GATX | GATX Corporation

2017 Third-Quarter Conference Call — October 19, 2017

Operator:

Good day, ladies and gentlemen, and welcome to the GATX Third Quarter Conference Call. Today's conference is being recorded. At this time, I'd like to turn the conference over to today's host, Ms. Jennifer McManus. Please go ahead, ma'am.

Jennifer McManus:

Thank you. Good morning, everyone, and thanks for joining GATX's Third Quarter Earnings Call. I'm joined today by Brian Kenney, President and CEO; and Bob Lyons, Executive Vice President and CFO.

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

I will quickly recap our third-quarter financial performance and then hand it over to Brian for a short discussion on the health of the North American railcar leasing market.

Today, GATX reported 2017 third-quarter net income of $49 million or $1.25 per diluted share. This compares to 2016 third-quarter net income of $95.7 million or $2.36 per diluted share. Year-to-date 2017, we reported net income of $159.9 million or $4.04 per diluted share. This compares to net income of $226.2 million or $5.49 per diluted share for the same period of 2016.

2017 year-to-date results include a net after-tax gain from the exit of Portfolio Management's marine investments and other items of $1.1 million or $0.03 per diluted share, which is recorded in the second quarter of 2017.

The 2016 third-quarter year-to-date results also include the positive impact from a number of Tax Adjustments and Other Items, all of which are detailed in our press release.

Despite challenging market conditions, our third-quarter financial results reflect continued execution by our team in the face of an ongoing oversupply of existing railcars and a large manufacturing backlog. Rail North America's fleet utilization remained strong at 98.5% at the end of the third quarter, and our renewal success rate remained high at 74.9%.

During the quarter, the renewal rate change of GATX's Lease Price Index was a negative 27% and the average renewal term was 35 months, which is generally in line with our initial expectations. The current lease rate environment remains extremely challenging, and Brian will address these challenges in a minute.

We continue to successfully place cars from our committed supply order with a diverse customer base and have already placed nearly 5,000 cars from our 2014 agreement. In addition, we've already placed the deliveries through the first half of 2018.

The North American Rail secondary market continues to remain active. Remarketing income was approximately $7.5 million during the quarter and $39.5 million year to date, and our planned remarketing activities have largely been completed for 2017.

Within Rail International, the European tank car leasing market remains stable, evidenced by GATX Rail Europe's fleet utilization of 95.6%. Year to date, GATX Rail Europe is performing slightly better than originally expected due to higher utilization and timing of new-car placements. That said, the competition in the market is intense and lease rates remain pressured. Rail International's investment volume was approximately $33.9 million in the quarter.

American Steamship Company is also performing better-than-expected due to optimal weather conditions and increased short-term demand for iron ore transport. Fourth quarter results will be heavily dependent on operating conditions on the Great Lakes.

The Portfolio Management segment is performing as expected, primarily driven by the solid performance of the Rolls-Royce & Partners Finance affiliates. Quarterly and year-to-date segment profit is materially down from 2016 due to the $49.1 million residual sharing fee settlement earned in the third quarter of 2016.

We continue to invest for the future as reflected by our year-to-date investment volume of $459 million. At the same time, we have the financial flexibility to return capital to shareholders and have continued to do so in the third quarter. In addition to our dividend, in the third quarter we repurchased nearly 415,000 shares for approximately $25 million. And year to date, we've repurchased nearly 1,250,000 shares for $75 million.

And now I'll turn the call over to Brian.

Brian Kenney:

Thanks, Jen. So, before we turn it over for questions, we thought it might be helpful for me to address what GATX thinks about the pace of recovery in the North American railcar leasing market. So, thus far this year, our fleet utilization, as well as absolute lease rates, have fared better than we thought coming into the year. As you know, we originally projected that fleet utilization would drop a few points due to car oversupply, especially in the coal market, but also due to extreme weakness in the legacy 30,000-gallon tank car market, as well as the high-pressured tank car market.

But as you've seen, thus far our utilization has remained at 98.5%, and that's down just 4/10 of a percentage point. So our commercial team has done a great job keeping those cars on lease and earning revenue in a difficult market.

On the lease rate side, we originally projected that our Lease Price Index would be down 30% or more in 2017. And year-to-date, that number is around 27% -- so it's a little bit better than we expected.

Now we derived that LPI forecast by assuming that absolute lease rates across the fleet would be flat in 2017, but that our average expiring rate would continue to climb. So the slight positive variance you see in LPI is due to the fact that absolute lease rates, after being largely flat from the fourth quarter of '16 through most of 2017, have now gone up about 3% in the third quarter on a fleet-wide basis. But given that they're still down 27% from the expiring rate this year, it's obviously nothing to celebrate, but at least it's headed in the right direction. So I call these lease statistics to your attention because it highlights the question that we get more than any other, and that question is when will the market recover and get back to equilibrium?

We're also told that others in the industry have appeared to be more optimistic than GATX on the timing of the recovery, but let me discuss why we're still a little bit apprehensive about the state of the market.

