Ryder System (R) Earnings Report: Q4 2015 Conference Call Transcript

The following Ryder System conference call took place on February 2, 2016, 11:00 AM ET. This is a transcript of that earnings call:

Company Participants

- Bob Brunn; Ryder System; VP - IR
- Robert Sanchez; Ryder System; Chairman, CEO
- Art Garcia; Ryder System; CFO
- Dennis Cooke; Ryder System; Global Fleet Management Solutions
- John Williford; Ryder System; Global Supply Chain Solutions

Other Participants

- Benjamin Hartford; Robert W. Baird; Analyst
- David Ross; Analyst Stifel Nicolaus; Analyst
- Scott Group; Wolfe Research; Analyst
- Matt Brooklier; Longbow Research; Analyst
- Justin Long; Stephens; Analyst
- Kristine Kubacki; Avondale Partners; Analyst
- Art Hatfield; Raymond James; Analyst
- Jeff Kauffman; Buckingham Research Group; Analyst
- John Barnes; RBC Capital Markets; Analyst
- Todd Fowler; KeyBanc; Analyst
- Casey Deak; Wells Fargo; Analyst

MANAGEMENT DISCUSSION SECTION

Operator:

Good morning. Welcome to Ryder System , Incorporated fourth-quarter 2015 earnings release conference call.

Today's call is being recorded. If you have any objections, please disconnect at this time.

I would like to introduce Mr. Bob Brunn, Vice President, Corporate Strategy and Investor Relations for Ryder. Mr. Brunn, you may begin.

Bob Brunn (VP - IR):

Thanks very much. Good morning. Welcome to Ryder's fourth-quarter 2015 earnings and 2016 forecast conference call.

I would like to remind you that during this presentation, you will hear some forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on Management's current expectations and are subject to uncertainty and changes in circumstances.

Actual results may differ materially from these expectations due to changes in economic, business, competitive, market, political and regulatory factors. More detailed information about these factors is contained in this morning's earnings release and in Ryder's filings with the Securities and Exchange Commission.

Presenting on today's call are Robert Sanchez, Chairman and Chief Executive Officer; and Art Garcia, Executive Vice President and Chief Financial Officer. Additionally, Dennis Cooke, President of Global Fleet Management Solutions; John Diez, President of Dedicated Transportation Solutions, and Steve Sensing, President of Global Supply Chain Solutions, are on the call today and available for questions following the presentation. With that, let me turn it over to Robert.

Robert Sanchez (Chairman, CEO):

Good morning, everyone, and thank you for joining us. This morning, we'll recap our fourth-quarter 2015 results, review the asset management area, and discuss our forecasts for 2016. Then we'll open up the call for questions.

With that, let's turn to an overview of our fourth quarter results. Comparable earnings per share from continuing operations were $1.66 for the fourth quarter 2015, up 4% from $1.60 in the prior year. Comparable results were below our forecast range of $1.72 to $1.82, but were impacted by $0.06 of unusual insurance-related items.

Absent this, we were at the low end of our forecast range due to our used vehicle sales and rental results. Fourth quarter comparable results exclude $0.19 of restructuring and other costs, and $0.05 of nonoperating pension costs. The restructuring costs during the quarter are related to workforce reductions impacting approximately 250 employees, and to a lesser extent, the pending divestiture of a small logistics operation in Canada.

Comparable earnings from the prior year exclude $1.38 primarily for pension buyout cost. Operating revenue which excludes fuel and subcontracted transportation revenue grew by 7% to a record $1.4 billion for the fourth quarter, and was higher in all business segments. Excluding the impact of foreign exchange, operating revenue grew by 9%.

Total revenue increased by 1% and was impacted by lower fuel costs passed through to customers, and foreign exchange. Page 5 includes some additional financial information for the fourth quarter. The average number of diluted shares outstanding for the quarter increased to 53.3 million shares, up from 53 million shares last year.

In December, our prior repurchase program expired and we received Board authorization for a new two-year, 2 million anti-dilutive share repurchase plan. The new plan allows Management to repurchase up to 1.5 million shares issued to employees after December 1, 2015, and another 500,000 shares from the recently expired plan that were not repurchased while activity was paused in early 2015.

We expect to begin repurchases in mid-year 2016, but we'll continue to evaluate the appropriate timing, primarily based on our declining balance sheet leverage.

Excluding pension costs and other items, the comparable tax rate was 32.1%, below the prior year's rate of 34.4%, reflecting a $2 million Canadian income tax settlement. Page 6 highlights key financial statistics on a full-year basis. Operating revenue grew at 6% to $5.6 billion, or increased by 8%, excluding FX.

Comparable EPS from continuing operations were $6.13, up 10% from last year. The spread between adjusted return on capital and cost of capital widened to 140 basis points, up 30 basis points from the prior year, driven primarily by higher leverage and higher earnings. I'll turn now to page 7 and discuss key trends we saw in the business segments during the quarter.

Fleet Management Solutions operating revenue, which excludes fuel, grew 7%, driven mainly by growth in full-service lease and commercial rental. Excluding the impact of foreign exchange, FMS operating revenue was up by 9%. Full-service lease revenue increased 7%, or 9% excluding FX, due to fleet growth and higher rates on replacement vehicles, reflecting the higher costs of new engine technology.

The lease fleet grew organically by 6,800 vehicles year-over-year, excluding the impact from planned reductions of UK trailers. This was above our initial forecast of 4,000 vehicles for the year, and above our most recent forecast of 6,000 to 6,500 vehicles. Sequentially from the third quarter, the lease fleet increased by 1,600 vehicles excluding UK trailers.

Miles driven per vehicle per day on US lease power units increased 1% versus the prior year and continued to run at normal historical levels. Contract maintenance revenue increased 2%. The average contract maintenance fleet grew by approximately 3,900 vehicles from the prior year and 4,100 units sequentially, reflecting a significant new customer that started up late in the fourth quarter and will primarily benefit revenue in 2016.

