ANSWER

Operator:

(Operator Instructions) We will take our first question from Allison Poliniak from Wells Fargo.

Allison Poliniak:

Hi guys, good morning.

Chris LaHurd/Bob Lyons:

Good morning

Allison Poliniak:

Just going back to the lease rates in general, you left quarter down sequential -- a pretty deep sequential drop from Q4 to Q1. Can you talk the Q1 to Q2 what that decline was, if there was one? And if we're seeing some stabilization there?

Tom Ellman:
Yeah, this is Tom Ellman. We are continuing to see sequential rate declines and obviously, as always, varies by car type, but in general tank cars are down a little over 20% and freight cars are down between 10% to 15%.

Allison Poliniak:

Okay. And that's from Q1 to Q2, then, still?

Tom Ellman:

Correct.

Allison Poliniak:

Perfect. And then on the renewal success rate, it seems to be trending a little bit below that 70% range that you had been discussing last quarter. Has that one stabilized or are you still seeing a little pressure there? Should 60s be our thought process going forward here?

Tom Ellman:

We're continuing to work on incenting renewals with rate and trying to keep our cars employed. This quarter, it was impacted by -- particularly by coal cars. If you took that out, it would have been a little over 70%. And we're going to continue to see that item under some pressure but it's worth talking about it in a historical context.

We're coming off of extremely high renewal success percentages, but that number has varied anywhere between mid- to low-50s and as high as 90%. Even where we are now is kind of a long-term normal -- it just is coming off extremely high numbers.

Allison Poliniak:

That's great. Thank you.

Operator:

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

Justin Long:

Thanks and good morning. So maybe to follow-up on that question on the lease rate environment. It seems like we've had two quarters where there have been some substantial sequential declines and I was just curious what you think it will take for the lease rate environment to stabilize and is this an event that could occur in the next couple of quarters? Or do you think it's going to take longer than that?

Tom Ellman:

So there's a lot of factors at play here. One thing we talked about, for a while now, is on the supply side -- that there are more cars available than the industry needs. One of the things that will help supply and demand come back into balance is when the very large backlog comes down a little bit and there's not so much available -- new car production space -- that's available to compete with every renewal and assignment opportunity.

But it isn't simply a supply story. There's also demand factors at work. Railcar loadings are down across the board. They are down significantly in energy-related car types, but they're down more modestly in virtually every car type. And then there is also the play of railroad velocity.

The railroads are getting more and more efficient and have maintained a high level of efficiency and high level of velocity, which means customers need less cars. Some of these things tend to reinforce each other. When there's less cars in the system, the system moves more fluidly.

I think on the demand side, I would take a look at railcar loadings as an indicator that things are getting a little bit better. On the supply side I would look at that backlog.

Justin Long:

Okay. Great. Maybe to ask one question, just number related. I was wondering if you could provide an update on the number of railcars in North America that are coming up for renewal in the second half of 2016? I know it's still a little early but is there a ballpark number for the number of renewals you expect next year?

Chris LaHurd:

Yes. Let me start with 2016. First of all our cars tend to renew somewhat ratably across the year. As you know, we had 12,500 cars with renewal exposure in 2016. You can assume even distribution across the year for those cars, so we've worked our way through about half as of June 30.

2017, we typically see anywhere between 15,000 to 20,000, 21,000 cars come up for renewal in any given year. Of course we are well below that in 2016. The good news for 2017 -- scheduled renewals were only 13,600; that's for 2017. But the actual lease exposure is now around 15,000. That's just because we put certain cars on shorter-term leases already in 2016.

Justin Long:

Got it. That's helpful. I'm going to sneak one last question in. You have an updated expectation for the LPI for 2016 that you are factoring into your guidance and it seems like after this quarter your expectation is probably that it will be down. How long do you think declines in the LPI could last?

Is there a scenario where the LPI declines for three years given what we're seeing on the supply side and demand side as you're walking through, Tom? Or should we not be as pessimistic about that?

Bob Lyons:

Justin, it is Bob. Let me start by taking the back half of this year to begin with the early part of your question.

Given the trends in the environment that we're in right now and what's happened with rates, obviously they've come down very sharply. More sharply than what we even anticipated just a quarter ago. That's a reflection of what's going on in the marketplace. We don't see that trend reversing anytime soon.