Now, on the demand side, a lot is being made about railcar loadings being up year-over-year for, I think, 4 consecutive quarters now. And that's true, but you need to look at what's driving that statistic -- you need to pull it apart. So, for instance, in the third quarter, if you exclude coal loadings and sand car loadings, which both were up nicely year-over-year, all other car loadings were actually down 4% from the second quarter and down about 2.3% from the prior year quarter. And that all-other category is obviously where the majority of car loadings are, and it's definitely what drives most of the demand for a large diversified railcar fleets such as GATX. So, we would not describe demand as increasing right now. And more importantly, there's no clear trend that we see that will quickly and dramatically push car loadings higher.

As we tried to drive home in the past year or so, more than demand, it's the oversupply of railcars that's been driving the weakness in the railcar leasing market over the last 2-plus years. And that's what remains the case today. There's considerable idle slack in the existing national railcar fleet, and you have to add to that a still very high manufacturing backlog. So, it's clear that we need help on the supply side to bring that market back in the balance.

That help is really not coming yet. In 2017, we continue to see more cars being delivered and registered than we see leaving the industry fleet, and we're adding to the oversupply problem. But more troublesome from our perspective are the recently announced orders and transactions that partner manufacturers with foreign banks, hedge funds and other investors that I will categorize as financial buyers. So, the manufacturers appear eager to sign these investors up to these railcar purchase and management contracts, and the financial buyer appears to be attracted by the yield and supposed stability of a railcar investment, especially in this era of low interest rates.

Now, I get that from a manufacturer's perspective. It's a way to keep the production lines running in a tough market without tying up more capital in their captive lease fleet and they get to earn fee income along the way. But the problem for the market recovery overall, is that these financial investors are just that. They're investors; they're not end users of equipment. And just because they sign up to buy cars does not mean that the national shipper wants to use those cars. And these management arrangements -- that direct connection between the car owner and the user of the car, is lost, and I think that can lead to poor investment decisions.

I've just described the current overcapacity in the market and the lack of that immediate demand catalyst. If you need further evidence of how the market does not need these new speculative cars, you have to look no further than where lease rates are today. And not only versus the peak, but also versus the average lease rate across the cycle.

In general, we think lease rates are still down about 40% from long-run lease rates that we think make sense for an investment to be attractive. So that's what you're seeing in today's market. That's too many cars chasing too few actual users. And it's reflected in very low average lease rates, and in some competitors' cases, lower fleet utilization as well.

So, we don't think this management model is really sustainable because if it persists and these speculative orders actually deliver, the investments could end up being a poor low-return investment. But these investors can certainly make it -- make the investment and hope the market will get better, and I can't stop that decision. But at GATX, I don't think hope is a good strategy. So, we think any speculative deliveries into this market just prolongs the road to recovery and makes little sense from an economic perspective. Eventually, what happens when these new entrants see what return they're actually getting and not what's originally projected, I think they'll exit the market, maybe at a loss. In fact, you might have just seen some of that occur in the third quarter. And GATX will continue to be there when it happens.

So what do we do in the meantime? Well, we have to continue to work to outperform our competitors. We'll invest new capital in existing customer relationships and into other markets that honestly offer better risk-adjusted returns than we're seeing in North America. And we'll maintain that disciplined returning capital to shareholders when it is in their best interest.

So, I hope that provides a little bit of a road map into how we're thinking. And really, that's all I had now. So operator, can we please open it up to questions?

QUESTION AND ANSWER

Operator:

(Operator Instructions) And we will take our first question from Allison Poliniak with Wells Fargo.

Allison Poliniak:

Hi, guys. Good morning. I just want to touch base on that last note. You obviously spoke to these speculative orders. Lease rates look like they're finally even modestly right of inflecting higher. I mean, how aggressive are these guys being in trying to get these assets utilized? And do you see that as a risk, as we enter '18 here, for you?

Brian Kenney:

Yes, it's definitely a risk. I mean, if you look at absolute lease rates, yes, they were up in the quarter. I don't want to get too granular, but up around 3%, as I said, across the fleet, a little bit more for tank cars, a little bit less for freight cars. But as I said, still dramatically lower than the prior peak and lower than where we would need them to be to invest. So what we're seeing is competitors be extremely aggressive on every new car opportunity. A lot of them have lower utilization than we do. So it's very competitive not only in lease rates -- lease rates themselves, but also in other terms they offer. So it's pretty competitive out there. And what you worry about is you're finally starting to see this bottom out maybe turn up a little bit, but there's still backlog out there and there's still orders being announced. And we're not seeing -- being in this business for 120 years -- we're not seeing that catalyst out there that says demand is going to pick up.

Allison Poliniak:

That's fair. Utilization, you pointed out, better than you expected. You haven't seen that drop in utilization that you thought you were. I mean, is it something we should be thinking about for Q4? Or is it a fairly decent level for you guys as we exit the year?