Contract-related maintenance was up 14% from the prior year. Included in contract-related maintenance are 7,200 vehicles serviced during the quarter under on-demand maintenance agreements, an increase of 29% from the prior year. Commercial rental revenue was up 6% for the quarter, or 8% excluding FX.

Although US demand increased, it was up by less than expected and reflected about two weeks' later start to the holiday shipping season versus our forecast. We also saw less robust demand than anticipated in the tractor class. Global pricing was up 3% for the quarter, reflecting higher pricing in the US and Canada, and was in line with our expectation.

The average rental fleet grew by 7% from the prior year. Rental utilization on power units was 77.6%, down 250 basis points from the prior year, but still at a strong level. Utilization comparisons reflect the demand items I mentioned earlier, as well as unusually high utilization levels in the prior year.

Although commercial rental delivered solid growth, due to a high level of uncertainty regarding the macro environment and somewhat less robust demand conditions with rental tractors, we made a decision to downsize our fleet during the quarter in order to more conservatively position our fleet for 2016. The ending rental fleet declined by 1,700 vehicles sequentially from the third quarter. Used vehicle results were negatively impacted primarily by lower pricing on tractors.

I'll discuss those results separately in a few minutes. Overall, FMS earnings increased due to higher full-service lease results and solid rental performance. Better lease results reflect fleet growth and vehicle residual value benefits.

These benefits were largely offset by lower used vehicle sales results and maintenance costs to downsize our rental fleet and reduce out-of-service vehicles. Earnings before tax and FMS increased 1%.

FMS earnings as a percent of operating revenue were 12.4%, down 70 basis points from the prior year. Of this 70 basis point decline, 60 basis points was due to used vehicle sales.

I'll turn now to Dedicated Transportation Solutions on page 8. Operating revenue growth was strong at 11% due to new business, higher volumes and increased pricing. Total revenue was up 5%, reflecting lower fuel costs passed through to customers.

DTS earnings increased 1% due to higher operating revenue and overhead cost improvements, partially offset by a customer bankruptcy charge of $1.5 million. Segment earnings before tax as a percent of operating revenue were 5.9%, down 60 basis points from the prior year. The bankruptcy charge negatively impacted EBT margins by approximately 80 basis points.

I'll turn now to Supply Chain Solutions on page 9. Operating revenue grew 4% due to new business, higher pricing, and increased volumes. SCS operating revenue grew 7%, including the impact of foreign exchange.

Total revenue was slightly down, as higher operating revenue was offset by lower third party purchase transportation costs, and lower fuel costs passed through to customers. SCS earnings before tax were up 5% due to operating revenue growth, improved operating performance, and overhead cost improvements, partially offset by a large medical claim of $2.2 million in the quarter. Segment earnings before tax as a percent of operating revenue were 7.4% for the quarter, up 10 basis points from the prior year.

The large medical claim negatively impacted EBT percent by nearly 70 basis points. Page 10 shows the business segment view of the income statement I just discussed. It is included here for your reference.

Page 11 reflects our full-year results by business segment. In the interest of time, I won't review these results in detail, but will just highlight the bottom line results. Comparable earnings from continuing operations were $327 million, up 10% from last year.

At this point, I'll turn the call over to our CFO, Art Garcia, to cover several items, including capital expenditures.

Art Garcia (CFO):

Thanks, Robert. Turning to page 12, full-year gross capital expenditures were $2.7 billion, to up $400 million from the prior year.

This increase reflects full-service lease fleet growth due to customer contracts signed, as well as planned rental investments. We realized proceeds primarily from the sale of revenue-earning equipment of $427 million. That's down $70 million from the prior year.

The decrease primarily reflects planned lower volumes of vehicles sold. Full-year net capital expenditures increased by $468 million to almost $2.3 billion. Turning to the next page, we generated cash from operating activities of $1.44 billion for 2015, up approximately $60 million.

The increase was driven primarily by higher cash-based earnings. We generated almost $2 billion of total cash during the year, consistent with the prior year. Cash payments for capital expenditures increased by around $410 million to $2.7 billion.

Free cash flow for 2015 was negative $728 million, versus the prior year negative of $315 million, reflecting increased capital expenditures to support growth. Our growth capital spend for 2015 was $1.3 billion. Page 14 addresses our debt to equity position.

Total debt of approximately $5.5 billion increased by almost $800 million from year end 2014. Debt to equity at the end of 2015 increased to 278%, up from 260% in the prior year, and just above the top end of our target range of 225% to 275%. Leverage increased due to foreign exchange, as well as vehicle investments to fund growth.

Year-end equity was just under $2 billion, up $168 million for the year, primarily due to earnings partially offset by foreign exchange and dividends.

At this point, I'll hand the call back over to Robert to provide an asset management update.

Robert Sanchez (Chairman, CEO):

Thanks, Art.

Page 16 summarizes key results for our asset management area. Used vehicle inventory held for sale was 8,000 vehicles, up from 5,500 vehicles in the prior year, and 1,900 vehicles above the third quarter.

This is at the high end of our target range of [6,000] to 8,000 vehicles. The increased inventory reflects our decision during the fourth quarter to downsize rental fleet in order to position it more conservatively for 2016. We expect to work this inventory down over the next few quarters and end 2016 closer to the bottom end of our target range.

We sold 4,500 used vehicles during the quarter, down 2% from the prior year, but up 2% sequentially from the third quarter. We sold 17,900 vehicles during the full year. During the quarter, used vehicle pricing declined by more than forecasted, particularly for tractors.

Compared with the fourth quarter of 2014, proceeds from vehicles sold were down 5% for tractors and up 5% for trucks. From a sequential standpoint, tractor pricing was down 9% and truck pricing was down 2% versus the third quarter of 2015. As compared to peak prices realized in the second quarter, overall used prices were down 9%, as compared to our expectations of down 7%, driven primarily by used tractor pricing, which was down 11% from the second quarter peak.