Given the fact that the average expiring rate continues to move up, you can assume that the second half of the year LPI will be lower than the first half of the year for sure. Trying to put a bracket around that -- a number around that right now is pretty difficult to do, given how dynamic the market is right now. Rates are changing real-time. It's pretty difficult to zero in, on a bracket with any reasonable range. But it will be lower in the second half of the year than the first for sure.

Brian Kenney:

Let me jump on that as far as how long it could last, whether it could last a couple years. That really relates to the earlier question about how real is that backlog. If all 95,000 plus cars in that backlog deliver, obviously that's going to be very bad for the railcar leasing market, because remember our belief is that most of those cars were originally ordered for the energy sector, and that sector is already oversupplied. There are other car types and situations in that backlog where the cars are needed, but in general, we think most of that supply will be surplus. So if that doesn't go down this could last for quite a while.

Unfortunately, we don't have a lot of visibility in the backlog because manufacturers don't really provide it. But if orders are not cancelled, they are going to be delivered into an oversupplied energy market or repurposed into other car types and honestly, we can't think of another sector where there's a need for that volume of delivery; that wouldn't be a great solution either. It really depends on what happens with that backlog.

Justin Long:

Okay. That make sense. Thanks guys. I appreciate the time.

Bob Lyons:

Sure. Thank you.

Operator:

And we will now take a question from Gordon Johnson from Axiom Capital Management.

James Bardowski:

Hey guys, this is James Bardowski in for Gordon.

Bob Lyons:

Morning.

James Bardowski:

Thanks for taking my question. Not to harp too much on the LPI -- it does look like it was at a record low, at least on the last full business cycle. You also comment in the press release that average lease rates were up, how do you reconcile those two?

Tom Ellman:

I will take the first part of that and then we will address the lease rate question. The LPI is at an all-time low and a big part of that, Chris mentioned this already, is the increasing expiring rate. The way the LPI works you're comparing the renewal rate to the rate it's expiring off of, and the rate it's expiring off of are all-time highs. While for the LPI statistic the fact that expiring rates are high is a challenge. It is a very good thing overall.

The vast majority of our leases are not expiring each quarter. The vast majority of our leases continue to earn those very high lease rates going forward. And even when you look at the LPI itself, comparing this LPI to a different period's LPI, you have to keep in mind that this one is expiring again off those very high rates so even a bigger decline in percentage doesn't necessarily imply a lower overall lease rate. You've got to put all of that into proper context.

Bob Lyons:

Just to back Tom's point out with additional data point, the fact that we've locked in so many of those high-rate leases for a multi-year period and record term and rate, speaks to the fact that our committed lease revenue is at a record level. It was over $4.2 billion in North American Rail alone coming into the year; that compares to just $2.5 billion just a couple years ago. So that lease income is locked in and locked in for a longer period of time than we have seen historically.

James Bardowski:

Okay. And on that topic -- for the duration of leases being locked in. Have you guys seen any cancellations or any threat of cancellations?

Bob Lyons:

There is some dialogue with a few customers throughout the course of the quarter, but we didn't see anything in the second quarter materially.

Tom Ellman:

One of the nice advantages of the upmarket is we're able to do all kinds of good things including target high creditworthy customers. So we feel very good about the leases that we have coming. And for commercial reasons, customers may certainly approach and ask for relief or ask for some sort of change to the lease, but that's something that we don't entertain unless it's valuable for us. So there could be a situation where we would renegotiate the lease, extend lease term, lease some other cars -- something like that, but we're not seeing anything in terms of a difficult credit situation.

James Bardowski:

Okay, that is helpful. Changing gears a little bit, looking at the remarketing income, I noticed that you said it was down a little bit more than expected. Was this due to fewer railcars that were disposed of or was that mainly on the pricing side? A little color would help.

Bob Lyons:

Actually, overall remarketing at GATX was up pretty sharply given what transpired within our Portfolio Management segment. First quarter to second quarter remarketing income, specifically at North American Rail, was down, but that was only -- really only due to the timing of sales. They occur sporadically as we put packages out into the marketplace. Year to date, our remarketing income at Rail is just a little bit over $20 million. We still expect for the full year that we'll be between $35 million and $40 million.

