2014 Second Quarter Conference Call

July 31, 2014

Operator:

Good day 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 Ms. Jennifer Van Aken.

Jennifer Van Aken:

Thank you, John, and good morning, everyone. Thanks for joining us for the Second Quarter 2014 Conference Call. With me today are Brian Kenney, President and CEO of GATX Corporation and Bob Lyons, Executive Vice President and Chief Financial Officer.

As a reminder, any forward-looking statement made on this call represents our best judgment as to what may occur in the future. We base 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 2013 Form 10-K 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. I'll give an overview of the results provided in our press release earlier this morning, and then I'll turn it over to Brian for comments on the proposed regulations for the transportation of flammable liquids by rail provided by PHMSA last week. After that, we'll take your questions.

Today, we reported 2014 second quarter net income of $53.1 million or $1.15 per diluted share. This compares to 2013 second quarter net income of $35.1 million or $0.74 per diluted share which includes a benefit from Tax Adjustments and Other items of $3 million or $0.06 per diluted share. Details related to Tax Adjustments and Other Items are detailed on Page 11 of this morning's press release.

Year-to-date 2014, we reported net income of $95.2 million or $2.05 per diluted share. This compares to net income of $62.2 million or $1.31 per diluted share for the same period of 2013. The 2013 results include a benefit from Tax Adjustments and Other Items of $1.7 million or $0.04 per diluted share. Our second quarter results are reflective of the continued strong demand for tank cars in North America and improved demand for several freight car types including small- and medium-cube covered hoppers.

The following fleet performance discussion excludes the GATX boxcar fleet. Rail North America's fleet utilization was 98.6% at the end of the second quarter and we continue to achieve very strong lease rate increases on long-term renewals. During the quarter, the renewal rate change of GATX's Lease Price Index was 36% and the average renewal term was 67 months. Our renewal success rate remained high at nearly 85% in the second quarter.

The secondary market for railcars remains active and Rail North America generated more than $20 million in asset remarketing income during the second quarter. As noted in this morning's press release, we've made good progress integrating the newly acquired boxcar fleet by putting idle cars on lease and scrapping older equipment. At the end of the second quarter, GATX's boxcar fleet was approximately 19,300 cars and utilization was 90.7%. The boxcar fleet size and utilization are provided on the last page of the press release.

Within Rail International, the European tank car leasing market remains stable. GATX Rail Europe is seeing steady demand in both the petroleum and chemical markets. Rail International's investment volume was more than $40 million during the second quarter as GRE continues to take delivery of new tank cars.

American Steamship Company had a challenging start to the year due to the severe ice conditions on the Great Lakes. The extreme weather conditions led to significant inefficiencies and lost operating days. However, customer demand remains brisk. ASC is currently operating 14 vessels and plans to bring one more vessel into service this season to meet customer demand.

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

GATX repurchased nearly 1.4 million shares for approximately $88.5 million during the second quarter. At the end of the quarter, there was $161.5 million remaining under our $250 million repurchase authorization.

With that brief overview, I'll turn it over to Brian.

Brian Kenney:

Thanks, Jennifer and good morning, everybody. Now last Wednesday the Pipeline and Hazardous Materials Safety Administration, or PHMSA, finally released the details of the long-awaited notice of proposed rule-making concerning the safe transportation of flammable liquids by rail.

Now, the notice addresses three areas. First, and obviously most relevant to us, GATX, it addresses revised tank car standards. Second, it addressed the classification and testing program for mine gases and liquids. And lastly, it addressed new railroad operational requirements, including braking, control, speed restrictions, etc. for what PHMSA designates as High-Hazard Flammable Trains. Now, in the NPRM, High-Hazard Flammable Trains are defined as a train with 20 or more cars of a Class 3 flammable liquid.

Once this NPRM is published in the Federal Register, and I think that will be in the next few days, there's going to be a 60-day public comment period. As far as our reaction to this notice -- first of all, we applaud PHMSA for trying to construct a comprehensive solution to this issue of improving the safety of movement of flammable liquids by rail. By addressing all three of the areas: product classification, operating procedures, and tank car standards, the regulations, once they're finalized, should meaningfully improve the transportation of flammable liquids by rail.