The number of leased vehicles that were extended beyond their original lease term decreased versus last year by around 750 units, or 12% during 2015, and is well below recessionary levels. This reflects a lower number of lease contract expirations this year. Early termination of leased vehicles increased by 70 units this year and were generally in line with levels seen over the past five years.

I'll turn now to page 18 to cover our outlook for 2016. Pages 18 and 19 highlight some of the key assumptions we've made in the development of our 2016 earnings forecast. As you know, the economic and freight environments are highly uncertain at the moment, which makes forecasting challenging.

Our approach to the forecast was to assume a significant negative impact in used vehicle sales and a weaker commercial rental environment, as well as some headwinds in new lease sales. We think this is a prudent approach to our initial forecast for the year and we'll make any appropriate adjustment as conditions merit. When looking at our earnings forecast, it is especially important this year to consider the assumptions that are driving those numbers.

In -- our 2016 forecast anticipates slow to moderate growth for the overall economy. We're expecting our average interest rate to be consistent with 2015, as lower fixed rate refinancing rates offset higher variable rates. We're assuming foreign exchange rates remain stable at their current levels, which will result in a negative year-over-year impact to both revenue and earnings.

In fleet management, we're expecting continued growth in full service lease based on our strong recent sales activity and secular trends that favor outsourcing, somewhat offset by softer freight conditions. For 2016, we're forecasting lease fleet growth of 3,500 vehicles excluding UK trailers, which would be our fifth consecutive year of organic fleet growth. This is similar to the initial forecast we provided in 2015 of 4,000 vehicles.

We expect over a third of our new lease sales to continue to come from customers new to outsourcing, driven by our initiatives to penetrate the non-outsourced market. In rental, we're assuming softer conditions with demand forecasts down 5%. This is worse than what we experienced in 2012, but not as bad as what we saw in the last freight recession.

Utilization is expected to be down, especially in the first half, while pricing is forecast to be up slightly reflecting higher vehicle costs. As I mentioned earlier, we took actions during the fourth quarter to more conservatively position our fleet in light of a softer and uncertain market condition. For the full year, we expect the average rental fleet to be down 4%, or 1,900 vehicles.

Our forecast also assumes used vehicle pricing will decrease materially in 2016, particularly for tractors. Tractor pricing is forecast to be down by 20% from the peak in the second quarter of 2015, which would drive an overall price decline of 11% across all vehicle types. This is equivalent to the price declines we've seen in other recent downturns, including the 2008-2009 period.

Volumes are expected to be higher as we work down the inventory of vehicles that were out-serviced during the fourth quarter of 2015. Significant increases in used vehicle pricing over the past five years will benefit depreciation rates in 2016, as these results are blended into our vehicle residual calculation. These benefits will partially offset lower expected gains on used vehicles sold.

Overall, we expect higher FMS earnings due to growth in our contractual full-service lease product line, partially offset by lower used vehicle sales results, and to a lesser extent, commercial rental. Turning to page 19, DTS revenue is forecast to benefit from strong new sales activity, including continued conversion of lease customers to Dedicated Solutions.

Dedicated earnings will benefit from revenue growth, lower insurance, and lower overhead costs. In supply chain, we expect revenue growth driven by new sales, partially offset by foreign exchange impacts. We're expecting volumes to be stable, with earnings growth coming from new business.

We've made reductions in discretionary and overhead costs in order to align our business with slower expected market conditions. We anticipate resuming anti-dilutive share repurchases in the second half of 2016, based on our current leverage projections. Despite this modest increase in share -- despite this, a modest increase in share count will negatively impact earnings since repurchases have been paused since early 2015.

Finally, we're forecasting an EPS headwind due to a higher tax rate, resulting from increased earnings in higher tax jurisdictions. Page 20 provides a summary of key financial statistics for our 2016 forecast based on these assumptions. We're expecting operating revenue to grow 5%, with revenue growth in all business segments.

Comparable earnings per share is forecast in a range of $6.10 to $6.30 in 2016, as compared to $6.13 last year. This reflects continued growth in our contractual product lines, offset by a softer expected environment for our transactional businesses. Our average diluted share count is forecast to increase to 53.6 million shares from 53.3 million last year.

We project a comparable tax rate of 36.3%, up from last year's rate of 35.3%. The spread between our return on capital and cost of capital is forecast to narrow to 100 to 110 basis points, down by 30 to 40 basis points from last year, primarily reflecting lower results in used vehicle sales. Our 2016 return on equity forecast is 15.3%.

The next page outlines our revenue expectations by business segment. In fleet management, operating revenue is expected to increase by 4% in 2016, or 6% excluding foreign exchange. FMS growth is driven primarily by higher full-service lease and contract maintenance revenue, partially offset by forecasted declines in commercial rental.

FX is expected to negatively impact revenue growth by 2 percentage points. Full-service lease revenue is forecast to grow by 6%, or 8% excluding FX. A higher lease fleet count due to new sales activity and higher lease fleet reflect increased vehicle cost -- vehicle investment costs, are expected to be partially offset by weaker freight conditions.

Longer term, we continue to expect that FMS can deliver operating revenue growth in the high single digits due to both market trends and our initiatives to drive increased rates of outsourcing. We are forecasting a 4% decrease in rental revenue, reflecting expectations for weaker demand conditions.

We're expecting operating revenue growth of 9% in Dedicated, reflecting strong new sales activity.

Supply chain operating revenue is expected to grow by 5%, or 7% excluding foreign exchange, also reflecting new sales. Page 22 provides a chart outlining the key changes in our comparable EPS forecast from 2015 to 2016. Weaker market conditions in used vehicle sales are expected to impact earnings by $0.62.

