GATX Corporation

2021 Second Quarter Conference Call **July 20, 2021**

Operator:

Good day, and welcome to the GATX 2021 Second-Quarter Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Shari Hellerman, Director of Investor Relations. Please go ahead.

Shari Hellerman:

Thanks, Nick. Good morning, everyone, and thank you for joining GATX's 2021 Second-Quarter Earnings Call. I'm joined today by Brian Kenney, President and CEO; Tom Ellman, Executive Vice President and CFO; and Paul Titterton, Senior Vice President and Chief Operating Officer of Rail North America.

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 those statements or forecasts. For more information, please refer to the risk factors included in our earnings release and those discussed in GATX's Form 10-K for 2020. GATX assumes no obligation to update or revise any forward-looking statements to reflect subsequent events or circumstances.

I'll provide a quick overview of our 2021 second quarter and year-to-date results, and then I'll turn it over to Brian for additional comments on our performance and our decision to raise guidance. Following Brian's comments, we'll open the call up for questions.

Earlier today, GATX reported 2021 second quarter net income from continuing operations of $5.5 million or $0.15 per diluted share. This compares to 2020 second quarter net income from continuing operations of $37 million or $1.05 per diluted share. Year-to-date 2021, we reported net income from continuing operations of $42 million or $1.17 per diluted share. This compares to $84.2 million or $2.38 per diluted share for the same period in 2020.

The 2021 second-quarter and year-to-date results include a net negative impact of $39.7 million or $1.10 per diluted share related to an enacted tax rate increase in the United Kingdom and a net negative impact of $3.4 million or $0.09 per diluted share related to debt extinguishment costs associated with an early redemption.

Both adjustments are non-cash events. These items are detailed on Page 13 of our earnings release. And as noted in the release, we are raising our 2021 full-year earnings guidance to a range of $4.30 to $4.50 per diluted share.

With that, I will now turn the call over to Brian.

Brian Kenney:

Yeah, thanks, Shari. I'll spend a minute or two explaining why we raised our EPS guidance. Even though business conditions really haven't changed significantly from our expectations coming into the year. So, first of all, it's the outlook for Rail North America that's driving the projected outperformance. Our other business segments are performing largely as we expected, but I'll get to those in a minute.

Within Rail North America, we originally said we expect relatively flat segment profit in 2021 compared to last year. And the rationale was that we expected revenue to decrease by $35 million to $45 million, because lease renewal rates would still be lower than expiring rates in 2021. And that's come to pass.

We also said there was a small risk to utilization due to the hyper-competitive market that's been created by the significantly lower utilization in our competitors' fleets.

Another prediction was that net maintenance expense would be up or down in that $5 million to $10 million range, depending on our ability to continue the recent operating improvements we've realized. And that remarketing income would be substantially higher in 2021, as we continue to optimize the fleet in a strong secondary market and we expected higher scrap prices in 2021.

So, looking at our actual results in the first half as well as the current operating environment, it's pretty consistent with those original

expectations of that slow market recovery. So, the reasons for the higher guidance is that we now expect most of the items I just described to be at the positive end of the ranges we provided. So, for instance, looking at revenue, both utilization and lease rates are at the higher end of the range we predicted internally, but they're not significantly higher by any means.

Maintenance expense -- we have operated safely and efficiently through the first half, and we now expect spending to be at the lower end of the range we provided. And by the way, as Shari indicated, Paul Titterton, who's our Chief Operating Officer of Rail North America. He has responsibility for rail maintenance network as well as the fleet. He's on the call and can answer any questions you may have about that progress.

And then the last two factors -- our expectation of increased railcar sales in the secondary market is right on target. And as I said, we did expect to realize higher scrap prices in 2021. But frankly, we had no idea they would go as high as $475 per ton, and that's what we've seen recently.

So thus, you can see that it's difficult to pinpoint any one factor that's driving the improved performance. So, I would characterize it as a slightly better market in Rail North America than we anticipated across the board and strong commercial and operating performance on our part. And so, the net result is that we now expect segment profit in Rail North America to not be flat, but to increase more than $20 million relative to last year.

Quickly touching on the other businesses. GATX Rail International is meeting our expectations of significantly higher segment profit in 2021. The COVID resurgence in India has slowed them down somewhat, but, in general, Rail International is operating in favorable markets; they're seeing strong investment opportunities.

