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Couldn't be better

The makers and lessors of tank railcars have no complaints about America's weak-as-water business expansion—for them it's a bonanza. The Bakken shale oil boom was a gift from the gods. Washington sweetened it with ultra-low interest rates, then iced it by refusing to build the Keystone XL pipeline, Middle America's own, forever-pending Second Avenue subway line. Collisions and derailments and environmental worries apart, the business of hauling crude oil by rail could hardly be better. It's about to get worse, to anticipate the investment conclusion of this essay.

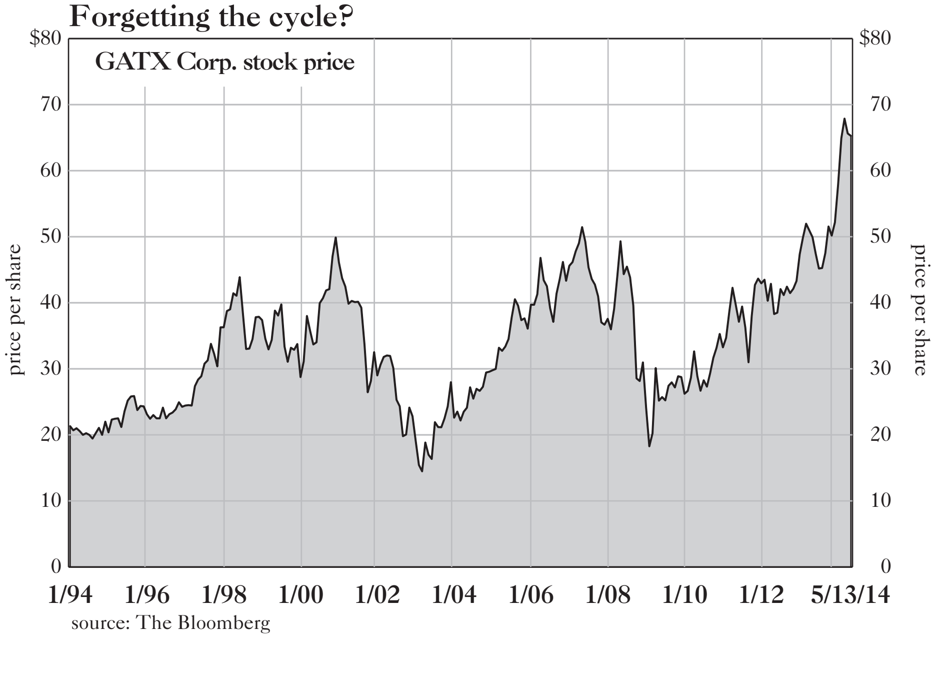
GATX Corp. (GMT on the New York Stock Exchange), the second-largest tank car lessor in North America behind Berkshire Hathaway's Union Tank Car, is the stock in the bearish limelight. GATX is as estimable a company as you ever will sell short. Founded in 1898 and based in Chicago, it's paid annual dividends for 95 uninterrupted years. We base our analysis on the cyclicality of the railcar leasing business and the market's over-generous appraisal of GATX's future earning power; the company itself is blameless.

GATX has its fingers in the aircraft-engine leasing business (in partnership with Rolls-Royce), in dry-bulk freighters (they ply the Great Lakes) and in a nascent Indian freight-car operation. Those are its fingers. Its body and soul are committed to railcars, of which it owns 150,000. The leasing of that rolling stock—about half are tank cars—accounts for 79% of assets and 76% of operating income.

Trinity Industries, Greenbrier Cos. and FreightCar America build many of the tank cars that GATX leases. To understand the bearish case on the lessor, it helps to review the spectacularly bullish results of the manufacturers. Shale drilling set up an urgent demand for rail transportation; the crude had to get to the refineries somehow, by rail if not by pipeline. The railcar makers could scarcely believe their good luck. A generically low-tech $100,000 tank car presently commanded $130,000 and then—in cases of especially desperate demand—as much as $150,000. Since the start of 2013, shares of Trinity and Greenbrier have delivered total returns of 122% and 215%, respectively (FreightCar America, up by only 10%, is the laggard).

In the ordinary course of business, a railcar lessor charges a moderate spread over the Treasury borrowing rate. In the extraordinary course of the Bakken boom, eager lessees consented to higher-than-average lease rates and longer-than-typical contract durations—say, to five years rather than four. "GATX forced both long-duration leases and inflated prices on buyers who were more than able to borrow money at low rates, but simply could not get orders filled by the tank-car makers within a 12-month window," relates colleague David Peligal. "The bull

Forgetting the cycle?



source: The Bloomberg

case is that the company has locked in advantageous terms on a meaningful portion of its 2013 bookings."

