GRANT'S
FORTY YEARS
INTEREST RATE OBSERVER®

Vol. 41, No. 3d 233 Broadway, New York, New York 10279 • www.grantspub.com FEBRUARY 10, 2023

Rent, then sell

Evan Lorenz writes:

Industrial activity is sputtering in the 50 states, but stocks of the companies that cater to manufacturing are outperforming the market. Since Sept. 30, 2022, the industrials component of the S&P 500 has outlegged the blue-chip gauge by 8 percentage points. It's this paradox that got us looking at United Rentals, Inc. (URI on New York Stock Exchange), the heavy-equipment rental giant. In preview, we're bearish on it.

Constant readers will remember the ticker. *Grant's* was bullish on URI near the start of the Great Recession (see the issue dated Feb. 8, 2008). It was quoted at the time at $18.18, an attractive entry point compared with the current price of $455.90, but the shares bottomed 13 months later at $3.03.

We took a bearish swing at United in the issue dated July 15, 2016, when the stock changed hands at $70.12. Elevated leverage and an incipient slowdown in commercial construction were the risk factors we identified. Net income did fall by 3.2% that year, but buybacks reduced the share count and URI was able to report a 6.2% rise in earnings per share. The cyclical slowdown proved a flash in the pan.

Covid-related distortions have reduced the never-superabundant stock of reliable macroeconomic forecasting signals. Even the good old cardboard-box indicator needs an asterisk nowadays.

The 8.4% plunge in U.S. box shipments during the fourth quarter is the largest decline since the 2007–09 financial crisis, KeyBanc Capital Markets, Inc. analyst Adam Josephson points out. Certainly, that fact commands attention; what tangible product doesn't live for a time in a cardboard box? Whether or not the decline spells recession, it's a striking example of the bullwhip effect.

In 2021, formerly locked-down consumers returned to their pre-Covid purchasing patterns, e.g., more travel, fewer Pelotons. Many a retailer, not foreseeing the shift and continuing to lay-in unwanted merchandise, found itself overstocked. The result was fewer inventory purchases, along with reduced box demand, in the final quarter of last year.

To be sure, weaker consumer spending did make its contribution to post-Covid strains. Personal-consumption expenditures, which include spending on both goods and services and which account for 68% of GDP, fell sequentially in nominal terms in both November (down 0.1% from October) and December (down 0.2% from November).

Real hourly wages, which declined every month from April 2021 through December 2022, were the culprit. A survey by PYMNTS.com and LendingClub Corp. showed that, in December, 64.4% of consumers were living paycheck to paycheck, up from 60.9% in December 2021. Higher income brackets not only participated in this worrying trend, but also led it: 50.8% of consumers earning more than $100,000 per year admitted to living financially hand to mouth in December compared with 42.3% in December 2021. And now Vanguard Group, Inc. reports that 2.8%

Mr. Market has noticed

source: The Bloomberg

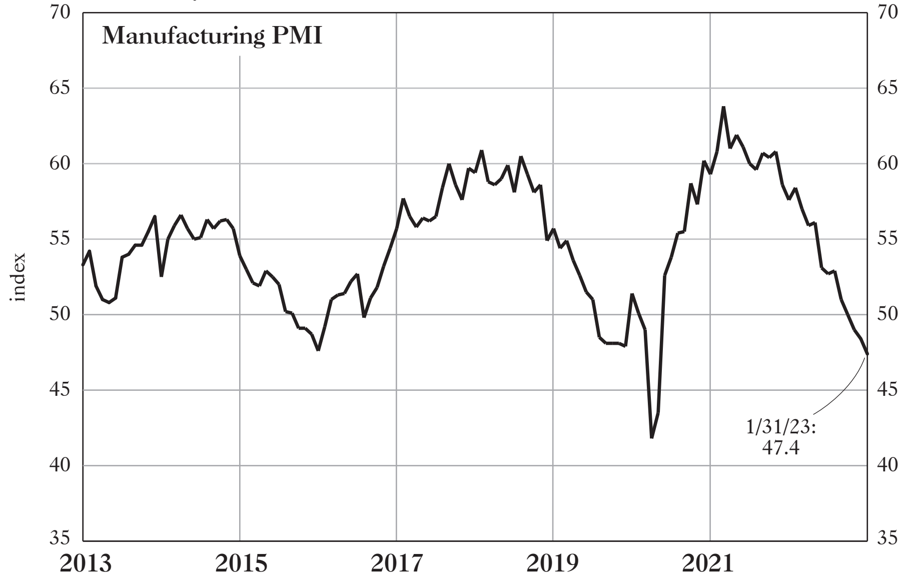
of the 5 million people whose 401(k) retirement plans it administers took out hardship withdrawals last year (so incurring a 10% penalty fee) versus a pre-pandemic average of 2%.