At RRPF, our aircraft spare engine leasing joint venture, they are operating as we expected in an extremely difficult market for international widebody air travel. Our expectation was that segment profit would be down $40 million or more from 2020. And for now, we're sticking with that estimate, although I will say their performance is the most uncertain component of our guidance and will likely remain that way until we start to see recovery in international air travel.

And then lastly, the early returns on our Trifleet acquisition have been extremely favorable. Tank container prices, utilization and lease rates are all increasing; that obviously helps the performance of the existing fleet. We're also seeing strong investment opportunities there as well. And we now anticipate the acquisition will perform a little bit better than we originally anticipated coming into the year. So that's the rationale behind the increase in guidance.

So operator, let's go ahead and open it up to questions.

QUESTION AND ANSWER

Operator:

Thank you. (Operator Instructions) And our first question comes from Allison Poliniak with Wells Fargo. Please go ahead.

Allison Poliniak:

Hi, good morning. I do want to ask about the maintenance expense. It seems to be an area where you continue to outperform. And I think you bring it -- push to Paul for this, but maybe kind of walk us through some of the changes that you're making, and I'm taking the view that this isn't just maintenance getting pushed out to the right at all. This is actually pure operational improvement. Just any color there?

Paul Titterton:

Sure. Allison, this is Paul speaking, and thanks for the question. We've really done a few things to try to structurally improve our maintenance cost. We've invested in technology. So, one of the things we've put in place is an audit system, which allows us to take wasted repairs out of our processes, and that's allowed us to measure it on, for example, an hours per car basis, dramatically reduce the amount of time we're spending on each car while maintaining safety and quality.

And we've been able to use that benefit then to create excess capacity in our shops, and we're able to drive more throughput through our shops as a result and thus reduce our dependence on contract shops.

And of course, we can take advantage then of economies of scale and the low marginal cost of production in our own shops. So, I think to broadly answer your question, those are all changes that we can continue to capitalize on going forward. So, while from year-to-year, you're going to see different maintenance demand, that's going to change the level of maintenance cost for a given level of demand; we believe we have structurally reduced our cost.

Allison Poliniak:

Got it. No, that's helpful. And then a question on lease term, just in terms of when I think about an improving environment, you start to see that expand, and that sort of stabilizes. Is that somewhat of a mix in terms of that lease term at this point, the average lease term? Or is it still sort of just the uncertainty that people are kind of pushing towards that lower time limit there?

Paul Titterton:

So, with respect to lease term, ultimately, lease term is a push and pull. There is the -- what the market demands and there's what we target through our pricing. And, in general, our philosophy for what we target on lease term is going to be as lease pricing rises above our long-run expectation, we're going to target longer terms. Right now, since a chunk of our fleet is still pricing below long-run expectations, we are generally very happy to keep terms relatively short.

Allison Poliniak:

Got it, understood. I'll pass it along.

Operator:

Thank you. Our next question comes from Justin Long with Stephens. Please go ahead.

Justin Long:

Thanks and good morning. I wanted to follow-up on lease rates in North America. It sounds like absolute lease rates have continued to improve sequentially here in the second quarter. Could you give some more color around the magnitude of that improvement that you saw? And any updated thoughts on the LPI for 2021?

Paul Titterton:

So I'll take it in reverse order. For the LPI, we're reiterating the guidance we provided previously, which is a range from negative 15% to negative 5%. But as we always talk about -- really thinking about absolute lease rates and how they're changing from quarter-to-quarter is really a much more instructive way to think about the market conditions. And we've seen from last quarter to this quarter, a sequential increase in the high single digits. Obviously, that's going to vary by car type. And we do see continued momentum upward from here out as the market continues to firm.

Justin Long:

Okay. And I think the prior guidance assumed a mid-single-digit sequential increase in each quarter throughout the year. So would it be fair to say that as we look forward to the back half of the year, that expectation is higher, so maybe a high-single-digit increase in the third and fourth quarter? Or how should we think about that?

Tom Ellman:

Yeah, Justin, I think it's hard to get that precise. Certainly, directionally, we expect to see the trend that we've seen so far continue, but we've been in the mid-single digits, the high-single digits. It will be somewhere in there, we think, going forward.

And then as far as the LPI goes, as you know, it's really hard to draw any conclusions from a

single quarter because a small number of transactions can move it. Likewise, it's really hard to predict what it does in any single quarter, which is why we still feel like that negative 5% to negative 15% range is correct.