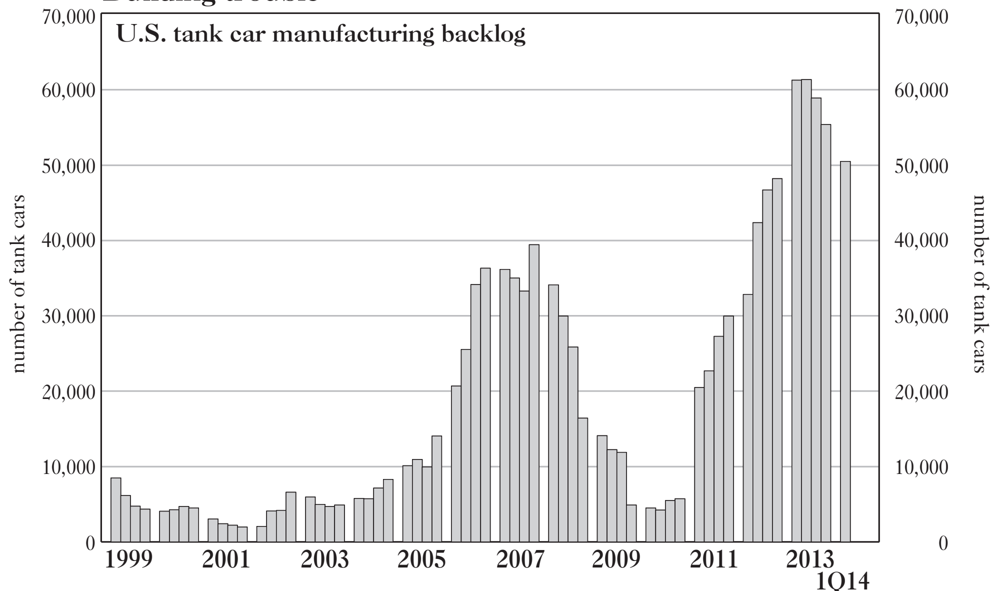
How advantageous? In the first quarter of 2014, renewal lease rates showed a 33.9% jump from the year-earlier reading. "For the full year," Peligal reports, "management is guiding for continued lease-rate gains on the order of 30% to 35%. For perspective, the average lease rate (as reflected in the company's own lease-price index) fell by 11% in 2009 and by 15.8% in 2010; it rose by 6.9% in 2011, by 25.6% in 2012 and by 34.5% in 2013. Since the start of 2013, GATX's common shares have delivered a total return of 55%."

We wonder if the bulls are watching enough television. Dramatic footage of the tank-car-related mishaps in Lynchburg, Va., last month and Lac-Mégantic, Quebec, last year are galvanizing demands for closer regulation of the rail-borne transportation of crude oil. Of GATX's 80,000 tank cars, perhaps 4,000 serve the crude and ethanol trade; 8,000 carry different kinds of flammable liquids. Legislation is expected this year to mandate the retrofitting of tank cars to reduce the chances of catastrophic accidents. No one knows what kinds of cars will fall under the regulatory ukase, nor how much the required work will cost. Speculation has it that owners—including GATX—could wind up spending between $30,000 and $80,000 per designated car.

What would this mean to the bottom line? "In the first-quarter earnings call," Peligal notes, "CEO Brian Kenney said that GATX would 'probably be less likely to do a very expensive retrofit on our fleet because it wouldn't make sense.' Meaning, it would probably cost too much. That's fine, but it's doubtful that the tank cars that can't be used for crude under new regulations would somehow self-destruct. They would find their way into alternative service—carrying food-grade oils, corn syrup or styrene, for instance—and in that capacity help to tilt the supply-demand balance marginally in favor of the lessees. It could be the start of something bearish for the lessors."

The invisible hand probably poses a greater threat to elevated profit margins than even the federal government. Resurgent tank-car prices have called forth tens of thousands of new tank cars. Nearly 29,000 were delivered in 2013, and another 30,600 are expected in 2014. Manufacturers are working off an order backlog of 50,000. For perspective, fewer than 5,000 tank cars came into service as recently as 2010. For further perspective, the population of tank cars is estimated at 330,000. Thus, with deliveries in excess of 30,000, you could replace the entire fleet in 11 years. Inconveniently, a tank car can keep rolling for 40 years.