Brian Kenney:

Well, where we get, we did better than expected. Once again, coal was -- it is what it is. I'm not going to get excited about keeping coal cars on lease if I'm doing a net lease rate of $5 a month, right? It doesn't -- it's better than having them returned and incurring the storage cost, but it doesn't mean anything for revenue. But where the surprise came for us, where we did a little bit better, was in that legacy 30 market, as well as the high-pressure market. So we're able to keep cars on lease there, and that was meaningful to results. That's why revenue was a little higher -- why we're pushing up our guidance to the high end of the range.

As far as fleet utilization going forward, I think in the fourth quarter, we still do have a lot of coal renewals. So utilization is still a risk. I don't think it's as much of a risk as it was, obviously, coming into the year. Next year, we'll talk about in January. But yes, it's continuing ongoing risk. Just as the market appears to have bottomed out here, we'll see if these speculative deliveries actually start coming next year.

Allison Poliniak:

Great. And then just lastly, lease term expanded obviously this quarter. Is that more mix related? Or is there something, I guess, fundamental that's driving that?

Brian Kenney:

Nothing fundamental at all. It does vary quarter-to-quarter. In general, since most of our car types are below that long-term equilibrium rate, we're going to try to keep terms low. There's obviously an excess in certain car types. But in general, that's the case.

Allison Poliniak:

Great. Thank you.

Operator:

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

Matt Elkott:

Good morning. Thank you for taking my question. So it's good to see the lease rates improvement in the third quarter. But that's a quarter that saw a few unusual events -- 2 hurricanes and also we had CSX that had some service issues, which may have prompted some shippers to have to lease their own cars. So I was just wondering if you guys have a sense of if any of this improvement in the third quarter in lease rates was partly attributable to the hurricanes and CSX's service issues?

Brian Kenney:

Yes, great question. First of all, we have a number of facilities and hundreds of employees down in the Gulf and they're all safe. But we didn't really have much damage in our facilities, so we got pretty lucky there.

As far as the commercial side, we did not see a lot of customer requests for cars even in the immediate wake of the hurricanes. Perhaps, they could be impacting some of the car loading data, but it also might be too early to tell. So we'll see once customers have assessed the damage, when construction or reconstruction gets back in full swing, but in the wake of the hurricanes, we haven't seen anything on the commercial side. In fact, it's been a little tougher to load our network and we're wondering if that's because of some of the disruptions from the hurricanes. So nothing positive in the short term.

On the CSX side, really, our direct exposure to them is around 400 cars. They were all returned. The vast majority of that has been in boxcars. We do think that our shipper, our customer dissatisfaction, has been high. They've actually tried to shift some of the -- some of the traffic away from rail to truck, which is difficult to do. If it showed us anything in terms of an increased demand in the CSX situation, it was probably in the boxcar fleet. We have seen some increased demand for boxcars that may be related, but nothing widespread across our fleet yet.

Matt Elkott:

Got it. That's very helpful color, Brian. And going forward, there's going to be probably a couple of years of rebuilding post-the hurricanes. Is that something that you guys are thinking about? Looking back at similar events in history, is it easy to -- it's probably not easy, but is it even possible to gauge how much of a benefit the rebuilding could have in the next year or 2 or even 3 years?

Brian Kenney:

Yes, that's a good part about a very diverse fleet like ours. It could affect it in a number of ways. So, center beams for lumber, for example, small cube, which has already had a nice increase in 2017 due to increased frac sand loadings. They carry a lot of commodities related to the construction industry as well, so you could see further strength there. A variety of different tank car types, for instance, carry asphalt. So there's a number of ways that could impact a very diverse fleet like ours. Going back to Katrina and those -- I don't really remember anything off the top of my head, but that was also during a pretty tough market. It's a good question, but I feel good about having a diverse fleet if that business does take off.

Matt Elkott:

Got it. And then I also had a question on lease terms, which you guys have done a great job making sure they move in the same direction as rates. But as rates remain stubbornly low, with the exception of the improvement in the third quarter. For a prolonged period of time, is it becoming increasingly difficult to keep terms down as customers want to kind of lock-in at low rates for longer times? And that's if you want to keep your fleet utilization from declining materially. Is this why we saw the average term go up and the LPI further -- declined further in the second quarter? And is this something that we should expect going forward?

Brian Kenney:

No. That's a very good question. I would say the more -- the larger, more savvy customers that also have big fleets and own railcars, they do, and we've seen some of them trying to lock-in for longer terms, to be sure. Obviously, we don't want to do that. But it's also -- if you look at it on the other side, it's also a good sign that people realize, okay, I better lock-in now or try to lock-in now because the market looks like it's bottomed out -- may be going up from here. So that's not necessarily bad news. But as far as the movement in the term of the quarter, like I said, it's really -- I wouldn't read anything into that.

Matt Elkott:

Okay. Perfect. And I just had one final question. You guys have just under 13,000 flammable liquid tank cars in the fleet. Is it fair to say that most of these leases were initiated or renewed in the 2012 through 2015 timeframe? And how does the kind of the top line revenue headwind look from a renewal perspective of these cars in each of the next couple of years? Will there be an outsized headwind in 2018 or 2019 or 2020? Just trying to get a sense of that.