James Bardowski:

Okay. Looking at your comments a little earlier saying that it was mostly coal cars that were returned as part of the reason that led to lower utilization, are you seeing any spillover right now with regard to people returning coal cars, basically spillover to other car types? It's affecting coal cars now, but can we see hoppers at risk or any other type of tank?

Tom Ellman:

Yes. As far as the overall environment, as mentioned earlier, the combination of some of the demand and supply factors are making everything relatively more challenging. But our utilization for the quarter was 98.1% -- you go car-type by car-type, that must mean that virtually everything is very highly utilized. The only thing that stands out as being materially below that overall number are the coal cars. We expect to continue to maintain a high utilization going forward.

James Bardowski:

Okay, that is helpful. All right gentlemen, thank you very much for your time.

Operator:

And we'll now take a question from Mike Baudendistel from Stifel.

Mike Baudendistel:

Thank you. I just wanted to ask you was there anything in the second quarter that made the LPI look worse than it otherwise would? Either a lot of coal cars being repriced during that quarter or extremely different comp or anything about that second quarter LPI that would make it sort of worse than it would normally be?

Chris LaHurd:

Mike, as I said in the opening commentary, energy car types, generally speaking, have the biggest impact on LPI. You mentioned coal -- if you take out coal, that number is a little bit better but it's still a decrease in the negative 20 range.

Brian Kenney:

Drive home the point of the LPI. It doesn't matter if there is a large number of cars in a particular car type because a constant waiting quarter to quarter, that's the nature of that index. What will affect it is dramatic decreases or increases in pricing, but the number of renewals doesn't matter.

Mike Baudendistel:

Okay. Got it, so you take the mix out of there. And another question I want to ask you is, what do you expect your cash flow after dividends to look like the next few years if the leasing market continues to deteriorate? Do you expect that to be positive because you pull back on investments in equipment or would you expect it to be negative because you'll invest more heavily in equipment?

Bob Lyons:

Well from an operating cash flow and portfolio proceeds standpoint we've been well north of $500 million a year, well north of that over the course of the last couple of years as we've sold more cars.

In a more challenging environment, as you know, Mike, our strategy is, we don't sell nearly as many and we look to buy more aggressively. But operating cash flow is going to remain extremely strong and positive throughout. Portfolio proceeds could move around a little bit depending on what we do from a sales standpoint.

Investment volume-wise, we have our committed order with Trinity, which runs out for a number of years but beyond that everything is opportunistic. And yes, in a more challenging environment, we will look to invest more aggressively and buy assets at an attractive valuation. Whether or not those opportunities develop, you can't force those to happen, but we certainly think there will be opportunities going forward.

Mike Baudendistel:

Okay. In order to make an investment like that, say if you see an asset that looks depressed now, that you have to have foresight to see that improvement in the next couple years or how does your time frame look like that?

Brian Kenney:

There are two things that we look at. One is that a historically attractive price versus what we think is a long-term outlook for that car type. And as far as seeing light at the end of the tunnel, that's not really necessary, as long as we have a long-term favorable view of that car type.

I'm really going back to what we did last time, we took a lot of cars that were depressed in that scenario. In fact, we added 18,000 cars and spent about $1 billion in 2008 to 2010, buying fleets out of bankruptcy and helping others manage their way through challenging lenders. We did another transaction where we helped some lenders manage their way through it. And really, I would say those car types were depressed at that time, but we were okay with the basis we had in those assets in the long-term outlook for that car type.

Mike Baudendistel:

Great. That's all I had for you. Thank you.

Bob Lyons:

Thank you.

Operator:

And we'll now take a question from Matt Brooklier from Longbow Research.

Matt Brooklier:

Hey, thanks and good morning. Tom, I think you mentioned the ranges of lease renewal success rate in the past anywhere from 50% to 90%. That 50% number, was that a trough number? Was that the lease renewal success rate in 2008 or in 2009?

Tom Ellman:

You're exactly right. That was the trough from the great recession which hit in 2009.

Matt Brooklier:

Okay. So, trough number there. What are your thoughts, you may have talked a little bit to it, but what are your thoughts on lease renewal success rate for the remainder of the year? Given where it ended at the end of Q2?

Tom Ellman:

So as far as how we'll end up, I think the car-type by car-type what we've seen so far is a pretty good guide. What happens though is you see a little bit of a different mix quarter to quarter. And that's one of the reasons Chris wanted to provide the statistic -- what would have happened if there was no coal cars where we would've been above 70%. I think that long-term average range which is over the long term renew about 2/3 of the cars, is pretty reasonable expectation right now.