In the way of the interconnectedness of knee bones and thigh bones, the consumer slowdown is putting a damper on industrial production. Thus, the Institute for Supply Management's Manufacturing PMI fell to 47.4 in January from 57.6 the preceding January (a level below 50 indicates a contraction). Regional manufacturing surveys from the Federal Reserve's branches in Richmond, Dallas, Kansas City and New York were also in the red during the first month of 2023.

"Overall demand is weaker for our products," one manufacturer informed the Federal Reserve Bank of Kansas City last month. "With high prices for capital projects, we are delaying all the projects we can." You can see this in the American Institute of Architects' Architecture Billings Index (ABI): In December, 38% of design firms reported significant delays in projects in the back half of 2022. As architects draft blueprints before contractors break ground, the ABI is an early indicator for commercial construction.

. . .

Industry wilts



source: The Bloomberg

United Rentals is the largest company of its kind in the world, with $11.6 billion in revenue last year and 1.02 million pieces of equipment on hand as of Dec. 31. United generates revenue by renting equipment (87% of last year's top line), selling used equipment (8%) and by selling new machinery, supplies and what-have-you (5%). Domestic sales accounted for 90% of the 2022 top line.

URI divides its business into general rental (73% of rental revenues) and specialty (27%). General rental includes construction and industrial equipment (backhoes, skid-steer loaders, forklifts, etc.), aerial work platforms, tools and light equipment. The specialty unit rents trench-safety equipment, power and HVAC units, fluid solutions, mobile storage equipment and modular office space. Last year, industrial customers generated 48% of sales, nonresidential construction, 47% and residential construction, 5%.

One interpretation of URI's fat 42% gross margin is that the rental customer is paying a very full price. Then, again, outright purchase entails maintenance and storage expense, separate and distinct from the initial capital outlay. Rent with us, goes the United sales pitch, and save between 15% and 35% on annual rental expense with our proprietary jobsite-management software called "Total Control."

Wall Street makes its own macroeconomic pitch. The pandemic-induced shift to "reshoring" means lots of demand for the capital goods required to substitute domestic factories for the vulnerable, overseas kind. Construction crews will need excavators, wheel loaders, cranes, etc., and URI can help.

The government, too, will lend a hand, the analysts say. The Infrastructure Investment and Jobs Act of 2021 adds $550 billion in infrastructure spending over the next five years; the Creating Helpful Incentives to Produce Semiconductors and Science (CHIPS) Act of 2022 provides $278.2 billion in spending over 10 years, including semiconductor fab construction; and the Inflation Reduction Act of 2022 contains $393.7 billion in funding for clean-energy investments.

Taking one thing with another, says United, its book of business is becoming less cyclical. "Longer term, the outlook for our industry continues to be very favorable, driven by several tailwinds that we believe are largely independent of macro conditions," the United Rentals CEO, Matthew Flannery, declared on the Jan. 26 earnings call.