Building trouble



source: Railway Supply Institute

"[T]here is an increasing level of competition in the North American rail market," said the chairman's letter in the GATX 2013 annual report. "In our experience, aggressive investment by new market participants is one of the primary signs that the tank-car leasing market may be peaking. GATX saw this activity in 2013. The current high returns draw inexperienced entrants to the railcar leasing business—and these entrants assume that the returns will be easy to maintain over the long term. We also are seeing more aggressive investment by certain banking competitors, who use their low cost of funds to win business. We have even seen these competitors fund their long-term railcar purchases with short-term financing, such as bank certificates of deposit. This aggressive behavior drives up asset prices, making it more challenging to grow our fleet in this robust market." Hello, Janet Yellen!

Not that GATX, a Baa2/BBB credit, isn't itself a gainer by today's teensy interest rates. The company raised $850 million in a three-tranche February debt financing. The 30-year tranche had a 5.20% coupon, the $5\frac{1}{2}$-year tranche a $2\frac{1}{2}\%$ coupon and the three-year tranche a 1.25% coupon; there is the cost of capital that the banks are undercutting. At the March 31 reporting date, GATX showed $4.55 billion of debt against $1.42 billion of equity. Earnings before interest and taxes covered interest expense by a factor of 2.3:1. For the most part, the company borrows on its name; particular assets—tank cars and ships—are largely unencumbered.

What you, gentle reader, would do at the top of the market, GATX is, in fact, doing. Management is selling some tank cars at prices well above acquisition cost and taking the profit into income. "Essentially," as Peligal notes, "what they're doing is booking liquidating earnings. Nothing nefarious here, of course. The risk to the share price would stem from a misguided hope that boom-like conditions are somehow not cyclical."

No need to conjecture that such gains are more in the way of manna than of ordinary operations: Just turn your eye to the accompanying graph. Thus, with respect only to the North American rail segment, net gains on asset dispositions in the first quarter amounted to $24.8 million, up from $10.2 million in the year-earlier period. Such gains-on-sale evidently account for much more than half the period's net income. They chipped in only 18% in 2008 and less than 30% as recently as 2011. Without presuming to read the mind of the management, we believe that we can hear the corporate wheels turning: "When the ducks quack, feed them," the higher-ups are saying.

Quoted at a price of 66, representing 13.7 times the consensus sell-side estimate for 2015, and yielding 2%, GATX looks anything but rich. Those looks are deceiving. Earnings are likely peak earnings, as the railcar market builds its way to cyclical trouble. "Looking at Bloomberg," Peligal observes, "we see that GATX is trading at a price to tangible book value of 2.3 times. That is the highest since 2000; subsequent to that year, the average is closer to 1.75 times. A bear (that's us) might suggest that GATX's book value is flattered by the inflated state of the tank car market. You could say that investors are currently paying peak prices for peak everything."

On April 29 and April 30, Kenney sold a total of 26,159 shares of the company he leads at prices close to 65. His remaining holdings come to 96,910 shares, of which he retains 88,383 directly. No shame in that, needless to say. If you were Kenney, wouldn't you be lightening up, too?

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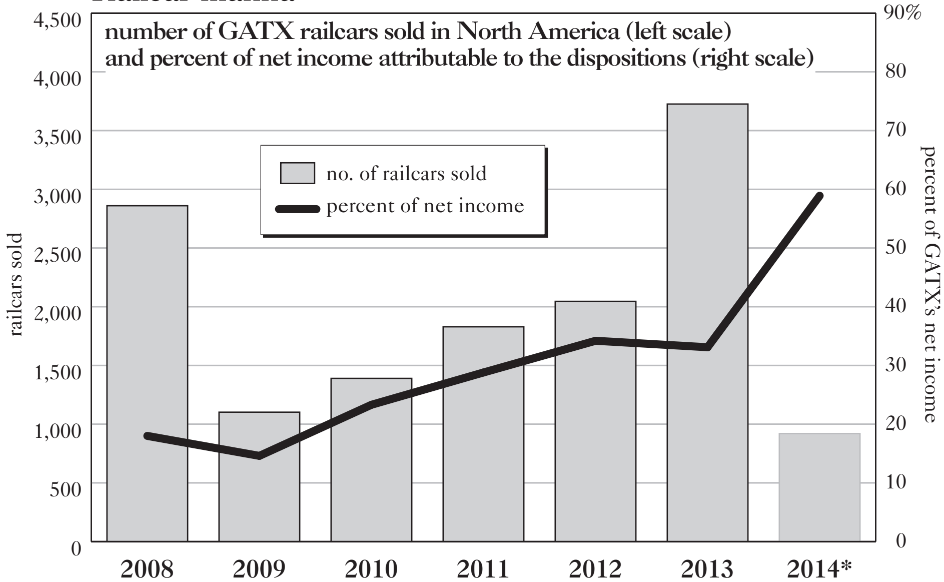
Railcar manna



source: company filings

*as of March 31