Matt Brooklier:

Okay.

Bob Lyons:

The other point I'd like to make too, just following up on that, is to keep in mind that we're talking clearly about -- even when renewal success rate was down in that low-50% range back in 2009, fleet utilization was still above -- 95% or above. So Tom and the commercial organization were very successful in placing cars we've received back with other customers and certainly given the renewal success rate this quarter but utilization staying at 98.1% we're seeing that play out again.

Matt Brooklier:

Okay. Just turning back to the $35 million to $40 million of remarketing income for the North American Division -- the expectations for this year, what's your conviction level in terms of hitting that number? What I'm trying to get at is, has the secondary market slowed down at all given the current environment? Or are used cars more attractive given this is a more challenging environment?

Bob Lyons:

One thing I'd point out too is, even though the market is more challenged, we're still seeing continued interest and purchase of railcars in the secondary market, primarily from financial institutions. With interest rates where they're at, there's plenty of investors out there looking for yield. So the cars themselves have a lot of attractiveness from that standpoint. So we're still seeing good bids from a number of different parties.

The other thing to keep in mind too is, the cars that go into the secondary market for sale go with leases attached. So they have a number of years of cash flow associated with them. So a potential buyer isn't looking at an idle car, they're looking at a car with a good credit, with cash flow attached, with a very strong underlying value to it. As of right now, it's still seeing a very good interest.

Matt Brooklier:

Okay. It sounds like pretty good conviction in getting to that number. Obviously --

Bob Lyons;

Yeah

Matt Brooklier:

-- there's potential for a change in timing but, to getting to that range for the year.

Bob Lyons:

Yeah. Based on inquiries and activity we continue to see -- feel very good about that number.

Matt Brooklier:

Okay. Appreciate the time.

Operator:

And we'll take our next question from DeForest Hinman from Walthausen & Company.

DeForest Hinman:

I had a couple questions. Can you talk about the depreciation trends we're seeing in North American Rail and also touch on the maintenance expense trends in North American Rail? I know some of the maintenance expense can go up as cars coming off lease, but on the D&A side, our average car count was down slightly but our D&A is up about 7% or 8%. Can you help me understand that?

Bob Lyons:

On a quarterly run rate basis from where we're at here, you won't see D&A move up too materially. You'll see it march up a little bit each quarter as we are bringing new cars into the fleet and scrapping older cars with no book value or very little book value out of the fleet. But you won't see a material change on the D&A front.

Brian Kenney:

Yeah. On the maintenance side, North America, coming into the year we said we expected to see flat-to slightly-higher net maintenance expense. We have lower tank qualification maintenance events in 2016 compared to 2015. And we said that would be offset by higher maintenance due to commercial activity. And by commercial activity, I specifically mean this lower renewal success that you're seeing driving more cars into the maintenance network. So that's what we expect. We are actually performing a little better than we expected thus far in North America.

But the real maintenance story at GATX, year to date, is GATX Rail Europe -- it's up substantially there. That's what's driving the $5 million increase overall in maintenance 2016 over 2015. And there's two things going on in Europe. One, it's a larger year from that revision perspective on both tanks and under frames. We've been aggressively modernizing the European fleet for a number of years and now those cars are coming in for their first scheduled revision.

So, obviously we knew about that one and factored into our guidance, but the second thing that's increasing maintenance spending in Europe, and therefore GATX, is last year, Rail Europe started to see the premature failure of some anticorrosion paint on certain wheel sets that were relatively new in the GRE fleet. As those cars come in for routine maintenance, we're obviously pulling those wheel sets off when we see this issue in an abundance of caution. And the financial impact has been higher maintenance expense in the first half of 2016 versus 2015.

One, to address the problem through repairs to the wheel sets and second, we've been purchasing some replacement ones as well. And that's what caused the variance year-over-year in maintenance, or really at GATX overall. Our expectation is that will decrease as we move through the year. I think we've incurred most of that expense in Rail Europe already. And we also expect at some point to recover some of that expense through warranty claims with the manufacturer. That's really what's driving the increase in maintenance in 2016 -- it's more Europe than it is North America.