Pricing on tractors is forecasted to decline by 20% from peak, while truck pricing, which has been holding up better, is expected to decline by 5% from the peak. Sales volumes are expected to be higher due to the limited inventory available for sale in 2015. Commercial rental is expected to decrease EPS by $0.28 based on lower forecast demand and utilization on a smaller average fleet, partially offset by higher residual values.

Higher compensation expenses is expected to impact earnings by $0.25 per share this year. 0This includes the cost of merit increases, higher medical costs, and planned bonus. We continue to make strategic investments to drive future growth, particularly for IT and sales initiatives, but at a slower pace than in recent years.

These initiatives will reduce EPS by $0.09. Higher earnings from other FMS product offerings such as on-demand and contract-related maintenance will be partially offset by fuel, driven by a tightening wholesale versus retail spread. In total, these items are expected to contribute an additional $0.09 to EPS.

Growth in dedicated revenue combined with margin expansion should add $0.20. In supply chain, we expect an additional $0.25 driven primarily by growth. Workforce restructuring and other cost savings actions were taken in order to better align our business with current market conditions.

These actions are expected to generate an annual benefit of $0.38. The largest driver of 2015 EPS improvement is growth and increased returns in our contractual FMS product lines, totalling an additional $0.73 this year. This result -- this results from fleet growth and a depreciation benefit from higher residual values.

The net impact of the operational items I've mentioned so far will result in an EPS of $6.54. In addition, however, we are forecasting a negative $0.24 impact from higher tax rate, increased share count, and impacts from foreign exchange. This brings the high end of our comparable EPS forecast to $6.30 with the range of $6.10 to $6.30 forecast for the year.

I'll turn the call over to Art now to cover capital spending and cash flow.

Art Garcia (CFO):

Thanks, Robert. Turning to page 23, we're forecasting total gross capital spending of $2 billion, down almost $700 million from last year, with lower spending in lease and significantly lower spending in rental. Lease capital is forecast to decrease by $280 million due to lower forecast fleet growth in a softer freight environment.

We are planning minimal capital spending for rental of $90 million, down $430 million from the prior year. The average rental fleet is forecasted to decline by 4%. The planned spending here is related to a change in the fleet mix to drive activity with better performing vehicle types.

Proceeds from used vehicle sales are forecast to increase by about 8% to $460 million. Higher sales volumes are expected to be partially offset by lower pricing, particularly on tractors. As a result, net capital expenditures are forecast at $1.6 billion.

This represents a $700 million decrease from 2015. Free cash flow is forecast at positive $100 million, reflecting lower growth spending in lease and only a minimal replacement capital spend in rental. With higher expected free cash flow, the business will de-lever and we expect debt to equity to come down to 245% at year end, just below the midpoint of our target range of 225% to 275%.

This will provide us with additional balance sheet flexibility going forward and will be the key driver in restarting anti-dilutive share repurchases. We've talked in recent years about the impact that higher growth capital spending has on the business. Page 24 highlights the amount of growth capital spending we've had by year, driven from both fleet growth and higher vehicle investment costs per unit, and its impact on cash flow.

For 2016, we expect to spend $680 million in growth capital for full-service lease with no growth capital in rental. That compares to growth capital spend of $1.3 billion in 2015. The box on the right-hand side of the page highlights 2016 growth capital spending in lease.

An increase in the number of leased vehicles will require $275 million of capital, while higher per-unit costs will require an additional $405 million. Free cash flow is favorably impacted by reduced capital expenditures, demonstrating the counter-cyclical nature of our business model. As you can see in the bottom line of the page, growth capital spending in recent years has significantly benefited operating cash.

Operating cash flow is projected to be over $1.6 billion this year, up over 60% since 2009. At this point, let me turn the call back over to Robert to recap our EPS forecast.

Robert Sanchez (Chairman, CEO):

Thanks, Art. Turning to page 25, we're forecasting EPS of $6.10 to $6.30 versus a comparable $6.13 last year. This improvement is despite a $0.24 negative impact a from higher tax rate, share count, and negative foreign exchange.

We're also providing a first quarter EPS forecast of $1.03 to $1.08 versus a comparable prior year EPS of $1.08. The first quarter forecast reflects used vehicle sales headwinds and softer rental performance, as well as an atypical fuel benefit of $0.03 last year. That concludes our prepared remarks this morning.

We had a lot of material covered today, with both the fourth quarter results and the 2016 outlook. As a result, I would like to ask you to limit yourself to one question each. If you have additional questions, you're welcome to get back in the queue and we'll take as many questions as we can in the time allotted.

At this time, I'll turn the call over to the operator to open up the line for questions.

QUESTIONS & ANSWERS

Operator:

(Operator Instructions)

Ben Hartford with Baird.

Benjamin Hartford (Analyst - Robert W. Baird):

Good morning, guys. Good summary.

Robert, if I could just talk about long-term, how you're looking at the FMS business, what is the confidence today after some of the challenges in the back half of 2015, the outlook that you provided here in 2016 with regard to softening used truck pricing and weaker rental utilization? What is the confidence of the growth that you've seen in the contractual business specifically, whole service lease is leverageable, is producing the operating leverage that you had expected, such that as you continue to grow that book of business and we get through some of these cyclical headwinds in 2016, that we will start to see operating leverage in FMS with line of sight exceeding prior peak margins?

Robert Sanchez (Chairman, CEO):

Ben, I think the confidence level is very high around the contractual business. If you look at the growth that we had in 2015, the lease fleet growth of 6800 vehicles, we're looking at next year even in a softer environment of starting out with a forecast of 3500 vehicles. The secular trends that are driving this outsourcing continue to be very strong.

We had a very strong fourth quarter sales in FMS, so we have not seen really a slowdown there at all. And we feel really good about our ability to do that. I think clearly if you look at the overall, your question about earnings leverage, the headwind from UVS is meaningful, certainly what we had forecasted in 2016 is a meaningful headwind with a pretty significant decline in pricing.

