THE FUTURE IS RIDING ON THE RAILROAD: WHY IT'S TIME TO FOCUS ON ACQUISITION

AN EQUIPMENT FINANCING & LEASING PERSPECTIVE

Citizens Commercial Banking®

For shippers, demand is up – but so are freight costs and competition for space. Rail still offers a cost-effective alternative to other modes of transportation. In fact, rail may save shippers as much as $100 billion a year, compared to the cost of shipping by truck alone.[1] The trouble is, today's uncertain global economy makes rail planning a challenge. How do you match 50-year assets to a shifting demand forecast?

Shippers are always looking to balance control and flexibility when it comes to the capacity equation: ensuring the capacity they need, when they need it, at the lowest possible price. As shippers navigated the rocky economic recovery, they leaned towards flexibility. When it came to rail, flexibility was especially appealing due to regulatory changes, tight supply of cars and the longer lead times to build them. An example of the market volatility in recent years was the 4,400% increase in crude-by-rail shipments[2], followed by a ramp up in new tank car builds and rising costs. But by early 2015, there was a significant shift in demand, distribution and financing:

- Shipments of crude plummeted
- New tank car production stalled due to regulator debate over proper car design
- The spot market for equipment softened and monthly lease rates for crude carrying tank cars fell 70% between December 2013 and June 2015[3]

Flexibility certainly has a place in the transportation equation – both market downturns and upside surprises like bumper agriculture crops necessitate nimble solutions. However, now in a maturing recovery, shippers have the opportunity to combine flexibility with greater fleet control in order to achieve shipping goals more efficiently, while uncovering greater bottom line value.

THREE ROUTES TO HIGHER CAPACITY

Rail shippers can choose from three options to meet their shipping requirements. Each offers varying degrees of flexibility and control:

- **Railroad-supplied equipment.** Many shippers opt to have their freight hauling railroad provide railcars. This is a viable solution, assuming the railroad has the equipment to meet shippers' specific loading and unloading requirements. Beyond the equipment configuration equation, equipment availability is also a challenge. As boxcars continue to age, car replacement becomes a pressing need. However, it's unknown whether future boxcars will continue to meet the needs of those shippers leveraging railroad-supplied equipment today.
- **Operating lessor-supplied equipment.** The operating lease companies provide shippers with a strategic approach to managing surge capacity needs by offering a wide array of equipment configurations – provided the lessor has the needed equipment available. Lessors can be expected to run at utilization ("on lease") rates above 93%.[4] Therefore, shippers looking for equipment during periods of tight supply are likely to succumb to sub-optimized equipment configurations and premium rates.

  Lulled by the convenience – including services like registering, shopping and maintaining railcars – shippers can become reliant on the lessor channel. Dependence is particularly high for firms with limited staffing. But shippers beware. A strategy focused on flexibility and convenience can expose a shipper to periodic shortages of equipment and spikes in lease rates. Equipment tends to renew in place three quarters of the time, generally at rates higher than in the prior lease. For some, this pattern of ongoing lease renewals at increased rates can become automatic, leaving shippers blind to corporate borrowing options, even when rates are attractively low.

  To gauge lessor reliance, shippers should consider renewal frequency. If a shipper renews a piece of equipment twice, meaning three leases have been applied to the same asset, it is likely time to revisit the equipment financing strategy with an eye towards acquisition.

- **Acquisition of equipment, either through ownership or a long-term lease at 100% financing.** It takes from six months to two years to build a railcar to spec. But once built, obsolescence is minimal, and the asset can last half a century. Acquisition can open opportunities for cost savings, certainty of availability, control of equipment configuration and equipment quality. What's more, acquisition can typically be done with off-balance-sheet financing structures.

Of these three options, the control afforded by acquisition, including longer term leases, better ensures that shippers will have the capacity they need when they want it at a price they can afford. This may be one of the reasons why privately owned railcars now carry 56% of tonnage for all railroads.[5]

WHY GOING DIRECT CAN LEAD TO GREATER PROFITS

To ensure capacity and control costs, the best practice is to place equipment financing emphasis on direct ownership or long-term leases. In general, 80% of the base fleet should be acquired with the help of an asset finance provider, and the other 20% secured through operating leases to accommodate unpredictable surges in demand.

For some shippers, getting to that mix will require breaking the cycle that keeps them trapped in excessively long operating leases. With disciplined planning and forecasting, a shipper can migrate to a mix of short and longer term leases. As a result of this equipment financing restructuring, shippers can better employ their treasury group's resources and minimize lease costs.

Those shippers with staffing constraints have a number of alternative service providers in the industry to help with this task. More mature shippers should work with their finance providers on smart refinancing arrangements in order to unlock profit opportunities hidden inside stale leases.

Demand forecasting has been a tricky task of late, but shippers can no longer leave their fates in the hands of operating lessors. It's time to make a stronger commitment to the future of their businesses with a strategy built on asset control. A smart, disciplined approach to making the best use of transportation – including rail and intermodal – can help shippers build better cash flow and uncover new income.

Intermodal Activity Accelerates

The U.S. intermodal industry saw record-breaking rail traffic in June 2015, with 1.1 million originated containers and trailers, up nearly 4% y/y.[6] The combination of expanded rail intermodal infrastructure ($0.40 out of every rail revenue dollar from 1980-2014), lower fuel costs and a truck driver shortage impacting resources for longer hauls has enhanced the service and accelerated the contribution of this interdisciplinary channel. In 2014, rail intermodal accounted for 22% of major railroad revenue, more than any other commodity group and ahead of coal – the long standing revenue leader.

By relying less on America's highways, intermodal is shifting tonnage from and reducing maintenance of heavily traveled motorways, while providing environmental benefits through reduced green house gas emissions.[7] While the market will naturally oscillate, the intermodal channel affords shippers' gains in efficiency and effectiveness by diversifying infrastructure and service risk across multiple transportation modes.

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1 The Economic Impact of America's Freight Railroads, *Association of American Railroads,* May 2015.

2 "Rail, waterways overtaxed by growing energy needs," *Quadrennial Energy Review, E&E News PM,* April 21, 2015

3 "Once shunned for oil, ethanol makes a return to U.S. rails," *Reuters,* June 23, 2015

4 "Why Railroads Can't Keep Enough Boxcars in Service," *The Wall Street Journal,* June 21, 2015.

5 "A Preliminary Investigation of Private Railcars in North America," Thomas M. Corsi, Ken Casavant and Tim A. Graciano, *Journal of the Transportation Research Forum, Vol. 51, No. 1,* Spring 2012

6 "Intermodal industry moves record-breaking number of containers in June," *Memphis Business Journal,* July 2, 2015

7 "Rail Intermodal Keeps America Moving," *Association of American Railroads,* May 2015