Understanding the Tank Railcar Lease/Finance Marketplace

Northeast Association of Rail Shippers

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Railroad Financial
CORPORATION

RFC Background

- RFC is a financial advisory firm founded in 1989 (Twenty-Five Years!):
  - The only firm focused solely on the global rail industry.
  - Arranged over $20 billion in financing related to rolling stock.
  - The principals in RFC have more than thirty years rail equipment financing experience.
  - Recognized industry leader in advisory work for rail equipment.

What does RFC do for its clients?

- Financial Analysis (before, during and after transactions are completed)
- Transaction Structuring
  - Currently restructuring fleet of 3,000 railcars for shipper
  - Lease of 1200 tank railcars for crude service
  - Lease of 1300 plastic pellet hoppers
  - Arranging various other lease financing
- Lease Documentation
- Fleet Planning and Analysis
- Market Survey, Input and Study
- New Railcar Acquisitions
- Lease End Negotiations

Topics to be covered

1. The Regulatory Puzzle
   - Lessee/Lessor Issues
   - The Retrofit
2. Tank Railcar Lease Marketplace
3. Today's Railcar Bubble
4. Tomorrow's Railcar Bubble
5. Who is Benefiting from Today's Market?
6. 2014 – 2015 Finance Market Trends

The Regulatory Puzzle

- Raise your hand if you love the DOT and PSHMA!
- Impending regulatory changes in railcar design dominate the rail industry
- Comment period ended September 30, 2014
  - As of Sept. 29 at 11:59 p.m., Regulations.gov indicated 2,440 public comments had already been received on the proposal.
- What issues remain critical
  - Timing for implementation
  - Potential for grandfathering of existing cars
  - Ability of industry to retrofit cars
  - All "flammables?" Some "flammables?" All crude? Some crude?
- As hesitation over the "flammable car" lingers, what is driving tank railcar market
  - Additional tank car types under construction
  - Long term demand trends remain strong

The Regulatory Puzzle – Lessee/Lessor issues

- How will the economics of upgrades work
  - Most (read: all) full service leases contain provisions for "Mandatory Modifications"
  - Lessor pays cost of upgrade
  - Lessee pays a portion of the cost of the upgrade amortized over the remaining term of the lease
  - Usually a percentage of each $100 spent by Lessor
  - Percentage amount always open to negotiation
- Mandatory Modification provisions were not drafted to anticipate modifications for the amounts (Say $50,000) contemplated in the changing tank car spec
- Potential Lessee cost increase could be as high as (or higher than) $1,000.00 per car per month

The Regulatory Puzzle – Lessee/Lessor issues

- Lessees have little leverage in negotiations surrounding mandatory modifications
- Requires overall leverage against lessors
- Generally, lessees do not have option to return cars still under lease
- Obligation to pay rent under lease (even full service) is "hell and high water"
- Many leases do not even offer rental abatement during period of mandatory modification
- In the "worst case" scenario, inability to modify cars in timely manner could leave a lessee paying rent and unable to use car in specified service
- All lessees what to pay a pro rata share of the cost associated with useful life of upgrade. Leases are typically not drafted this way

The Regulatory Puzzle – The Retrofit

- Final result of retrofit still undetermined
- Likely result is continued long term backlog for tank railcars
- The need for retrofits will increase pressure on new manufacturing marketplace
  - Where will the work be completed
  - Fitting in with HM-216
  - Scope of tank railcar modification work
  - How many cars will require retrofit to run in flammable service? Will it include Ethanol?
- Timing of retrofit: Capacity is for 6,000 cars per year <u>right now</u>. Expect capacity build outs once retrofit standard is established
- Estimated number of cars for retrofit 40,000 – 75,000 some estimates as high as 100,000

The Regulatory Puzzle – The Retrofit

- Speed and unit train service are two big differences regulators are clearly struggling to make adaptation to for modern service
- Counterpoint – Ethanol has been in unit train service for years
- Don't forget: the push on DOT 111A began in 2009 after the ethanol accident in Cherry Valley
- In some ways, one BIG problem is that there are too many solutions (train speed, train size, separation of NGL's, car design, sub classification of crude types and commodities) and too many conflicting interests for a "one size fits all" solution to manifest itself ***and*** accommodate public opinion.
- After sitting on the 1232 design for two years, it would have been difficult for the DOT and PSHMA to come out in support of that design without additional safety improvements