Also, through their introduction of this High-Hazard Flammable Train concept, PHMSA attempted to address the greatest risk to safety which has been the unit train transportation of crude oil and ethanol. So, we also applaud them for that as well. As far as the effect on GATX, obviously, there is continued uncertainty inherent in this notice. For example, in the NPRM, PHMSA is seeking comment on issues ranging from tank car design -- where there is three different potential new car designs they put forth -- to train speeds where they're seeking input on three or four different options there.

They're also seeking feedback on a variety of assumptions that were made in their economic impact analysis so there's still a lot of uncertainty in the notice. And, from our perspective, until these questions are answered and the tank car design standard is finalized, we obviously don't know what the retrofit standard will be. We're also a little bit unsure of the practicality of the High-Hazard Flammable Train definition. The railroads have that operational knowledge to know if that's feasible. But they also have the data concerning how many of these commodities beyond crude and ethanol actually travel in more than 20-car quantities on a single train on a regular basis. And, until that information is known, it's difficult for our car owners, such as GATX, to know what other commodities are acceptable for transport in the existing fleet of tank cars.

So once that's clear, we'll have a better idea of whether the retrofit deadlines are practical and that brings us to the question of how we plan to comment back to PHMSA. First of all, you've seen it's a 200-page document and we're working to understand the intricacies of the NPRM more completely and we'll figure out our response in the coming weeks. But, as you may remember from this discussion on previous earnings calls, GATX has worked within its industry group, the Railway Supply Institute, or RSI, and we've delivered a very comprehensive design and retrofit plan to PHMSA in response to their advance notice last September.

And that plan took a risk-based approach to the priority of retrofit and that was based on the type of commodity that each car carries. We continue to believe that that commodity-based plan is more practical and provides more certainty both to railroads and car owners. In fact, you could argue that a commodity-based approach also may be more comprehensive as to the number of cars that must be retrofit to remain in service. But, later in the NPRM you see that PHMSA appears willing to be -- to at least consider a more commodity-based rule by some of the public feedback they're requesting. So we'll just have to see how that discussion goes through the comment period.

Another point that we've discussed on prior earnings calls is that we believe that retrofits on a large number of cars in the GATX fleet are likely to be very difficult to justify financially. Now, all of the various retrofit proposals involve jacketing and insulating the older cars at a minimum in crude and ethanol service. And given the great expense of this retrofit and the older age profile of GATX's fleet of these cars, we believe that in most cases we're more likely to try to redeploy the car into other service if allowable or send them to scrap.

So that's another reason why the certainty of a commodity-based rule just makes more sense to us. I want to end the summary with a quick update on the exposure we have in our existing fleet to the flammable liquids. We have approximately 13,000 cars in flammable liquid service. Approximately 4,900 of those cars are currently in crude and ethanol service and for those of you that read the rule and proposed rule in detail, we can't be certain of the Packing Groups of these various crude and ethanol cars that they're carrying because the level of disclosure is not really required in our customer leases.

But, anyway, that leaves 8,100 cars in other flammable liquid service. So, that's mostly fuel oil such as heating oil, bunker fuel, diesel, a variety of other commodities. And, as I discussed, there's considerable uncertainty around how the NPRM will impact these 8,100 cars. And until more information becomes available concerning how these cars are grouped in trains today.

So, you can understand, again, why we believe the certainty of a commodity-based rule might make more sense. That's all I wanted to address upfront other than I know you probably have some pretty specific questions, but hopefully, now you realize that enough uncertainty exists in this proposal that it makes answering the specific questions, with any degree of precision, difficult.

Until we get that certainty, we'll just continue to work with the other industry participants and the regulators to develop rules that make this type of transportation safer. Let's go ahead, operator and open it up to questions.

QUESTION AND ANSWER

Operator:

(Operator Instructions) And we'll go ahead and take our first question from Justin Long, he is with Stephens. Please go ahead.

Justin Long:

Brian, that was a helpful overview of the regulation and what's been proposed. I wanted to start with a question on that. If you look at the 13,000 cars that you have in flammable service today, that you noted, about how many of those could you redeploy into non-flammable service?