Justin Long:

Okay. And then finally, on the remarketing income in North America. I think the prior guidance was for an increase of $35 million to $40 million. So, I just wanted to make sure that, that was still the right range, maybe the more kind of favorable end of that range is what you're expecting?

And kind of second part to the question, Brian, curious if you could comment on the acquisition market and where you're seeing the best risk-adjusted returns as you look at your different investment opportunities?

Tom Ellman:

Yeah. So, I'll start with the guidance and then kick it over to Brian for the opportunities. And we are still thinking about that same range. As Brian went through in his opening comments, talking about basically in Rail North America, the offsetting factors were an expectation for a decrease in renewal revenue -- I'm sorry, revenue, and an increase in asset disposition gains. We haven't really moved off that asset disposition gain number and the revenue is doing a little bit better than expected. So that's the offset.

Brian Kenney:

Yeah. On the M&A side, it really depends on the region. Obviously, I can't discuss individual opportunities. There are some opportunities out there. Obviously, we'll look at everything or at least attempt to look at everything, but try to maintain our discipline.

In North American Rail, there's probably a little bit of a change from where we said in the past is, I think -- it's fairly unlikely right now, mostly due to the fact that the large portfolios that may come up for sale are likely to be of lower quality. And -- but people are still seeking a high price that certainly we're not willing to pay. So, I'm not optimistic about that.

On International Rail, I'm sure you saw the press coverage that SNCF has apparently entered into an exclusive agreement with CDPQ and DWS over the sale of Ermewa. Outside of that deal, there could still be some opportunities for smaller fleets. So, we're still plugging away. But Tom and Paul can chime in, but over the last year or so, it's been a case of the competition on portfolio acquisitions as much as it’s been potential sellers coming to terms with the real value of their fleet. I think that's the real issue.

Justin Long:

Okay, I appreciate the time.

Operator:

Thank you. Our next question comes from Matt Elkott with Cowen. Please go ahead.

Matt Elkott:

Good morning. Thank you. I know you guys haven't changed your remarketing income for assumptions for the year, but a lot of the assumptions you had coming into the year have trended towards a positive end of the range. Does that bode well for secondary market valuations and scrapping income? Isolated from your guidance, but in general, is a market question, do the improving fundamentals in the industry as a whole bode well for secondary market sales?

Tom Ellman:

So Matt, I'll start with what we're thinking. And then if Paul has any additional commentary on -- color on the market, he can provide that. We came into the year expecting it to be a strong environment for secondary market sales, and it is. As you know, though, the timing of the individual sales can be difficult to predict and historically has been pretty lumpy. So what happens in a given quarter isn't really a great proxy for what's going to happen for the year as a whole. We still feel like it's a strong market.

Our original guidance and our updated guidance both reflect that expectation.

Matt Elkott:

Okay. And then, Tom, I mean, does your fleet -- seems to be pretty close to optimal with utilization and increased remarketing activity? Even if market conditions warrant asset sales, do you have any material portions of your fleet that are -- that could be viewed as suboptimal that could be candidates for asset disposition?

Paul Titterton:

So, this is Paul. I'll jump in and say in terms of dispositions, we're always making an economic evaluation and looking at what the whole value of our fleet is economically versus the sale value. And so, quite honestly, it's not necessarily an asset attractiveness play. It's simply a question of whether the market values an asset more highly than we do. And that could be true, frankly, of an asset that we otherwise view as attractive just as it can be true of an asset that we otherwise view as unattractive. So, for us, really the process of evaluating what to sell into the secondary markets just has to do with the relative valuation of the market view versus the GATX hold view.

Matt Elkott:

That makes sense. And then just one last question, Paul and Tom. Over the last -- this is a larger, "bigger picture" question -- over the last five years, lease rates have really been pretty anemic except for a couple of brief periods, maybe. And that's because we've had above industry builds for almost a decade now. and then you had declining rail traffic and PSR implementation. All these dynamics seem to be reversing in favor of leasing. So is it unreasonable to think that we're entering a period of favorable lease rate comps for the next couple of years?

Paul Titterton:

So what I will say is, certainly, some of the favorable things you've talked about have underpinned some of the recovery in lease rates. But it's very difficult to project out to long term. I mean, as we've seen in this industry, you've had quite a bit of cyclicality over time with various investors entering in various kinds of boom-and-bust cycles within railcar manufacturing. What I will say right now, we are seeing a recovery for all the reasons we've talked about in lease rates: higher scrap prices, higher car costs, some recovery in carload demand. So, certainly, we're seeing a positive trend in lease rates right now. But obviously, it all depends on how those factors play out over the next few years to see whether that trend continues and to what degree.