DeForest Hinman:

Okay. On the Rolls-Royce JV, I think the way we disclosed it, there's a couple things in the number that we report on that affiliate income. But the $7.7 million of affiliate income this quarter versus the $12 million last year, is there any reason for the decline there?

Bob Lyons:

Primarily driven by the timing of remarketing events and sales of engines within Rolls-Royce. We still expect overall full-year 2016 Rolls-Royce -- the contribution from Rolls-Royce will be similar to where it was in 2015.

DeForest Hinman:

All right. Maybe just high-level thoughts for the current level of the share price in the continued strong performance of the Rolls-Royce spare engines -- have we given any thoughts to the internal valuation that we have talked about publicly of what that JV is actually worth?

Bob Lyons:

Obviously, it's on the books today for roughly $350 million -- that's our investment. We don't disclose mark-to-market or anything of that nature. Obviously, we believe strongly it's worth well -- materially a number north of that, given the value of the underlying engines. But we don't provide any type of specific value with regard to the underlying assets.

DeForest Hinman:

Maybe a different question. You talk about total booked revenue of $4 billion for the rail business. How much booked revenue is in that JV?

Bob Lyons:

It's about $1.2 billion.

DeForest Hinman:

Okay. Thank you.

Operator:

And we'll now take a question from Justin Bergner with the Gabelli & Company

Justin Bergner:

Good morning everyone.

Chris LaHurd:

Good morning.

Justin Bergner:

First question is just a quick one. I missed the repurchase number for the quarter that you provided at the end of your opening comments, could you remind us how many shares you repurchased?

Bob Lyons:

For the quarter, I think Chris referenced $20 million worth of stock, about 440,000 shares; average price about $45 a share.

Justin Bergner:

Okay. Thank you. Switching gears to the Rolls-Royce joint venture. You suggested that the year-on-year decline in affiliate earnings, $7.7 million versus $12 million, was due to remarketing income within the joint venture. Should I sort of think about that near $8 million of affiliate earnings in the joint venture as to the operating earnings, excluding remarketing? And then the higher amount in prior quarters has been mainly on the remarketing side?

Bob Lyons:

Yeah. Justin, that's a fair assessment. There wasn't much at all in the way of remarketing income in the second quarter there.

Justin Bergner:

And can you give the 2015 number, in total

Bob Lyons:

We had about $17 million or $18 million in total 2015 of remarketing income out of the $66 million in pre-tax income at Rolls.

Justin Bergner:

Okay, that's helpful. I wanted to address an earlier comment that was made about the LPI index reflecting renewals versus high-rate expiring leases. If I take where we are in mid-2016 and rewind four or five years, 2012ish, it would seem that the leases that would be being replaced are not necessarily peak rate leases, which sort of is more in the '14 timeframe. Is it the case that the LPI is again shorter-term renewals and therefore reflects a higher rate base that's being calculated against? Or just help explain that discrepancy.

Tom Ellman:

Yeah. The way the LPI works you are absolutely right, you reference back to the expiring rate and look at the time period that it was put on. What happens is any time period you're doing leases of a variety of lease terms. So for shorthand, I understand why you referenced 2012 but there's actually a variety of leases that those are coming off of. The key point is each year for the next few years, it's going to get harder because that average expiring rate is going to be going up because a larger and larger percentage of those leases are going to be expiring from high rates. In fact, by the end of it, at all-time highs.

Justin Bergner:

Okay, that's helpful. But in terms of this quarter's negative 25% LPI, we shouldn't necessarily infer that that was against shorter-term leases rolling over that would of -- the prior lease would've kicked in in 2014, it reflects sort of a normal term set of leases rolling over?

Tom Ellman:

That's correct.

Bob Lyons:

Yeah. the other thing to point out Justin, to your reference back to 2012, if you think back to how the last cycle played out, in early 2011 is when the market really started to strengthen again. And when it did, as typical in this market, rates moved pretty sharply over the course of the next year and we're at healthy levels already -- very strong levels already in early 2012.

Justin Bergner:

Okay. Thank you for taking my questions.

Bob Lyons:

Thank you.

Operator:

And we'll now take a question from Steve O'Hara from Sidoti & Company.

Steve O'Hara:

Hi, good morning.

Bob Lyons:

Good morning.