Hence, the new URI dividend, instituted at an annual rate of 1.3%, or $1.48 per share per quarter. "We have the intention of growing the dividend over time," CFO Ted Grace told the earnings call audience. In addition to the dividend, United said it means to repurchase $1 billion's worth of stock this year (out of a current market cap of $32 billion).

On top of which, the bulls would like you to know, business is booming. In 2022, United's revenues leapt by 20%, earnings per share by 56%. Last year's EPS of $29.65, in fact, is almost double that of the prior peak of $15.73, in 2017. Meanwhile, the Dodge Momentum Index, which tracks planning-stage nonresidential building projects, rose to a record high of 222.2 in December from 163.7 in December 2021.

The trouble is that neither equity nor credit investors have overlooked these glad tidings. Rated double-B-plus, the penthouse of junk, URI's senior unsecured 4⅞s of 2028 trade at $96.62 for a yield of 5.7%, or just 183 basis points over Treasurys. That yield pickup is closer to what's on offer from triple-B-rated corporate bonds (150 basis points) than from other double-B-rated issues (256). Last year, operating income covered interest expense by 7.3 times and net debt was equal to two times trailing Ebitda.

Since year-end 2019, United Rentals' stock has generated a 174.3% total return, compared with the S&P 500's 35.4%. Granted, the current URI price-earnings multiple of 15.4 looks reasonable enough next to the 18.4-times price tag on the S&P 500, but it's a substantial premium to the average 12.8 multiple that URI commanded in the three years ended 2019.

Out of the 22 analysts who follow the stock, a dozen identify as bullish. While only two say sell, short interest has climbed to 5.7% of the float from 2.7% at the end of last April. Insiders, not so bullish themselves, sold a net 53,235 shares over the past 12 months for proceeds of $18.8 million.

. . .

United Rentals, Inc. at a glance

all figures in $ millions except per share data

	2022	2021	2020	2019	2018
sales	$11,642	$9,716	$8,530	$9,351	$8,047
operating income	3,232	2,277	1,800	2,152	1,951
net income	2,105	1,386	890	1,174	1,096
earnings per share	29.65	19.04	12.20	15.11	13.12
shares outstanding	71.0	72.8	72.9	77.7	83.5
cash	106	144	202	52	43
debt	11,370	9,685	9,682	11,428	11,747
total assets	24,183	20,292	17,868	18,970	18,133

source: company reports

United Rentals could hardly have asked for more than the set of opportunities (misleadingly labeled problems) it was presented with in the time of Covid. When lockdowns were announced in March 2020, the equipment-rental industry prepared for the worst. "Fleets were cut," Mircea Dobre, who rates URI as neutral for Robert W. Baird & Co., tells me. "You saw de-fleeting at the big guys and the little guys as well. United Rentals ended 2019 with 665,000 units in their fleet. They exited 2020 with 615,000 units."

Eventually, as demand came roaring back, supply-chain congestion slowed the production of new equipment. That URI prospered in these macro- and micro-economically gusty conditions is proved by sharp improvement in a composite management metric called "fleet productivity." Gains in equipment utilization, rental rates and product mix pushed readings up by 9.4% in 2022 and by 10.4% in 2021, a bullish eruption compared with the low-single-digit changes common in pre-pandemic times, e.g., down by 2.2% in 2019 and up by 1.9% in 2018.

As one of the biggest North American customers of Caterpillar, Inc., Deere & Co. and Terex Corp., URI gets first dibs on the production of heavy equipment. So even as OEMs struggled to make production meet demand, United boosted its equipment purchases to $3 billion or more in each of 2021 and 2022, compared with $2.1 billion in both 2019 and 2018.

In thus splashing out, United reaped many advantages. First, obviously, it got what the competitors didn't get. Thwarted buyers of backhoes, forklifts, aerial work platforms, etc. discovered they had to rent instead of own, and they very likely rented from URI. For another thing, smaller rental companies, unable to acquire new machinery, watched their disappointed customers turn to URI. Finally, scarcity itself worked its predictable magic. Machinery prices climbed, and with them the gross margin that United earns on used-equipment sales: to 58.7% last year from an average of 39.8% in the three years ended 2019.