These cycles happen in used truck sales. We know they typically last four to six quarters, and it's typically just when supply and demand get out of whack a little bit. But we see us getting through this like we've gotten through them in the past.

I feel really good about our ability to respond quickly to them. And see us continuing our target of getting above our prior peak once we have gotten past this slowdown in our transactional businesses.

Benjamin Hartford (Analyst - Robert W. Baird):

And I guess to that point, given the confidence, given the fact that you have been through a number of cycles, you personally, and the company obviously, and you've seen this before, kind of extending the anti-dilutive share repurchases could generate cash this year, why not be more aggressive as it relates to buybacks, given where the stock is trading relative to history on various valuation metrics? Why not be a little bit more aggressive going above and beyond just the anti-dilutive share repurchase, given the confidence that you have in the outlook of the business? Thanks.

Robert Sanchez (Chairman, CEO):

Well, I think what we're talking about right now is based on -- right now we're in the high end of our target leverage range. We're a little bit above it. So clearly in this environment, it's difficult to do that.

As we look out, we say if this environment materializes in 2016, if we have a weak freight environment as we have forecast here, we expect our leverage will drop to the middle of our range and we are going to be restarting the anti-dilutive repurchase program. I think depending on how this thing materializes, we'll make -- we could make different decisions as we get there. I think as we sit here today on the high end of our target leverage, that it's difficult for us to say we're going to do anything beyond that yet.

Benjamin Hartford (Analyst - Robert W. Baird):

Okay. Thanks for the time.

Robert Sanchez (Chairman, CEO):

Okay.

Operator:

David Ross with Stifel Nicolaus.

David Ross (Analyst - Analyst Stifel Nicolaus):

Good morning, gentlemen.

Robert Sanchez (Chairman, CEO):

Hi, David.

David Ross (Analyst - Analyst Stifel Nicolaus):

Can we talk a little bit more about the deceleration in the fleet growth in the leasing in 2016? You're looking at going back down to 3500. And that's with some strong fourth quarter sales at FMS.

So are those fourth quarter sales already baked into that, implying I guess more deceleration through the year?

If you can talk a little bit about why this environment matters for lease growth, if a lot of these leases are long-term contractual in nature, they are trucks the people need, and not as cyclical as the rental division?

Robert Sanchez (Chairman, CEO):

Right. Well, let me point out, we are still forecasting growth. This would be the second largest growth rate that we've had in the company.

So we're not really backing off growth. What we're looking at saying, if you look at the overall freight environment -- if freight environment slows down, it all trickles down. And at some point you have a fewer -- less of a need for trucks. You're right.

We are kind of assuming that's going to happen later in the year, because what we're seeing right now is a relatively strong environment in terms of truck leasing. So we've put that forecast out there based on, again, a very soft freight environment in 2016. But as the year goes on, we'll adjust based on what we're seeing.

And I feel really good about the work that Dennis is doing with his team on converting more people to leasing. This will be the first time that we have five straight years of lease fleet growth, and we feel good. We did not -- the only thing I would tell you is we cut back in some areas, we did not cut back in the number of front line sales people that we have, knocking on doors and finding new customers.

So I would say that's, that's just to give you a little better color as to where -- how we came up with the 3500. But clearly, we'll see how the year progresses. And if the freight environment comes in better, then you'll see us do better than that.

I don't know, Art, Dennis, if you want to add anything to that.

Dennis Cooke (Global Fleet Management Solutions):

Yes, David, I would add as we look at Class 8 production for the year, we're looking at a number that's similar to what it was in 2014. In 2014, we had 3200 units of fleet growth. So we think the 3500 number is a prudent number to start the year with.

David Ross (Analyst - Analyst Stifel Nicolaus):

And then what is the average lease fleet age currently? And do you think given the growth prospects, that it should still lower again in 2016, or should it flatten out this year?

Dennis Cooke (Global Fleet Management Solutions):

David, it's Dennis again. So the fleet age right now for power is at 37 months, and as we look into next year, we do see that declining slightly, not much, but slightly. So that's what we see right now.

Robert Sanchez (Chairman, CEO):

I think -- I think, David, remember that the benefit of the declining fleet age was sort of behind us, even with the new technology and all, it doesn't really play as big a factor anymore.

David Ross (Analyst - Analyst Stifel Nicolaus):

Excellent. Thank you very much.

Robert Sanchez (Chairman, CEO):

All right. Thanks, David.

Operator:

Scott Group with Wolfe Research.

Scott Group (Analyst - Wolfe Research):

Thanks. Good morning, guys.

Robert Sanchez (Chairman, CEO):

Good morning, Scott.

Scott Group (Analyst - Wolfe Research):

So on the used truck pricing, I think you said down 20%. What have you seen to date relative to that peak? How much incremental downside on used truck pricing are you assuming in the guidance?

Is there maybe any color you can give us on January so far? And then is there any good sensitivity to use if we want to assume a 30% drop or something, what that means?

Robert Sanchez (Chairman, CEO):

Well, here's the way I would frame it up. We've seen -- we're talking about tractor prices, primarily Class 8 is where the bigger issue is. So what we saw in the fourth quarter was 11%.

So we're assuming another 9 percentage points beyond that, which is consistent with what we've seen in other - in prior used vehicle sales downturns, several of the most recent ones including the one during the last freight recession. So that's sort of how we've teed that up. We have not seen 20%, but we're assuming there's going to be some further deterioration as there continues to be, appear to be an oversupply of class 8 tractors in the marketplace.

Scott Group (Analyst - Wolfe Research):

Okay. And just given that oversupply, what are you assuming for OEM pricing that you're paying? Are you starting to see that come down yet, or is that more stable?

Robert Sanchez (Chairman, CEO):

No, that -- remember, we're buying directly from the OEM. So we don't -- we're typically getting some pretty competitive pricing regardless of the environment. So I don't see that as a big change.