Steve O'Hara:

I was just wondering in terms of looking at the backlog and how many cars are in the backlog, what's the argument for not canceling the deliveries or is it too painful to do so? Why would somebody not do their best to cancel given the current environment, if things are as negative as they appear with overcapacity and rates?

Tom Ellman:

Yes. First of all let's talk about GATX and then maybe hypothesize a little bit about others.

For GATX in particular, there's a couple different things going on. One, we order cars under long-term supply agreements. We have commitments to take a given number of cars month in, month out, and we're going to do that. The reason we felt comfortable doing that, is because of our very, very large installed base. Even in periods of very challenging demand, a certain number of cars, new cars, are going to become available for placement simply because you're replacing cars that are retiring out of the fleet. That is a big part of the reason we did the supply agreement and that is where the majority of our cars are going.

As far as what others may or may not be doing, it's really tough to understand the backlog fully for a variety of reasons. One of which is, one thing you should be able to do is take the beginning backlog plus orders minus deliveries and get to the ending backlog -- in the first quarter of this year it didn't work. That math would've indicated that there should been 5,800 less cars in the backlog.

What we hypothesized at the time, was that there were either cancellations of orders or people were switching from one car type to another. Well, this quarter came around and you're off by 2,200 cars in the opposite direction. So, because you don't have a lot of visibility into -- those numbers are self-reported -- not all of the builders are public, where they provide some detail. So, it's hard to know what everyone is doing with those numbers.

We believe that some numbers were put into the backlog and then taken out of the backlog. Or the other way around, taken out of the backlog in then put back in. There's a lot of challenge just figuring out what's going on in the first place.

The other issue is there's no time element to the backlog. So, anything that could be happening, is that orders are being deferred for a long period of time. And then you also have captive leasing companies who are ordering for their own account, and you don't know when they would take deliveries of the cars in the backlog.

So, one of the things you asked is, why would people take delivery when they don't need the cars. A long enough deferral has the same effect, but we don't have any visibility into that. If some of that is happening and those deferrals are long enough that would actually help that supply demand imbalance that we're talking about. But it's hard to know. The other one is some people are probably in the same position we are, they're taking -- part of the reason they're taking deliveries of cars is because they committed to do so.

Steve O'Hara:

Okay. I appreciate that. On the order pricing for the long-term order you have, how does that work? If lease rates continue to deteriorate or get worse, how does the -- your purchase price work in terms of that agreement?

Tom Ellman:

Yeah. I can't get into the specifics of the pricing in that contract, but it was negotiated in advance so we filled the mechanisms of the contract.

Steve O'Hara:

Okay. I guess what I'm saying is if you're basing pricing on 2014 levels when you sign the agreement, and then you get to 2018 and rates have gone down, let's say 10% or 15% -- 10% or 15% for a few years, is there any mechanism in the contract other than steel prices to make it closer to an economic win-win?

Brian Kenney:

It's not driven -- has nothing to do with lease rates. What we do have, and you can read in our Q, is the ability to cancel this order and Trinity has the ability to react to that cancellation in a way that would keep us in that order.

Steve O'Hara:

Okay, that's helpful. Finally, in terms of the exposure to the best and worst sectors of the market, is there a heat map that you can provide? In terms of your portfolio and versus -- what are your biggest exposures versus what the better or worse performing sectors are?

Bob Lyons:

Well, just for reference too, I'd point you to the equity presentation on the website. Embedded in that is a full breakdown of the fleet by size of car, by tank freight, by the commodities it serves and the percentage that it incorporates of our overall fleet. I won't run through that here, but it's right there on our website for you. Pretty good detail.

Steve O'Hara:

Maybe compare that to the railcar loading data or something, is that a good way to think about it?

Bob Lyons:

Well, you can pull it out of there by -- you can break it down right there by tank and freight and line up all the various commodities.

Steve O'Hara:

Okay. Thank you very much.

Operator:

And we'll now take a question from Steve Barger with KeyBanc Capital Markets.

Steve Barger:

Q. Hi. Thanks. I'm curious if you are seeing a divergence in renewal lease rates for flammable versus non-flammable tank cars. Are the non-flammables lease rates holding up better?

Tom Ellman:

Yes. So one of the things Chris has talked about a couple times is energy versus non-energy. While everything is challenged, the flammable liquids cars, which are a component of that energy group, are clearly more challenged and you are seeing much more significant declines there.