The Regulatory Puzzle – The Retrofit

- Industry stance on retrofit issue: "You cannot put a price on safety." Well…
- DOT proposal specified either 7/16" or 9/16" tank to support the transportation of flammable commodities
- American Petroleum Institute and Class I RR's have proposed an 8/16" (1/2") tank: the "compromise" car
- Greenbrier supports the 9/16" car without ECP brakes (the "Tank Car of the Future"
- The difference is in the payload of the car. Data supported that incremental increases in tank thickness provided modest improvement. Biggest improvement came from jacketing and thermal insulation
- Railroad veterans think that this is a large overreaction where a broad brush is being used to paint the muntin in your window
- Familiar refrain: No car could have withstood Lac-Mégantic

Tank Railcar Lease Marketplace

- **Lease Rates: High** – After a rate peak (spike) in mid 2013, lease rates continue to run high as availability is king. As big money has poured into the oil producing regions, some of the sharper lease pricing has dulled. Is the small money out of the game?
- **Lease Terms: Long** – Operating lease terms trending at seven years on new cars being built today
  - Limits risk to pipeline capacity shift
  - At high lease rates, lessors are able to write down assets and minimize investment risk when the oversupply bubble finally arrives
- **Lease Terms and Conditions: Lessor Favorable**
  - Mandatory Modifications
  - Return Condition
  - Mileage Charges
- **Impact not limited to CBR style cars. Rising tide lifts all**

What is driving the market today?

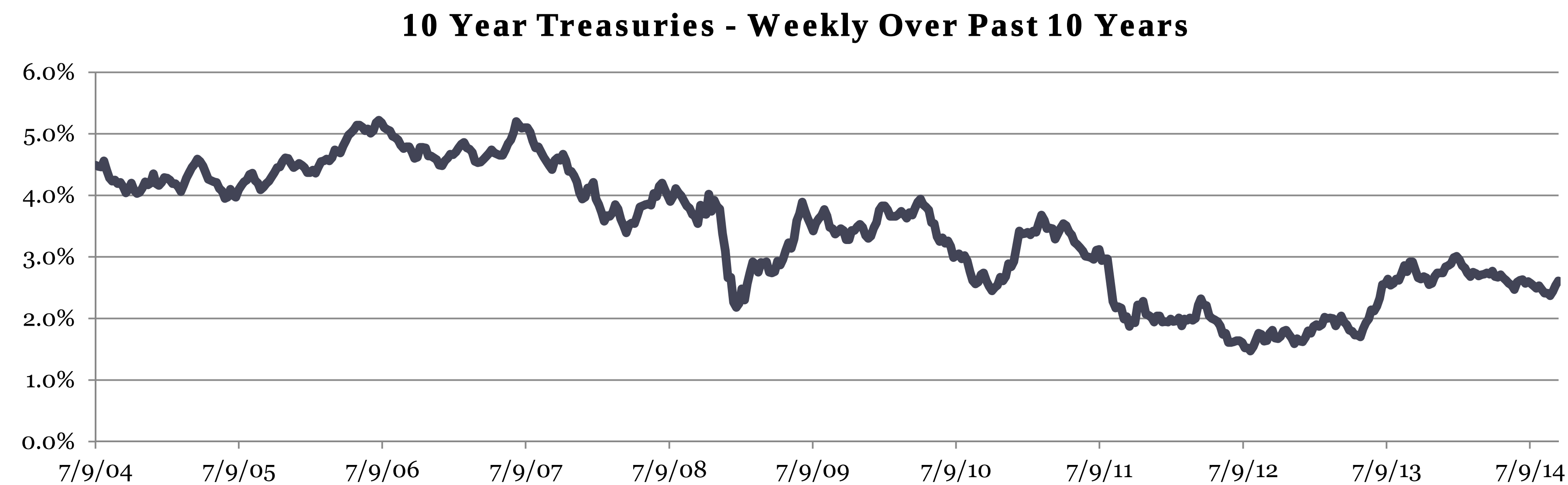
- **Demand:** The need for tank railcars continues to drive demand in the market. Current demand is tempered by fear of regulation