Scott Group (Analyst - Wolfe Research):

And you're not seeing that come down with the OEMs. It's kind of just flattish?

Robert Sanchez (Chairman, CEO):

No, it's relatively stable, yes.

Scott Group (Analyst - Wolfe Research):

Okay. All right. Thank you.

Robert Sanchez (Chairman, CEO):

Thank you, Scott.

Operator:

Our next question is coming from Matt Brooklier of Longbow Research.

Matt Brooklier (Analyst - Longbow Research):

Thanks. Good morning. I wanted to go back to the expectations for lease fleet growth.

The 3500-unit addition number, what -- can you talk to roughly how much of that you've already won, how much of that is already contract signed at this point in time?

Robert Sanchez (Chairman, CEO):

Remember, it's 12 months, so it's really hard to kind of break that out. I think you're going to see us continue to have probably higher than that growth in the first half of the year, then maybe slow down in the second half. Again, more based on what we predict, or our assumptions - not what we predict - our assumptions around a weaker freight environment.

So, that's kind of the way it lays out. But I would tell you, though, fourth quarter was a strong sales quarter for, for full-service lease, and we've got a healthy pipeline going into the first quarter and our sales guys are busy. So as of right now, we haven't seen that materialize.

I think it's important -- I guess what I would want to probably point out is unlike other years where I think we've had better visibility to the year, I think this year probably is a little murkier. There's a lot more uncertainty. You've heard a lot of talk about the industrial recession and a softer freight environment from some of the truckers.

We've seen it manifest itself right now in our used truck pricing a bit, and clearly a little bit more in rental, but that's why we felt it was prudent to really build this plan around that type of an environment. The truth is, it could turn out to be better. And if it does, I think we're well positioned to capitalize on that.

Certainly our lease sales will do better, it could help our used truck pricing and rental - especially in the first half of the year - could benefit from a better environment. So I just want to make sure everybody is clear on that.

Matt Brooklier (Analyst - Longbow Research):

Okay. And then just kind of a segue into a rental question, your guidance talks to the fleet being down 4%, but I guess your pricing mix being pretty much flat. So I'm trying to get a sense for what's kind of your confidence level that you're able to - I guess maintain pricing on a year-over-year basis at rental and I guess, is there any potential offset in the fact that if maybe if the market's a little bit weaker than we anticipate from here that there could be increased demand on the rental side and you could actually see I guess better pricing?

Robert Sanchez (Chairman, CEO):

Well, there's a lot of questions in there. I think we do -- first of all, the price increase is something we're implementing early in the year, and we do feel in this environment we have an opportunity to get it. The vehicles cost more and the overall market, I think, is moving in that direction.

Clearly, if things -- we think that will continue. We believe in the environment we've painted here -- with softer freight environment, we can still achieve that pricing increase.

Matt Brooklier (Analyst - Longbow Research):

Thank you.

Robert Sanchez (Chairman, CEO):

Dennis?

Dennis Cooke (Global Fleet Management Solutions):

Yes, I would just add to that, Matt, if we do see a stronger rental environment, we'll utilize our centralized asset management capability to move units that are coming off of lease that still have life with them. We'll move those into the rental product line, if we do see upside. We would do that before we would spend CapEx on vehicles.

So again, we'll leverage our central asset management capability.

Robert Sanchez (Chairman, CEO):

Yes, it's our ability to flex up if things are better. I'm sorry, Art. Did you want to mention something?

Art Garcia (CFO):

I wanted to follow back up on Matt's comment. Given we did have a good sales quarter, Q4, and we do see a softer environment as we go into 2016, you're going to see our fleet growth probably be a little more front-end loaded this year than it was last year, given that.

Robert Sanchez (Chairman, CEO):

Good.

Matt Brooklier (Analyst - Longbow Research):

Okay. Appreciate the time.

Robert Sanchez (Chairman, CEO):

Thank you, Matt.

Operator:

Our next question is coming from Justin Long with Stephens.

Justin Long (Analyst - Stephens):

Thanks, and good morning.

Robert Sanchez (Chairman, CEO):

Good morning.

Justin Long (Analyst - Stephens):

So there's a lot more talk today about the possibility of a recession on the horizon and with that in mind, I was wondering if you could just talk about how outsourcing trended during the past recession? Did you see a trend toward more outsourcing as your customers looked to cut costs? Or did you see more hesitancy from customers to make structural changes to their network in a weak economic environment?

Robert Sanchez (Chairman, CEO):

Well, when you say the last recession, if you look at 2008/2009, that's probably a tough comp, because everything was down during that time. But certainly in, in prior recessions to that, I would say there is some headwind clearly on existing customers not needing to grow, but our opportunity, and I think with our improved sales and marketing efforts, the additional sales people we have on the street, the overall secular trends that favor outsourcing, I see it as an opportunity, because I think just as customers are looking, prospects are looking for ways to cut costs, and we've got products that typically can get you 10% to 15% savings, I think it's a nice opportunity for us to be able to grow. So I think this is a little different environment than -- certainly different environment than the pre-2008/2009 recessions. I think to your point, it could create an opportunity for us.

Justin Long (Analyst - Stephens):

Okay, great. And just given the uncertainty, could you talk about the month-to-month trends that you saw in rental? I'm just curious if things got incrementally weaker over the course of the quarter.

And also, if you could share what you're seeing so far, or what you saw in January.

Dennis Cooke (Global Fleet Management Solutions):

Justin, this is Dennis. So I'll start with Q4. As Robert said in his opening remarks, we looked at the parcel companies.

They were picking up units a little later than we expected, than what we had forecasted. So October and early November were a little weaker than we expected. And then it got significantly stronger as we headed into the back half of November and December.

And in January, the markets looked decent, as we look at the demand here in the US in particular.