Brian Kenney:

And to drive that point home, back in 2013 there were 42,000 cars in crude oil service in North America and almost half of those, or over half of those, were legacy DOT-111s. In the first quarter of 2016, that number dropped from 21,000 legacy DOT-111s in crude oil service to 700. So, people are quickly moving as demand has dropped to newer cars from the legacy cars; that's also another reason. All along we've said we've had zero requests. Don't expect any; it's not economic. I think this is more evidence supporting that fact. These cars are being put aside and obviously you're not going to retrofit an idle car.

Steve Barger:

Right. Have you actually seen the scrap activity start yet? Or do you think they'll just hold them until the end of the regulated period?

Tom Ellman

Yeah. The way the statistics come out, it's hard to get the scrap activity of the market real-time. But what we can see is a lot more cars being idle; that's easy to see. I think it's a very realistic expectation that you'll see scrapping soon.

Steve Barger:

Right. When you -- we can all look at the small-cube covered hopper and figure out what those are. But when you look at the 24,000 tank cars in backlog, do you have a guess as to what the mix is in terms of flammable versus non-ethanol or crude?

Tom Ellman:

Yeah. That's a better question for a builder. It's tough for us to know. We know that what we have tried to focus on, like we do in all markets, is a wide variety of car types and not just chase the hot market.

Brian Kenney:

The fact is we don't have that visibility. Most of these orders were placed during the energy boom, so we suspect that most of them were originally earmarked for energy service. And one of the issues for us and everybody else in this market is as those orders are being repurposed you end up competing with that other position somewhere else.

Steve Barger:

Understood. Bob, is that 40% gross margin for North American Rail sustainable, or how do you expect that plays out relative to the operating environment versus any cost actions you might be able to take?

Bob Lyons:

Well our full-year expectation for North American Rail segment profit hasn't changed materially. So what we laid out at the beginning of the year was that it would be down overall in the 10% range and we still expect that for the full year, for North American segment profit.

Now on the SG&A front, we made great progress and we're very happy with where we stand here at the mid-year point. We indicated that would be down probably in 3% to 5% range full year, 2015 to 2016. Still expect that. You can just glean from that the second half SG&A will be a little bit higher than it was in the first half of the year. That's not unexpected as we have some projects that are going flow-through, and some IT work, and also some pension expense primarily related to some true up activity related to the early retirement program we ran last year. We'll come in at that range or maybe a little bit better. That's a nice reduction in SG&A overall '15 to '16.

Steve Barger:

And typically, Q4 SG&A is skewed a little heavier than Q3, is that pattern going to persist this year?

Bob Lyons:

Yeah. I would hazard that it probably will.

Steve Barger:

Okay. Last question. Not talking about 2017 specifically, but just in general. When you think about the conditions of the North American railcar cycle, should we be thinking that the gross margin in that segment does trend back to what we saw in '12, '13, '14, or is there any structural difference that's taking place as to why those margins would be higher than they were in a more normalized market?

Bob Lyons:

Well, from a structure standpoint, one thing I would note is that we've locked in much higher lease rates for a much longer term, overall at North American Rail. I won't delve in at this point to what 2017 is going to look like. As I mentioned before, the market's moving pretty fast. So we'll see where rates end up playing out for the full year. I know certainly looking at this downturn versus where we were back in 2009 and '10, at that point in time I feel very good about the book of business that's embedded in the fleet today.

Steve Barger:

Right. Just given the term structure, you would not expect a rapid deterioration in gross margin just because the way the book is?

Bob Lyons:

Yeah. Any given year -- remember lease rates, what happens to lease rates in any one given year is not that impactful overall. Utilization is a bigger element, a bigger factor than lease rate any given year.

Brian Kenney:

And that's exactly what I was going to say. It's really utilization -- is the driver of current year earnings. And so far, that's hanging in there nicely.

Steve Barger:

All right. Thanks for the time.

Operator:

And sir, with no additional questions, I would like to turn the conference back over to management for any additional closing remarks.

Chris LaHurd:

I just want to thank everyone for their participation and feel free to contact me with any follow-up questions. Thank you.

Operator:

Ladies and gentlemen this does conclude today's conference. We do thank you for your participation. You may now disconnect and have a wonderful rest of your day.