Tom Ellman:

Yeah. And Matt, the other thing I'd say is particularly comparing it to the last upturn. Last time, we had the additional catalyst of crude by rail. We've talked before about how we expect this to be more of a slow and steady increase because we don't see something of that magnitude coming along this time.

So directionally, as Paul indicated, we expect continued improvement, but probably not the steep slope that you saw last time.

Matt Elkott:

Got it. Thanks, Tom. And just one final follow-up. Can you provide any more color on the lease rate improvement by car type? I think your freight cars were outperforming maybe tank cars, but is that still the case?

Paul Titterton:

Yeah. So, what I would say is, we're not going to get into specifics by car type. But in general, certainly certain freight cars, and I would describe them as the non-overbuilt and non-energy-related freight cars have been the leaders in the lease rate recovery. And when I say non overbuilt, the cars that didn't get built in huge numbers during the wave of builds that accompanied the crude boom.

So that's really where we're seeing the best lease rate performance. And the laggards are really some of the more energy-related car types that we've talked about.

Matt Elkott:

Thank you very much.

Operator:

Thank you. Our next question comes from Bascome Majors with Susquehanna. Please go ahead.

Bascome Majors:

Thanks for taking my questions. Back to lease rates, could you give us a little bit of a snapshot of where you're tracking across the fleet relative to your long-term average? And how close you're getting to that kind of inflection point?

Paul Titterton:

Sure. I'll start that and others may chime in. But across the fleet, I would say, we're generally going to be 20% to 30% below long-term rates. But again, it varies a lot by car type. I refer to kind of some of those non-overbuilt, non-energy-related freight cars.

And those are parts of the fleet where we are, frankly, at or above long-term levels. And in contrast, some of the more energy-related car types that are still challenged because of historical overbuilding and other factors, those would be below that level. But 20% to 30% below long-run levels is a good rule of thumb, broadly, right now.

Bascome Majors:

And on capital deployment -- your last quarter, you surprised us a bit with the amount of capital you're able to put to work directly in the aircraft engine leasing business. Have we seen most of that? Are there some more opportunities either with Rolls or with other manufacturers that you're seeing potentially attractive risk-adjusted returns? Just any anything on that front as compared to what you're able to do in 1Q would be helpful.

Tom Ellman:

Yeah, Bascome. So you're absolutely right. When we talked about that, we talked about being able to deploy capital for our own account, but still managed by RRPF for the best engine types with the best credits on long lease terms. And we indicated that we continue to have appetite for that type of investment. It remains to be seen how much of that is available in the market, but it's certainly something that is attractive to us, and we're going to continue to pursue.

Bascome Majors:

Thank you for that. And lastly, similar question, but on the Trifleet acquisition. Are you seeing pockets of opportunity there to expand that fleet inorganically? Could that be a needle mover mid term or long term? Are you still kind of in the "we need to understand this business before we can get more aggressive" stage of owning it? Thank you.

Brian Kenney:

Well, that's a good question. There's no question that investment volume has picked up. A lot of this was just good timing on our part. Luck, I should say. We bought it at the beginning of the year. Almost immediately, tank container prices started increasing. You saw greater demand just as the world economy, industrial production picked up. Utilizations increased. Lease rates are starting to follow it. And we are seeing really good investment opportunities there. So, I would anticipate that we're going to outperform what we originally thought in investment this year.

And I don't think -- I think we said it would be 10% dilutive this year. It'll do better than that. So we're very excited about it. We're also very excited about the co-investment opportunities. There's a lot of similar customers. And we've had a couple of early wins on that. So, I'm very pleased with that acquisition so far. But as far as investing aggressively, I don't think we're there yet. It's just organic investments that's going very well right now.

Bascome Majors:

Thank you for the time.

Operator:

Thank you and our next question comes from Justin Bergner with G. Research. Please go ahead.

Justin Bergner:

Good morning, Brian. Good morning everyone on the team.

Tom Ellman:

Good morning.

Justin Bergner:

A couple of cleanup questions. Most of my questions have been asked. The UK tax rate increase -- you indicated that was non-cash, but what is the economic effect of that for the business or any of the assets sort of on the books in the business?

Tom Ellman:

Okay, Justin. So specifically, what that is, is the UK announced that their statutory tax rate would increase from 19% to 25%, but not effective until April of 2023. So even though the tax rate will not impact current operations until 2023, we need to increase our deferred tax liability based on the new tax rate. So that's why it's a non-cash item.