Brian Kenney:

Well, that depends on where the ultimate rule falls out because right now we don't have the information. Only the railroads really have the information on how these cars, that are outside of crude and ethanol, travel today. In other words, do they travel in more than 20 cars on a single train -- don't have great information there. So once that becomes more certain or they go to a commodity-based rule, we'll know how many cars can be redeployed in other service. Right now, it's hard to tell.

Justin Long:

Okay. Fair enough. You know, I wanted to ask about non-tank demand or freight car demand picking up. I know you guys -- when you're looking at the potential returns on a lease, you have a normalized market rate assumption by car type. Given the strengthening we've seen in demand for freight cars, are there now some freight cars types where the market rates are above the normalized expectation? And if so, is there a way to frame up the magnitude of this difference?

Brian Kenney:

It's always hard to say this is what it is for freight cars because it's a very diverse fleet and sometimes a frustrating answer. Anything like this, about GATX as a diversified fleet, is it depends on car type. To give an example: coal, no. It's not really at a normalized rate right now. Anything in construction is not anywhere near a normalized rate right now. Small-cube covered hoppers, they're probably at or above a normalized rate right now. Grain is approaching a normalized rate right now. So broadly speaking, if you make me generalize, I'd say there's still a ways to go on freight cars in general, but it's definitely improving.

Justin Long:

Okay, great. That's helpful. You know, I also wanted to ask, you know, we had an announcement during the quarter from Mitsubishi that they're planning to build out a U.S.-based lease fleet. Element is building out a fleet as well. What's your take on the supply coming into the market and do you think it creates a more competitive market dynamic or is demand right now strong enough to absorb this supply?

Brian Kenney:

Definitely -- and this is typical of an up-cycle as new players come in. It creates a lot of demand. People are chasing deals, especially in the secondary market and especially on the freight car side. So yes, it does impact that and it makes it more difficult to add older cars to your fleet. We have a very long-term view and we'll just wait for the right opportunity.

Bob Lyons:

Justin, I was just going to add -- it's Bob Lyons. I was just going to add, too. If you look back in 2006, 2007 and 2008 there were a number of new entrants that came into the marketplace at that point in time and we were able to buy a lot of those cars in 2009 and 2010, so we've seen this pattern before.

Justin Long:

That makes sense. Thanks, Bob. And I'll just ask one more and pass it on. Modeling question. Expectations for remarketing income in the back half of the year, could you give some more color on what's implied in your guidance, relative to what we've seen in the first half?

Bob Lyons:

Sure. If you recall, last year, 2013, we had roughly $71 million of remarketing income and we indicated coming into 2014 that we expected this year's remarketing income to be a bit lower than that. Year to date, we've already had $47 million of remarketing income -- so a very strong first half of the year. That would -- I would not double that for the back half of the year. The second half of the year, marketing income will be lower than the first. Putting in a specific number around that is a little bit difficult, but it'll come in under that $71 million in total. At least it looks that way right now, but in line with what we expected.

Justin Long:

Okay great, that's helpful. I appreciate the time today, guys.

Bob Lyons:

Sure, thank you.

Operator:

Go ahead and take our next question from Mike Baudendistel with Stifel. Your line is open.

Mike Baudendistel:

Thank you, it was great detail on the regulations. Just wanted to ask on that -- in your experience, is there a significant safety difference between the 7/16-inch and 9/16-inch steel?

Brian Kenney:

Obviously, the thicker you make the tank, it has better puncture resistance. But as far as -- define significant? It depends also what else is put on this car and that's why it's a little difficult to react and say we favor this proposal of DOTs. We really have to study this, but, absolutely, as you increase the thickness you're going to have more puncture resistance. Whether it's worth doing it -- we really think it makes more sense to look at each commodity and what that commodity deserves to travel in and that's what the RSI proposal was.

Mike Baudendistel:

Okay and the new entrants that the other analyst mentioned -- do those competitors -- do they have the same degree of service and fleet management capabilities that you do? And even though they're competitors on the leasing side, is it possible they could become customers on the service side?

Brian Kenney:

Well, we've been in business for 114 years, so it's hard to say they have the same capabilities we do on the service side. As far as being a customer, I'm more focused on our own fleet right now than trying to work for others. And, you know, depending on the final regulations, there could be a lot more work to do.