Justin Long (Analyst - Stephens):

Okay. That's really helpful. Thanks for the time.

Robert Sanchez (Chairman, CEO):

Thank you.

Operator:

Kristine Kubacki of Avondale Partners.

Kristine Kubacki (Analyst - Avondale Partners):

Good morning, guys. Just a quick question.

Robert Sanchez (Chairman, CEO):

Good morning, Kristine.

Kristine Kubacki (Analyst - Avondale Partners):

Wondering if you can talk more about the maintenance trends, both in contract and contract-related. You keep talking about a softer freight environment and presumably less utilization across the whole truck fleet. Are you able to continue to add more trucks to that and offset less maintenance, as I would assume, per truck?

And I guess to add on to the question, it was a little bit earlier, is this an area that fleets will continue to outsource during a soft freight environment? Or will they ever think about bringing that back in-house?

Robert Sanchez (Chairman, CEO):

Well, let me just -- I'll split out contract maintenance versus contract-related. Contract maintenance is under a contract where customers paying typically a flat rate for maintenance and then we handle all the maintenance associated with that. So there really -- it isn't a tool that a customer will pull back on maintenance.

We maintain those vehicles to our standards. Contract-related, and within that on-demand maintenance, you're right. When things slow down, they may pull back on some of the -- [may as be] running fewer miles.

But I think in this environment, given our opportunity to save customers money, we could offset that with growth of new customers. So I think that's the two sides of the coin, if you will, as it relates to growth in those items.

Kristine Kubacki (Analyst - Avondale Partners):

Okay. Very good. Thank you very much.

Robert Sanchez (Chairman, CEO):

Thank you.

Operator:

Art Hatfield of Raymond James.

Please go ahead.

Art Hatfield (Analyst - Raymond James):

Good morning, everybody. I've kind of been in and out. Listening to some of your commentary, just a couple quick ones, if I could.

You are talking about a softer freight environment in 2016. And the last three months of 2015, you did see miles per unit per day increase 1.3%.

Do you expect that to go negative in Q1? Or is that something that you may be up a little bit, but worsens as we get -- move through the year?

Robert Sanchez (Chairman, CEO):

No. We're still assuming that to be flat, flattish, I would say.

Art Hatfield (Analyst - Raymond James):

And then on the used vehicle sales, just the two-part question to that. One, I didn't hear you comment on this, but the 8,000 units held for sale at the end of the quarter, kind of what's your thought on where that goes to over the next quarter or two?

And then secondly, you commented on how you're looking at this relative to prior downturns in the used vehicle market. Is there any reason to believe because of model year changes over the last several years that we should think about -- it could be different than we've seen in last cycle?

Robert Sanchez (Chairman, CEO):

Well, first, Art, on the 8000 units, that came up really in the fourth quarter because we did move a lot of units out of rental. We felt it was the right thing to do to start to get the rental fleet down further, to be more conservative in our fleeting. So those vehicles were out serviced and put at the UTC for sale.

So you did see it come up to the 8000. We expect that to probably peak a little bit over 8000 in the second quarter. And then really start to work their way, start to work its way down.

So by the end of the year, we expect that to be at closer to the 6000-unit range. So well within -- and again, that's primarily also because we don't have a lot of units coming up for renewal this year, as certainly we're below the average. So that will kind of help us throughout the year.

As it relates to the pricing of used tractors or used trucks, new technology versus old, I would tell you that our experience certainly through last year prior to this downturn was that the new -- we were getting the appropriate pricing on the new technology. So we've got to see how that plays out. We've got a team that's out doing a great job of marketing the new technology.

Again, you do get to the point where the old technology becomes so old that a customer wanting a certain amount of uptime has to go with something newer. And we're probably getting to that point. As you know, we hold our vehicles probably longer than most in the industry.

So we feel good about the opportunity to sell the new technology and to continue to move those at appropriate pricing, especially as we get past this soft patch that we're seeing in the market.

Art Hatfield (Analyst - Raymond James):

If I could follow up on that real quick, so within your plan to have that peak a little bit above 8000 vehicles held for sale and then work down to 6000 and the hit, the headwind of $0.62 in 2016, does that assume all of those vehicles get sold through the retail channel?

Robert Sanchez (Chairman, CEO):

No.

Art Hatfield (Analyst - Raymond James):

Okay.

Robert Sanchez (Chairman, CEO):

No. We're going -- we are doing the appropriate change in mix in order to be able to move those.

Art Hatfield (Analyst - Raymond James):

Great.

Robert Sanchez (Chairman, CEO):

And by the way, that's built into the 20%.

Art Hatfield (Analyst - Raymond James):

Okay. Okay. That's very helpful. Thank you.

Robert Sanchez (Chairman, CEO):

Okay. Thanks, Art.

Operator:

Our next question is coming from Jeff Kauffman of Buckingham Research.

Jeff Kauffman (Analyst - Buckingham Research Group):

Thank you very much. I wanted to focus a little bit on DCS. You talked about the big revenue increase there and I'm looking at the guidance you're giving on gain on sale and kind of bridging the gap on the 140-basis point, 110-basis point spread.

What kind of new business are you bringing on there? And what type of -- sorry, blanking on this. What type of fleet growth are you looking for there?

Robert Sanchez (Chairman, CEO):

You're talking about on the DTS side?

Jeff Kauffman (Analyst - Buckingham Research Group):

DTS side, yes. Because it looks like revenue per unit on DTS is down on a year-to-year basis, almost 7%. Maybe I'm calculating that wrong.

I'm just wondering what kind of new business is coming on there.

John Williford (Global Supply Chain Solutions):

Well, Jeff, this is John. Let me try to address a few things. First, on the growth side, I think you hit it right.

We had 11% growth on dry revenue. So first, make sure that you're working off the dry revenue number, because the total revenue number is impacted by fuel changes and the price of fuel is down 30%. But if you look at our base measure of operating revenue, we're up 11%. And that's been growing in the second half.