Brian Kenney:

Yes, that's probably too far ahead. The problem with giving scheduled renewals, I know we do it -- we try not to, but we're kind of forced to. But the problem is that change is so rapidly in a down market because you're doing a lot more short-term leases and you're moving that number. In general, on the 30,000-gallon tank cars of flammable service, I mean, you remember at the peak, lease rates were well over $1,000. They're still dramatically lower than that, dramatically lower than our long-term rate that would be attractive to us. And honestly, we don't see that changing in the next couple of years. There is some talk of increased demand out of Canada for crude-by-rail. But honestly, I think most of our customers would like to -- probably would fill that with DOT-117s. And to prove that concept, you can look at what was carrying crude oil 3 years ago. I think it was 30,000 or 35,000 legacy cars. And today that number is literally in the hundreds, if at all. So people are looking to the new car.

Matt Elkott:

Perfect. Thank you very much– very helpful.

Operator:

And we will take our next question from Prashant Rao with Citigroup.

Prashant Rao:

Hi, good morning. Thanks for taking the question. Brian, thank you for all the color on how you're thinking about the current market and as we head into 2018. I kind of wanted to get a sense as -- now that the remarketing income program for the package has pretty much run and looking at the guidance sort of being at 4, 6 years slightly above. Now, the implication is that we could see 4Q, what might be a core rate for EPS. It's probably lower than maybe what some investors are expecting. So I just wanted to get a sense if we should be thinking about that -- it's kind of like a core EBIT EPS generation, like a remarketing income. And then how do we think about that going into 2018? Is that the right kind of run rate? Or what are some of the puts and takes we should be considering as we're trying to think about that on a cadence basis?

Bob Lyons:

Yes. This is Bob Lyons. It certainly won't be a run rate. There's a few factors here going into the fourth quarter that lead to the guidance that we've given today.

One, you hit on, the obvious one, which is remarketing activity, is largely done for the year in terms of the planned activity. So if you're just going kind of bridging from the third quarter to the fourth quarter, that's roughly $8 million pre-tax number that we're not expecting would be there in the fourth quarter.

Also, you have American Steamship, which had a very good third quarter, but we're coming into a much more difficult operating season for American Steamship. So if history repeats itself, their segment profit will drop materially in the fourth quarter. It always does.

In addition to the remarketing income that we generate from, on the rail side of the portfolio, we also generate remarketing income at our Rolls-Royce and affiliates joint venture. We have roughly $5 million, maybe $6 million of that in the third quarter. They had a very good result. We're not expecting that again in the fourth quarter. That's just due to timing. Again, it's similar to rail remarketing. And even more lumpy than rail remarketing given the size and net book value of the assets. We'll also likely, as Brian had alluded to, we still have a number of coal renewals here in the fourth quarter. We expect a number of those cars will be coming back to us. We haven't decided exactly what we will do with those cars yet. There's a possibility we may -- just given the overhang in the market -- we may scrap some of those cars out. And some of those may scrap out at a loss. We'll go through the process of looking at that -- or looking at that in the fourth quarter. So while we've had scrap income year to date, that may not be there in the fourth quarter just given that coal overhang. And we'll see a little bit of a tick down in lease revenue as we've seen sequentially each quarter with the renewals.

So there's a number of factors coming into play in the fourth quarter that lead to that full-year guidance that we're giving, but certainly not indicative of what we would expect for 2018 or annualizing that for 2018.

Prashant Rao:

Okay, that's really helpful, Bob. And just a quick follow-up. The coal cars that are coming in, how big is that portfolio that's coming back to you in 4Q? And what's the timing on the remainder of the coal fleet? Is there more in the coming quarters? Will that be a near-term headwind that we should be factoring in?

Jennifer McManus:

Yes. So there's about 1,600 left to renew in the fourth quarter of this year. And as a reminder, there was about half of our coal fleet up for renewal this year.

Prashant Rao:

Okay. That's helpful. And just one final one, taking a step back. If I take sand cars and the strength of sand cars this year out of the lease rate for the fleet and what -- and the tank cars are up maybe 3% sequentially. I don't know if that is what you said, Brian. Is everything else wholesale could we call it flat? Or is there anything where there are other maybe incremental inquiries where you see some promises of what might drive the next 100 or 200 basis points of sequential improvement for the fleet? Or are we still waiting for that if we take out the sand cars and those portions of the tank cars where you're seeing some uptick from bottoms?

Brian Kenney:

Yeah. First, the tank cars are up a little more than 3%. Freight cars, up a little less. The small cubes have probably gone up 100% this year, at least. So they're pretty close to an investment-type rate. As far as other car types, there's some strength in very small tank car type, certain acid cars, things like that. But if you look across the fleet, there's nothing else where we're saying, “Boy, that's really going to drive some meaningful difference next year.”

Prashant Rao:

Okay. Thanks very much, guys. I appreciate it. I'll turn it over.

Operator:

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

Justin Long:

Thanks and good morning. So Brian, you mentioned lease rates were a little bit better sequentially. But I was curious if you could speak to how inquiries for the North American railcar fleet have trended recently. I know that's something that you guys track pretty closely. So during the third quarter, did you see a pickup in inquiries or the quality of those inquiries?