- **Low Cost of Capital:** A long period of low interest rates enables investment of all types, infrastructure, ownership, leasing

- **Buzz:** CBR (crude and frac sand) continues to be the talk of the market, with ethanol running a close second (cost in modifying the ethanol tank fleet). Also seeing spillover in demand to plastics and grain as a result of shrinking new car production capacity

- **Pipelines:** How much of the long term capacity for Crude by Rail (CBR) is going to be lost when (and if) pipelines are built. What's the timeframe for pipline construction (such as XL) if and when approvals are given? How much power do the greens have in Canada to hold up the pipeline approval process?

Treasury Rates



Tank Railcar Lease Marketplace

Tank Railcar Type	New Car Price (2014)	Lease Rate (2014)	Lease Rate (2012)	New Car Price (2010)	Lease Rate (2010)
DOT116A (28 Mg)	155,000	$1,750	n/a	n/a	n/a
105J300	235,000	$1,900	$1,800	$165,000	$650
DOT 111A (31 Mg)	140,000	$1500	$1,750	$100,000 (30Mg)	$450
25Mg C/I (Non flammable)	145,000	$1,500	$1,700	$115,000	$575

Today's Railcar Bubble

- Rail industry used to equipment bubbles
- Generally railcar manufacturing bubbles are more broad based in scope
- Bubble fueled by low cost capital, infrastructure build out and decreasing railroad velocity
- All bubbles are not created equal
- If you remove the regulatory changes headed into the tank car market, the future prospects for the tank market, while not at full balance by any means, would be less robust

Tomorrow's Railcar Bubble

- The post DOT regulatory implementation period tank railcar lease market will resemble the forty day flood
  - Lessor's, looking at piles of cars that cannot be retrofit will move to repurpose cars quickly
  - Lease rates on DOT 111As that cannot be retrofit and on pre DOT reg 23 Mg, 25 Mg tank railcar should also see a significant decrease in demand
- Don't get too excited: Tank railcar lessors have exercised restraint and maintained their aggressiveness throughout the increase in demand. Many tank railcars are on leases with term of five and seven years of above average lease rates
- Some lessees will be luckier than others in terms of their ability to take advantage of the changes
- If you remove the regulatory changes headed into the tank car market, the future prospects for the tank market, while not at full balance by any means, would be much less robust at this point in the cycle.

Who is Benefiting from Today's Market?

- **Lessors:** Which lessor doesn't love high lease rates?
- **Component Suppliers:** After years of purging and consolidation in the supply industry in the early 2000s, the survivors are well capitalized, strong multi platform companies that are profiting from the longest bull market in railcars that many of us will ever see. Historic.
- **Manufacturers:** Heading out of the economic downturn from the recession, the railcar manufacturing group was on the upswing before the rest of the economy while their stock prices languished. With backlogs high and predicted demand strong, building railcars is finally a sexy business. Two year backlogs on covered hopper railcars! You might as well have told me that metal birds would rule the skies
- **Lessees:** KIDDING! TYPO!
- **Lessees:** Low capital costs continue to fuel a competitive market many lessees are accessing to their benefit. For those lessees that have accessed the competitive furor of the market, they are attracting lease rates that rival the rates of a decade ago for cars that cost 30 -40% more in cost. Ask me how!

2014 - 2015 Market Trends

- Its all about the regulatory environment. The industry waits and watches and comments and waits. Gentleman: start your lawsuits!
- How many new tank railcars and retrofits can the industry absorb?
- What is the duration of the velocity impacted car supply shortage?
- For how many years can the CBR boom carry the industry?
- When will interest rates begin to rise: Is the Fed's latest prediction (sometime in 2015) correct?
- Will the Class I Railroads become active and long term tank car owners?

THANK YOU.