Mike Baudendistel:

Okay, great. And then just wanted to ask on the boxcars, since that's a new business for you. How are you able to increase the utilization as much as you have and how are the arrangements structured with customers? It seems like those are structured somewhat differently than the rest of your fleet.

Bob Lyons:

Yes, it's Bob Lyons. The fleet, when we purchased it, there was a couple of -- a number of very compelling reasons why we made the investment when we did. First of all, we felt we were getting the assets in extremely attractive valuation. We also felt we were approaching a point in time where the supply and demand balance would be working in our favor.

A number of the cars that we acquired back at the end of April -- at the end of March, were idle and we felt some of those cars would be destined for scrap and others we could put into service. We picked up 12 points of utilization during the course of the last three months, which was a very strong performance. About 3% of that, 300 basis points of that really, came from scrapping. About 100 basis points from selling certain boxcars that we had targeted for sale. But the biggest increase, about 8% of the utilization points really, came from putting idle cars into active service.

That's about 1,600 cars that our commercial team was able to allocate for active service very quickly. The rates are attractive and many of those that were going to move from idle to active are actually going out on longer-term leases. The vast majority of the boxcar portfolio is per diem business, as you know. But, we're finding homes for these cars at very attractive rates on longer-term leases. So I'd be a little hesitant to commit to that performance, that type of utilization increase each quarter, but certainly, right out of the gate, the first three months -- the returns are very attractive and I think validate the thesis behind the investment.

Mike Baudendistel:

Great, that's helpful. Thanks very much.

Operator:

We'll take our next question from Art Hatfield with Raymond James. Please go ahead, your line is open.

Derek Rabe:

Good morning. This is Derek Rabe on for Art.

Bob Lyons:

Morning.

Derek Rabe:

I wanted to circle back to your earlier commentary on your portion of your fleet that's in flammable service. Can you just ballpark what the legacy pre-2011 percent looks like?

Brian Kenney:

Sure. As far as the legacy cars, jacket and non-jacket are in total -- do you -- ?

Derek Rabe:

If you've got both, that would be great.

Brian Kenney:

It's about say -- out of the 13,000, we have about 11,000 that are legacy cars. Most of them, I'd say, probably 6,500, are non-jacketed and the rest are jacketed.

Derek Rabe:

Okay. Thank you. So as we look at the new regs, I think the onus, from our perspective -- the way we read it -- it might be more on the retrofit side and we're seeing a number of the industry participants start to ramp up the repair capabilities. How should we think about the portion of the potential umbrella of potentially affected railcars that might be pushed out to third parties versus done in-house? Is there a way to ballpark that? Size that up from an industry perspective?

Brian Kenney:

From an industry perspective? Or GATX perspective?

Derek Rabe:

Either/or. I guess I was just thinking in terms from an industry perspective how much of that's not going to be done by the internal -- the leased aspect of it. So guys like you just doing them in-house.

Brian Kenney:

We're going to try to do our fleet in-house, for the most part. I really shouldn't comment on others. A lot of other lessors don't have any capability internally, including tank car lessors. So they're going to have to use a third party.

Derek Rabe:

Okay. Okay that makes sense. And as we look at the LPI, it ticked up a little bit in the quarter -- it's still at a strong level. When do we start coming up against really tough comps for that number? When should we start seeing that moderate?

Brian Kenney:

The LPI is right in line with where we expected it to be, coming into the year. We said it would be in the mid-30% range. The first two quarters out of the year are right in that ballpark. It's been an extremely strong level for LPI and given where rates are today -- as I indicated back in the January earnings call, we have a fairly long runway ahead of us of positive comps. Now, we'll start -- the bar will start to get raised a little bit more next year and into 2016, but given where rates are today, on the environment we're in, we're still in -- have a long runway of positive territory.

Derek Rabe:

And are the lease rates for crude cars -- have they remained pretty steady or have they started to fall?

Brian Kenney:

Remember, at the third quarter, I think, of last year, we started talking about some of those crude car rates coming down. Some of the rates, especially in early 2013 were not only unprecedented, but unrealistic to assume that would last a long time and so it's come down since then; it's come down a little more this year. Most of that is the overhang of the regulatory situation, but some of it is just not as quick growth in the crude-by-rail out of the Bakken and -- but they're still at incredibly healthy rates and well above any historical norm but they have backed off from what we saw in early 2013.