Brian Kenney:

No. Nothing that I would get on the call and pound the table about. I think it's been fine. And what I would point you to is, we're still sold-out for '17. We're sold-out well into '18, in fact, into the third quarter. So they're there. I would say, they've picked up this year, but I wouldn't think it was tremendous pick up anymore in the third quarter.

Justin Long:

Okay, that's helpful. And secondly, I wanted to ask about the rate of scrappage in North America. If you go back historically and just look at that data, is there a certain level of scrap prices where you start to see a meaningful positive inflection in the scrappage rate? I know it's something that can vary a lot by car type. But I wanted to get your view if there was a high-level way to think about that trend.

Brian Kenney:

Yes. So over the last -- since the last downturn back in 2008, I don't know if it's all scrapping. But as far as cars that have left the national fleets, it's probably averaging about 50,000 cars a year. More recently, it's been in the 30,000 to 40,000 range. This year, it's probably on track for that. Scrap rates increased during

2017. They were 200 or below at the end of '16. They were up to like, I think, was it 265, 285, in the third quarter? But they've come back down again in October. So great question. We really like to see that increase. But I don't think you'd see that meaningful increase until you're into the 300s or more than. Then hopefully, you'll start to see some more serious attrition in the national fleet.

Bob Lyons:

Yes. Justin, there isn't a dollar level at which the switch gets flipped, and you see incrementally less or more scrapping activity. With a fleet our size, we're always going to be scrapping cars. Usually 2,500 to 3,000 a year are going to come out of the fleet. They're just going to age out. But every dollar increase in that scrap price helps and hopefully causes other lessors as well to look at idle inventory and potentially scrap it out of the fleet.

Justin Long:

Okay, great. And lastly, as you think about some of the new entrants that have come into North America, at what point do you think they start to feel more pain as it relates to higher maintenance cost? I know maintenance is something you view as a competitive advantage, but I'm just curious when you expect to see that competitive advantage become a little bit more apparent.

Brian Kenney:

Yeah. Can you ask a different question? [Laughter] The problem with that, of course, is cars are -- especially tank cars, are, relatively maintenance-free for a period of time, and you don't see that first tank qualification become due for 10 years. So if somebody really added to their fleet in the ethanol boom, say, in the mid-2000s, they're starting to feel that right now. But the crude oil boom, it's going to be a little more if you added a lot due to that. It's going to be a little later.

Justin Long:

Okay, great. I'll leave it at that. I appreciate the time.

Operator:

And we will take our next question from Matt Brooklier with Buckingham Research.

Matt Brooklier:

Hey. Thank you and good morning. I wanted to dig in just a little further on the increase sequentially in terms of lease rates across your fleet. You indicated that, I think, tank cars were up a little bit more than that 3%. Can you talk to maybe some of the tank car categories or commodities that potentially drove that sequential increase a little bit above what you saw, I guess, for the average fleet?

Brian Kenney:

Across the tank car fleet, once again, I won't get too granular. It was pretty widespread across the tank car. And that's the good news in the quarter. Once again, I hate to talk about good news when rates are down 27% for the year. But as far as absolute rates bouncing up in the quarter, it was pretty widespread across the tank car fleet.

Matt Brooklier:

Okay. And your best guess is that's just a function of continued Class 1 volume growth? Was there some sort of like supply event, maybe some flammable cars that got scrapped? I'm just trying to think through the puts and takes here.

Brian Kenney:

Yes. And that's exactly -- that's why I'm not calling it a trend yet because it was a quarter. So we're not getting overly excited about that. And again, as I said there's no demand catalyst out there that says, "Oh, wow, this is really going to take off." The best thing to point to is small cubes, right? There was a demand catalyst there with the increase in frac sand use earlier this year. And you say, okay, that fleet got used up really quick. It's 100% utilized. That's the issue that we're seeing. I mean, things this period have bottomed out. They've come up a little bit. Some people are trying to lock-in term. But there's not that demand catalyst out there that's obvious to us that says, "This is going to be great, now." Back in the mid-2000s, it was ethanol. In the late -- in 2012 to '14, it was crude oil. I can't point to anything like that now saying, "Wow, this is really going to drive that demand and lease rates up."

Matt Brooklier:

Okay, fair enough. And then can you remind us what your fleet looks like on the small-cube hopper side, the total number? And then maybe if you could talk to how many cars you think you have in sand service right now?

Jennifer McManus:

Yeah, Matt. There's about 6,000 small cubes in our fleet and about half of those are in frac sand service.

Matt Brooklier:

Helpful. And then looking at ACS (sic) [ASC], you talk to a pickup in terms of iron ore and shipments. And I realize there's obviously some seasonality in the numbers as well. But any inkling as to what drove the pickup in terms of, I guess, demand for iron ore and the increased shipments that you saw?