"So, we have a setup here in which, if you are a very large buyer of equipment like United Rentals, this is the best possible environment in a generation, as people who have been in the industry for more than 30 years describe it to me," says Dobre. "It would be almost impossible to replicate."

Today, the major OEMs, too, are sitting pretty. "[S]upply-chain improvements enabled stronger-than-expected shipments, particularly in construction industries, and supported an increase in dealer inventories," Caterpillar chairman and CEO James Umpleby told analysts on the Jan. 31 earnings call. "We saw increases in each of our primary segments, and within construction industries, dealer inventories are now in their typical historical range of three to four months of projected sales. In construction industries, the largest dealer-inventory increase came in North America, which has benefited our most constrained region."

Even without a downshift in demand, the greater availability of equipment will likely mean a reduction in fleet utilization and also, therefore, in pricing power. As the availability of new units increases, used-machinery prices may retreat. URI's gross margins on used-equipment sales in 2022 were 18.8 percentage points above the average in the three years ended 2019.

There are a lot of "great things happening" in infrastructure on account of the aforementioned stimulus bills, Chad Dillard, who rates URI a sell for Bernstein Research, tells me. "But, in terms of getting the funding mechanisms set up on the state and municipal level [for these bills], it's probably going to take longer than what everyone expects." It's more likely to be a 2024–25 event, Dillard says, than a recession-mitigating 2023 event.

Even when the various federal spending bills begin making an impact on construction outlays, rental companies may not capture all the projected incremental demand. It's significant that the dollars will be infused not all at once but over the course of years. "Presumably that will give contractors a lot of comfort that these are long and enduring projects and that they should own some equipment as a result," says Stephen Volkmann, who rates URI a hold for Jefferies Financial Group, Inc. "So you may see the pendulum swing back from rent a little bit to own."

United Rentals' end markets are already starting to sag. As noted above, 48% of sales are to customers in the industrial line. Besides the slump in the Manufacturing PMI and regional-manufacturing surveys, the Federal Reserve's index of industrial production registered a fourth-quarter decline, expressed as the annual rate of 1.7%. Lower rental demand from industrial customers would almost seem a foregone conclusion.

While the Dodge Momentum Index hit a new all-time high in December, the Architecture Billings Index slumped to 47.5 in December from 58 in May last year. The ABI, as noted, is the index to watch, especially with regard to nonresidential construction spending—the kind that delivered 47% of URI's 2022 top line.

. . .

Warehouses generated 51% of commercial construction last year, up from just 30% in 2017, and it may come as no surprise to learn that the Everything Store is the nation's top warehouse builder.

"[W]e took a fulfillment-center footprint that we've built over 25 years and doubled it in just a couple of years," Amazon.com, Inc. CEO Andy Jassy explained on the Feb. 2 earnings call. "And then we, at the same time, built out a transportation network for last mile roughly the size of UPS in a couple of years." However, after that capital-expenditure blitz, America's biggest spender on commercial real estate is subleasing excess warehouse space and canceling some expansion plans. And though mortgage rates are off their highs, the run-up in residential borrowing costs has nonetheless taken its toll on home construction.

Because, as Volkmann observes, "equipment is somewhat fungible," a bull can draw only so much consolation from URI's 5% exposure to vulnerable residential markets. Naturally, some of its peers are much more heavily exposed. "If your competitors all of a sudden are calling on your industrial or commercial construction customers because they have spare equipment that used to be utilized in housing, that still hurts you," Volkmann adds.

The bounding equipment-rental business has had a brilliant cycle. But recession or no, the 2021–22 earnings bacchanal is ending, and Mr. Market will sooner or later be saying his goodbyes.

•