In terms of how it's going to affect our operation, the primary business that is related to the UK is the Rolls-Royce joint venture, and that continues to be an attractive business to us and doesn't really change the strategic approach to it.

Justin Bergner:

Okay, great. That's helpful. And then your interest expense looks like it stepped down sequentially quarter-on-quarter pretty materially. Is that mainly just refinancing your debt stack at lower rates? Or was there change sort of in the amount of cars that you sublease versus own directly?

Tom Ellman:

Yeah. So, maybe what you're looking at is the Operating Lease Expense, which had a favorable variance because we exercised a buyout on some of the sale leasebacks.

Justin Bergner:

Okay, that might be it. So that would sort of be the major driver of the lower sequential interest expense for the business as a whole?

Shari Hellerman:

Yeah, Justin. Yes, we also paid down about $580 million of debt over the course of the second quarter.

Justin Bergner:

Okay, got it. And then with respect to the tank container business, I guess you're very pleased with the operating performance, which is great. Just, how do I understand the $5 million loss -- segment profit loss in the sort of Other segment in your business -- in the second quarter? And how do I juxtapose that against sort of the strong performance in the tank container business?

Shari Hellerman:

So, I think that's the Debt Extinguishment costs.

Justin Bergner:

Okay, okay. It's embedded in that segment. Okay, great. And then maybe lastly, you talked about the major driver of -- I mean, you sort of talked about the different factors driving higher sequential lease rates and you started off with higher sort of cost and higher steel prices or scrap prices.

So were you trying to suggest that the sequential acceleration in lease rates is being more driven by sort of asset value and operating cost considerations than by demand tightening considerations at the current point in time? Or did I sort of infer incorrectly from your comments?

Paul Titterton:

There are actually multiple factors. So, demand is rising. And if you look at year-over-year carloads, that can clearly indicate that demand is rising. We are also benefiting from higher steel prices, which really has two benefits. Number one, you see a greater level of scrapping activity, which means more cars leave the industry fleet. And, you also see the price of new cars higher, so the new car alternative to an existing car is higher, which raises the value of an existing car. And then, finally, there's been a bit of a velocity slowdown at the Class I railroads. And of course, we all know that as velocity slows, the need for cars goes up given -- for a given level of traffic. So all of those things are underpinning the improvement in lease rates that we've seen.

Justin Bergner:

Great, thank you.

Operator:

Thank you. (Operator Instructions) Next, we will go to Barry Haimes with Sage Asset Management. Please go ahead.

Barry Haimes:

Thanks so much for taking my question. Actually, I had two. One is -- and you just alluded to the higher new car costs because of higher steel. And the question is -- and I'm just sort of looking for order of magnitude, how much would lease rates have to go up to justify buying a new car to add to fleet to make that good economics for you guys?

And then second question is I'm guessing following in your earlier comments that if we were to do a storage update by car type that probably still a fair amount of excess energy-related cars, but the other car types are back to normal levels. So maybe just an update on storage. Thanks.

Tom Ellman:

So, I'll start and then let Paul add some additional color. In terms of attractively investing in new cars, we're doing that right now. The way that we look at new investment is we have lots of experience in this industry. We have a really good handle for what's going to happen over the long term to the lease rates for a car and the cost to maintain that car. So we're always looking at this as a long-term investment.

So, in this environment, there certainly is the ability to attractively invest, which we've done, both inside of our long-term supply agreements and outside of them. You may recall in the first quarter, we commented on reaching agreement on over 1,000 new railcars outside of the Supply Agreement. So it's been an attractive investment environment.

Paul Titterton:

And then I'll take, this is Paul speaking. I'll take the storage question. And you are correct that certainly the bulk of the cars that are still in storage across the industry are in some form or fashion tied to the energy markets. It would be incorrect to say that there's complete full utilization in all other car types. But certainly, the significant majority of the industry's idle cars are in some way tied to the energy markets.

Barry Haimes:

Great. Thanks very much – appreciate it.

Operator:

Thank you. And that will conclude today's question-and-answer session. Ms. Hellerman, at this time, I'll turn the conference back to you for any additional or closing remarks.

Shari Hellerman:

I'd like to thank everyone for their participation on the call today. Please reach out to me with any follow-up questions. Thank you.

Operator:

And this concludes today's call. Thank you all for your participation. You may now disconnect.