Bob Lyons:

Yes. There's a -- I assume you're talking about ASC. So, we saw some short-haul -- some short-term short haul -- or I'm sorry, longer-haul iron ore moves. Some of that is export-related. Some of that is the year-end inventory build that hadn't been anticipated initially. So again, no big secular driver you can look to, to say that we've reached a new level there in terms of demand. But we're certainly capitalizing on the opportunity both from having vessel capacity available to move product and capitalize on some term -- or some rate opportunities as well. It has been a nice contributor there in the third quarter.

Matt Brooklier:

Good to hear. I appreciate the time.

Operator:

And we will take our next question from Art Hatfield with Ensign Peak.

Art Hatfield:

Hey, morning. Thanks for taking the question and I apologize upfront, Brian. My question is a little nuanced. But it's about the cycle. And as I look at kind of where we were at the peak of the cycle to where we are today, I kind of view it as a relatively soft landing. And one of the things that kind of comes to mind as we go through that, and I'm just not speaking to the leasing market but the building -- the manufacturing market, as well as in relationship to the leasing market. And I think about your comments about the financial entrants coming into the market, and I think about it currently as for them being a very rational decision that even in a difficult railcar market, they're still able to get yield relatively speaking to other options that they have that is attractive.

So I guess, here's the question, if and when interest rates actually do start to move higher and these financial participants can go get yield elsewhere, is that the capitulation moment that needs to occur to finally starts to get some of the slack out of the industry?

Brian Kenney:

Obviously, first of all, welcome back, Art.

All:

[Laughter]

Art Hatfield:

Thank you.

Brian Kenney:

But it could be -- it's hard for me, I don't have that crystal ball, but it also could be -- I would dispute you a little bit on that positive yield. It kind of depends on how you define yield.

If you buy into a fleet and the utilization starts to drop, I don't know if you'd call that a positive yield situation. And you have seen some people exit the business in the past year and some of them at a loss. So we could already be seeing some of that. But yes, increasing interest rates probably wouldn't hurt that situation. But I think more likely the way it's worked in the past is that people realize that the railcar market is not quite as attractive as it appeared to be at the top of the market when they got in and utilization starts to suffer and lease rates are, as we described today. And then they move on to other things. Now, that hasn't happened.

This one has been a little different this year. I mean, some people have exited. There's some noise about some other people exiting. But it hasn't been the mass exodus that you saw during the last downturn, and that's because the capital markets are so much stronger this downturn. So people are still showing up at these opportunities. And last time we had our pick because nobody wanted to invest in it, and they didn't have the capital to do so. So I will admit, it is different and more difficult this time to take advantage of those situations. But as far as what drives it, I think, as I said, in my opening, it's going to be, "Wow, this return is not as great as I thought it could be" as I deliver all these new cars into a market that doesn't need them.

Bob Lyons:

And, Art, I'd add, too, that we're not unfamiliar with the financial buyers. We know some of them well and we've heard from some that they're kind of in that early phase of realizing that this is a leasing business and cars come back, they go idle.

Art Hatfield:

Right

Bob Lyons:

They're starting to deal with that and really try to contemplate what that means. This certainly was not in their model when they made the initial investment.

Art Hatfield:

Have you seen participants that you hadn't seen before that appear to act more irrational than some of the kind of historic financial participants?

Brian Kenney:

No, not really. I mean, everybody who has an idle fleet tries really hard to put it back to work.

Art Hatfield:

Got it. Okay, thanks for the time.

Operator:

And we will take our next question from Steve O'Hara with Sidoti & Company.

Steve O'Hara:

Hi, good morning. Just going through the gains, I know you'd noted some of the things that you're kind of calling out. And so just -- I want to make sure I understand. I mean, based on the guidance you're looking for, it sounds like 0 remarketing income and then I guess, a pretty significant drop in ASC sequentially, which I think is seasonally a much tougher quarter for them. And then did you call out the amount of the Rolls remarketing income or gains that happened within that portfolio?

Bob Lyons:

Yeah. They've had about, on a pre-tax basis, Steve, about $5 million each of the last couple of quarters. And we're not counting on that in the fourth quarter, though.

Steve O'Hara:

Okay. Okay, perfect. And then the railcar orders going forward, can you just remind us what your current order book looks like? And maybe the makeup of those orders if that's changed -- the car types or just kind of the usual state of affairs? Thank you.

Brian Kenney:

Yeah, sure. Our existing supply agreement from 2014 with Trinity, it's for about 9,000 cars. I think the deliveries end in early 2020. And we've placed about 5,000 of those at this point. As I said, we're placed out well in the next year. And most of that is tank cars. And I'm trying to think a mix. There's really -- I can't think of anything that stands out or anything I'd want to say, for competitive reasons, on this Call. But there's certainly nothing that's different than what we usually take delivery of there.

Steve O'Hara:

Okay. And then just on the -- I think, the number of boxcars continues to drop. I mean, is that just those cars aging, getting older and you euthanizing them along the way?

Bob Lyons:

Well yes, we've scrapped some cars out of that fleet for sure. And we've also sold some, too. And so we've seen some opportunities there in the 200-, 300-car range to sell some cars at attractive valuations to users.