Derek Rabe:

So that scale down in 2014, has that been from -- any of that from 1Q to 2Q or is most of that in 1Q?

Brian Kenney:

It's been gradual, I'd say from the absolute peak in the middle of last year, it's probably down 15%, but compared to what we saw in the downturn it's still up multiple times, 3 or 4 times -- so still very, very healthy rates.

Bob Lyons:

Just a reminder, too, a lot of that rate quote that you hear in the secondary marketplace -- a lot of times that's shorter-term rate type stuff that GATX doesn't pursue that business, really.

Derek Rabe:

No, that's very helpful. I just wanted to take one more question here on the boxcar fleet relative to your normalized fleet or the non-boxcar fleet. Is there any way to handicap the percentage of revenue that came from the boxcar fleet?

Bob Lyons:

Sure. In the second quarter, we had about $18 million of revenue from the boxcar fleet. If you recall when we put out the -- when we made the announcement of the transaction, we expected annualized revenue to be right around $70 million and our experience in the first quarter of ownership was consistent with that.

Derek Rabe:

Okay. And then a more specific question on the international basis. I think the numbers are slightly different from what I'm seeing in my model in terms of the historical numbers of the past few quarters. Is there reason for that?

Bob Lyons:

There may be a very slight -- a very, very small change because the utilization numbers that are provided here are for GATX Rail Europe. Previously, we included a very small number of cars from India in the international number, but it really wasn't reflective of the vast majority of the fleet. It may be up a very, very small decimal difference between what you have historically.

Derek Rabe:

Okay, perfect. Thanks for the time.

Operator:

And we'll go ahead and have our next question from Matt Brooklier with Longbow Research. Please go ahead, your line is open.

Matt Brooklier:

Thanks. Good morning. I wanted to circle back on the redeployment question and I guess I'm trying to get a sense for if the tank cars that you currently have in flammable service get redeployed outside of flammable service completely? What markets would that equipment make sense? Where would there be a good fit for you guys in the market in general to transition some cars into non-flammable commodities?

Brian Kenney:

The non-flammable commodities likely would involve some type of cut down or major revision to the car. So, it's kind of hard to answer that right now. But, theoretically, you can cut down some cars and put them in another service -- fertilizer, etc. It's way too early to talk about that.

Matt Brooklier:

Okay.

Brian Kenney:

We're likely to try to redeploy them as the rule becomes clearer and especially if they -- the commodity angle of the rule becomes clearer, we're more likely to redeploy them into other commodities. In fact, a lot of them are in other commodities today, as I said.

Matt Brooklier:

Okay, so, just to clarify. It sounds like these cars, the size and specifications, the ones that you have in flammable service there's no natural fit outside of flammable service because you need some modification? Or there are some commodity classes where you know you could more easily transition those cars?

Brian Kenney:

I think most of them are best used for other flammable liquids without substantial modification.

Matt Brooklier:

Okay. And then if I'm just looking at your consolidated maintenance expense that was up a little more -- it was more than we had anticipated. Just curious as to what was the driver there?

Bob Lyons:

Well, you've got to -- in the second quarter there was some incremental expenses in there for the boxcar fleet.

Matt Brooklier:

Okay.

Bob Lyons:

So they added -- the boxcar fleet added about $5 million of maintenance expense during the quarter, so it will be at that level -- potentially, it will be a little bit less on a run-rate basis.

Matt Brooklier:

Okay. And were there any other maintenance cost anomalies in the quarter that continue or don't continue?

Brian Kenney:

Remember, we're in the middle of that compliance bubble and compliance costs are a little higher this year. We're seeing a lot of railroad repairs this year as well -- more wheel replacements, running repairs, brakes, trucks, couplers. So, this year you're seeing what Bob mentioned and you're also seeing higher compliance costs and more wheels.

Matt Brooklier:

Okay. Appreciate the time.

Operator:

We take our next question from Justin Bergner with Gabelli & Company. Please go ahead, your line is open.