Steve O'Hara:

Okay. Alright, thank you very much.

Operator:

And we will take our next question from Jordan Hymowitz with Philadelphia Financial.

Jordan Hymowitz:

Hey, guys. Thanks for taking my question. Were any of the residual value gains as a result of the nuclear power residuals?

Bob Lyons:

No, we did have a very large one last year, $20 million last year, 2016.

Jordan Hymowitz:

Okay. And how are you recognizing that? Like are they quarterly re-evaluated, annually re-evaluated, something like that?

Bob Lyons:

Only happens when a facility is either sold or a new long-term lease is put in place.

Jordan Hymowitz:

Alright. Could you remind us how many of them are left? Is it 7 or 8?

Bob Lyons:

No. It's fewer than that. And the $20 million gain realized last year was on the high end of what we would expect going forward.

Jordan Hymowitz:

Okay. So you won't say how many are left at this point?

Bob Lyons:

3 or 4.

Jordan Hymowitz:

Okay. Thank you very much.

Operator:

And we will take our next question from Justin Bergner with Gabelli & Company.

Justin Bergner:

Good morning, everyone.

Bob Lyons:

Good morning.

Justin Bergner:

First question relates to the Rolls-Royce affiliate remarketing income. I think you said, Bob, that they've been running at about $5 million per quarter for the last couple of quarters. But I guess, if that's the case, then the sequential increase in the affiliate earnings of about close to $4 million sort of stands out. I'm not sure if I heard you correctly before about the remarketing gains being $5 million a quarter and if my interpretation is correct.

Bob Lyons:

Well, yeah. It is correct from the standpoint of the second and third quarter. First quarter was light. But if you look at where we're at year-to-date on a pre-tax income basis for Rolls-Royce, it's about $39 million total pre-tax income, our share. And we expected that full-year number to be right around $50 million. We still expect that to be the case. So if they generate $10 million here in the fourth quarter, that would be absent any remarketing income, -- that would put us right where we thought we would be for the year.

Justin Bergner:

Okay, that makes sense. So if I look at the $12.3 million of Rolls-Royce income in 2Q and if that included, I guess, close to $5 million of remarketing income, that would have made the non-remarketing income a little bit light versus, I guess, the annual pace. Or was there anything that was sort of anomalous in 2Q maybe, instead of being anomalously positive in 3Q?

Bob Lyons:

No, nothing significant. There are other items that go into that, whether it's provision for losses -- loss recovery that can be in the $1 million, $2 million range any given quarter. So it's not just operating income and remarketing income. Yeah, it could have a swing factor on any one given quarter. I think the key point is we expect fourth quarter to be around $10 million, somewhere in that range.

Justin Bergner:

Okay, that's helpful. And Brian, building on your sort of comments from earlier. I think you sort of called out 2 factors: sort of a lack of demand growth in terms of railcar loads and deliveries exceeding scrappage. And I guess, the third one that -- in fact, that wasn't discussed, was sort of utilization. Have any of those sort of key drivers worsened over the last 3 months? Or you just sort of making these comments to suggest that despite some lease rate improvement, things don't necessarily look like they're getting materially better?

Brian Kenney:

No, what I'm saying is it's a supply-driven downturn this time. There's no obvious demand catalyst that will snap us out of that. And if you continue to throw surplus railcars at the problem, it's going to prolong the recovery. That's the summary of that rant [Laughter] I went on at the beginning -- at the beginning of the Call.

Justin Bergner:

Okay. That's very helpful. And on the utilization front, nothing materially changing there that would add to your comments from earlier?

Brian Kenney:

No. No, it's actually a little bit better than we thought. We've done a nice job. The commercial team has done a great job keeping our cars employed. Now, like I said, we're not too excited. It's better having coal cars not come in and be stored than -- that's good but it's not anything exciting as far as revenue goes over the next couple of years. But keeping the tank car fleet utilized despite this market weakness has been outstanding. And that's the source of the upside you've seen this year in our earnings.

Justin Bergner:

Okay. And then in terms of Tier 1 railroad utilization increasing or decreasing the demand for railcars -- no real material change to your view there over the last 3 to 6 months?

Brian Kenney:

I think the idle fleet in the industry is actually down just a tick. But nothing meaningful there.

Justin Bergner:

Okay.

Brian Kenney:

I think it went to 19 from 20.

Justin Bergner:

Alright. Thank you for taking my question.

Operator:

And we will take our next question from Steve Barger with KeyBanc Capital Markets.

Steve Barger:

Hi. Good morning, guys.

Bob Lyons:

Good morning.

Steve Barger:

Brian, earlier in the call, you had said it's been a little tougher to load the network and it could be hurricane related. If it's not that, what would you think it could be?

Brian Kenney:

Well, that could be a positive if customers are unwilling to give up their cars. So there's a number of things that you really have to see if it's a multi-quarter trend. Like I said, people wanting to lock-up for longer lease terms. That's tough with these lease rates, but potentially a good sign. Cars that are expired riders, all of a sudden people want a decision there -- that could be a good trend. So I think some of this is what ticked up lease rates in the quarter, though I want to see it happen for multi-quarters before we get excited. And once again, with this supply overhang, it would be easy to derail, no pun intended, at this point.

Steve Barger:

And for aftermarket services that you may contract for outside your own network, are there any capacity or lead time issues? I'm just trying to get a sense for parts and service availability as traffic has stepped up a little bit.

Brian Kenney:

We're more focused on doing more and more of our own fleet maintenance internally, and that's increased dramatically over the last year -- few years from roughly half to over 80% in tank and specialty freight now. We'd like to continue to do more of that and actually increase the capacity in our own network, which we're investing to do right now. As far as third party, I mean, we'll do it for really big customers. But at this point, we're not out trying to sell that capacity. I'd rather just use it myself.

Steve Barger:

Understood. Well, inside your own network then, are lead times changing at all for parts? Do you have any issues related to service for the cars?

Brian Kenney:

I have not heard of anything of that nature, no.

Steve Barger:

Alright. Great. Thank you.

Operator:

And we will take our next question from Gordon Johnson with Axiom Capital Management.

James Bardowski:

This is James Bardowski, in for Gordon. I just have a few follow-up questions here. First, with respect to your cash balance, it was down roughly about $85 million in the quarter, which is typically a positive cash quarter. Can you just give us a little color on where you deployed the cash, what was it mainly spent on?

Bob Lyons:

Sure. The cash balance is not something I really look at from the standpoint as it moves around a lot quarter to quarter. There's no consistency to it. Because a lot of that has to do when we're refinancing debt, when we're paying down debt or issuing bonds. So for example, if we did a big debt issue at the end of the second quarter, we'd carry a huge cash balance until we paid down whatever maturity was coming up. So it's just the ordinary working capital use of cash, nothing significant. Our next debt maturity is in

February of 2017, and so maturity scheduled in 2017 is very typical.

James Bardowski:

Okay, got it. Got it. And then with respect to the lease rates, as naturally we should expect a lower LPI going forward. Presumably, this would put pressure on the ROE. With that said, do you guys have any have target to what you consider optimal fleet level, particularly for the U.S. side?

Brian Kenney:

Optimal fleet level?

Bob Lyons:

North American fleet? Rail...

James Bardowski:

North American, correct. On the North American rollover, basically what you'd like to manage that at?

Bob Lyons:

No, there's no significant number that we have. We've never had a target number up or down. What we're trying to do is generate the highest risk-adjusted return for our shareholders on the assets we have, on the fleet we have. And that factors in to all of our new investments as well as selling assets in the secondary market. So there's no, and there never has been, a target fleet count.

James Bardowski:

Got it. Got it. And then quickly on the lease renewals. I think it was about 74% this quarter -- or last quarter. A nice job on that. How are you guys managing to keep that so high, given the market conditions?

Brian Kenney:

Well, I think there's a lot of reasons for that. One is our service, which we think -- and our relationships, which obviously I'm not going to keep talking about that. We've been doing it for 120 years. But I think a lot of our successes, what we structured during the upmarket as far as what is renewing now – granted, there are a lot of coal renewals this year, and we renewed more than our share, but once again, not at great rates. But I think structuring it in the upturn so that we're not facing a lot of the challenged renewals now has been key to keeping that renewal success rate high. And just great work by our commercial team. And it's been -- the good news for me this quarter -- what was it? -- about 74%, 75% and it was in prior quarters, you've seen a much different rate for tank and freight, and both of them were right in that range this quarter. So that's a good sign for me.

James Bardowski:

Okay, that's very helpful. And given my shoddy memory, how many coal cars do you guys have? Is it about 2,500, 2,200?

Jennifer McManus:

We have about 6,000 coal cars in our fleet.

James Bardowski:

6,000, very low. Excellent. And then one more, and I'll hand it back. You mentioned that there's no demand catalyst, understandably. But looking at the mix of railcar freights, it seems to be coal and non-metallic minerals are basically disproportionately carrying the weight for the industry. Noting your 6,000-car coal fleet, how much of this has given you -- given benefit to your utilization rate? And is there any intention to -- for GATX to change the mix towards some of the higher-demand cars versus staying overweight in your tankers?

Brian Kenney:

No, we're very much invested for the long-term, and I don't want to beat this to death either, but obviously, that's why we didn't invest heavily in crude-by-rail just because it's a short-term trend. It didn't mean much to us. As far as coal, yes, it probably helped on the utilization side -- I'd have to verify that. But once again, I was putting them at really low rates. So, still not that excited about it. So, the return, in other words, returns are still very poor on that asset, despite the fact that they're utilized.

James Bardowski:

Okay, perfect. Thanks a lot, guys. Appreciate it.

Operator:

And it appears there are no further questions at this time. I'd like to turn the conference back to our speakers for any additional or closing remarks.

Jennifer McManus:

Thanks, everyone, for their participation on the Call, and please feel free to contact me with any follow-up questions. Thank you.

Operator:

And ladies and gentlemen, that does conclude today's conference. We'd like to thank everyone for their participation. You may now disconnect.