Justin Bergner:

My question relates to the proposed PHMSA regulations. If they stick with the 7/16-inch standard, is there anything that GATX anticipates needing to do with respect to the shell? Or is the existing CPC-1232 standard sufficient for that 7/16" option? And, the second part of the question would be, do you have an estimate of the costs related to thicken the shell if it ends up being 9/16 standard?

Brian Kenney:

You can't thicken the shell. You can put a jacket around the car, in some cases. The answer to your question is, it depends on what car you're starting with and what design standard you need to end up with. You can't really get more specific than that until the standard is out there. One thing I can't do is normalize the steel or make it thicker. So, it is a standard they're proposing out there and theoretically, you can come up with something that meets that standard, but we have to see what the standard is first.

Justin Bergner:

Okay. And as it relates to the 7/16-inch option, would the CPC-1232 car satisfy the option as it relates to the shell?

Brian Kenney:

Yes. If they come out with a design standard that says the 7/16-inch tank is acceptable and that's what the CPC-1232 is -- but, they're also proposing a number of other enhancements that you may need to apply the 1232, depending on that final standard. So, thermal protection, ECP breaks, whatever else they decide on. So, yes, it is currently the CPC-1232 has a 7/16 shell.

Justin Bergner:

Okay. Thank you for that clarity. And then just a non-safety question. Would you say that the general environment for lease rates on tank cars is still sequentially flat-to-improving?

Brian Kenney:

On tank cars? I'd say it's stable, except for crude, which as I said earlier in the call, has come down a little bit since the middle of last year. Otherwise, I'd say we're stable at very high -- in fact beyond the prior peak rates.

Justin Bergner:

Great. Thank you. Those were my questions.

Operator:

We'll take our last question from Kristine Kubacki with Avondale Partners. Please go ahead, your line is open.

Kristine Kubacki:

I apologize if I missed this and I was wondering if you could talk a little bit about the conditions in Europe. Obviously, you got out of the JV last year and it allows you to be more of an acquirer over there. What's the situation there?

Brian Kenney:

With regards to acquisition opportunities or in general?

Kristine Kubacki:

Both. I think, just a little bit about the end market conditions and then what's the opportunities on the acquisition side?

Brian Kenney:

I'd say, the European tank car market -- we have a wholly owned tank car platform over there -- it's stable. It's been quite choppy over the last two years due to that continued economic weakness in Europe and as we discussed last year, the competitive pressure definitely increased in 2013. It was a tougher run-rate environment, but they've continued to perform well over there. They increased their segment profit last year, they've done it again so far this year; they continue to execute in their multi-year order program. They place virtually all of their new deliveries.

The reason you saw utilization drop a little bit in Europe in the first half -- it was, as opposed to the U.S., which had a very severe winter; most of you know it was very mild in Europe over the last winter. So, GRE did see some return of petroleum cars during the first quarter -- that appears to have stabilized. In their other market, the chemical market, they're seeing a slight uptick. In general, they perform very, very well in a difficult market.

Now, the second part of your question about acquisition opportunities. Yeah, we think they're going to become available. It is a very fragmented leasing market after the top two or three players over there. The regulatory and maintenance regime has become much more complex and costly and complicated and we think some of these smaller players may desire to get out over time and so we think there's probably some acquisition opportunities going forward.

Kristine Kubacki:

Okay. And then just my last question is on -- you mentioned on the small-cube covered hopper side that it seems like rates are a little bit above normal and it looks like we have some good supply coming on. Is there any risk to that market that we might bubble over here in the short term or is it just that there's that much demand out there?

Brian Kenney:

Great question. I wish I could answer that better other than -- what's been driving that is the frac sand market. That has created somewhat of a short supply for other uses and we're starting to see some of that demand for cement, roofing granules and commodities like that. So, it's a little more broad-based demand, but to the extent the crude market suffers a downturn here, you're going to see that car type suffer a downturn.

Kristine Kubacki:

Okay. Very good. Thank you very much, I appreciate it.

Operator:

I have no further questions in queue at this time and I would like to turn the conference back over to our speakers.

Jennifer Van Aken:

All right. I'd like to thank everyone for their participation on the call this morning. Please contact me with any follow-up questions. Thanks.

Operator:

This does conclude today's conference and you may disconnect at any time.