We've had some pretty good traction with prior fleet conversions and some of that is taking place in the second half of the year. So that's what impacted fourth quarter, if you look at the sales in the prior fleet conversions we saw during the quarter. And then that momentum, we expect to carry over for the first half of 2016 and then it will temper in the second half of 2016.

Jeff Kauffman (Analyst - Buckingham Research Group):

Okay.

Robert Sanchez (Chairman, CEO):

I think the fleet count as it relates to DTS could -- the revenue per unit could vary based on the type of accounting. They have more trailers than tractors.

So I think you focus on the revenue growth. We're looking at 9% revenue growth in 2016, so we're really expecting that continued strong sales and strong growth there as we convert customers that lease into dedicated.

Jeff Kauffman (Analyst - Buckingham Research Group):

All right, and just one detailed follow-up. You gave a great breakout on vehicles by lease versus rental versus DTS. And you spoke about the differences you were seeing on truck pricing versus tractor pricing.

Can you give us a rough idea how the fleet breaks out right now? Trucks versus tractors versus trailers.

Art Garcia (CFO):

Held for sale fleet.

Robert Sanchez (Chairman, CEO):

You're talking about the fleet that's at the used truck centers, or are you talking about the overall fleet?

Jeff Kauffman (Analyst - Buckingham Research Group):

Used truck centers. Thank you.

Art Garcia (CFO):

Oh, at the used truck centers.

Jeff Kauffman (Analyst - Buckingham Research Group):

Let me --

Robert Sanchez (Chairman, CEO):

We can take it offline. That's fine.

Jeff Kauffman (Analyst - Buckingham Research Group):

We can go to the next caller and then we'll come back.

Art Garcia (CFO):

Thank you.

Robert Sanchez (Chairman, CEO):

All right, Jeff.

Operator:

John Barnes with RBC Capital Markets.

John Barnes (Analyst - RBC Capital Markets):

Couple things. First, you mention that normally these used truck cycles last kind of four to six quarters -- you obviously went through a period where you kind of enjoyed like that three-year reprieve where there were not a lot of Class 8 truck deliveries during that kind of 2010 -- 2009, 2010, 2011 timeframe. Now we've gotten back into a several-year period where we're kind of well above replacement levels of deliveries.

Does that suggest that four to six quarters becomes something different and you get into maybe this is a more pronounced downturn, or do you see what I'm saying? It's a much different environment than what we're kind of used to.

Robert Sanchez (Chairman, CEO):

Yes, look. Obviously, nobody has a crystal ball here, but I think if you look at even at the rates that Class 8 production, the rates we saw in 2011 and 2012 and 2013, they are still relatively stable. If you compare them to what we had historically done in the early 2000s, it is not at -- the peak levels that caused the chaos, which were the sales we had in 1995 and in 1999 and in 2006, those levels have not been achieved in this cycle. So I don't see that as being dramatically different than what we've seen in the past.

I would tell you also, remember, we hold vehicles seven years. So we're still selling vehicles from 2009 in this year, and we are still, we're still at a point where there's not a lot of new unit, there's not big production years coming into our used truck environment. So I think that will bode well through this downturn, and as we get out of it, then we'll probably have some additional units coming in and we'll be in a good position to sell them.

John Barnes (Analyst - RBC Capital Markets):

Okay. And then secondly, I just want to go back and follow up on the 3500 units of lease growth that you're forecasting. I recognize that it's a long sales process.

You say fourth quarter was a good quarter from a sales perspective. I mean, can you just -- as we think about trying to model this in, is it -- are we talking two-thirds of these units should be layered into the first half? And then begin to lighten it up in the back half?

Or should we -- should it be more rateable per quarter than that? I heard you say that probably a little lighter in the second half. But just maybe magnitude, can you give us a little color on that?

Robert Sanchez (Chairman, CEO):

Yes, I would say the first half of the year -- if you just did year-over-year comps, the first half of the year, you should still continue to see in that 5000 to 6000 range as you're doing first quarter to first quarter, second quarter to second quarter. And then it really drops, it really slows down in the second half, more to what we're talking about ending, right around that 3000 to 4000 range.

John Barnes (Analyst - RBC Capital Markets):

Okay. All right. That makes sense. Thanks for your time today. Appreciate it.

Robert Sanchez (Chairman, CEO):

Okay.

Operator:

Todd Fowler with KeyBanc Capital Markets.

Todd Fowler (Analyst - KeyBanc):

Great. Thanks. Good morning.

And thanks for all the detail. Robert, just on the expected decline in the used truck pricing, if you did see that 20% drop from peak to trough as you have in your guidance, where would that put the residuals for 2016? Would those still be favorable relative to the residuals you would be rolling off? And really what I'm trying to get at is, as I think about that depreciation benefit that you've got penciled in for this year, how does that look going forward, if we see the softness in the used truck market play out the way you're expecting it to?

Robert Sanchez (Chairman, CEO):

I think as we considered the depreciation policy, we did look at that also. If we had a type of bleak environment, as we've painted here, you would still be -- you would be in a situation probably 2017 where things would be flat, right, in terms of depreciation. So there wouldn't be depreciation policy movement one way or the other.

Art Garcia (CFO):

Right.

Todd Fowler (Analyst - KeyBanc):

Okay. That helps. And this is maybe a little bit along the lines of what John was just asking, but do you have a sense of what the increase in used truck pricing was this cycle maybe relative to last cycle? And when we look at equipment gains as a percent of your overall earnings, it does feel like it's been elevated maybe to where it's been in the past and it feels like there's been a bit of a bubble on the used truck side. So did the -- was the increase in used truck pricing this go-around consistent with where it was last cycle so that the fall would be consistent, or is it kind of difficult to maybe look at it on an apples to apples basis?

Robert Sanchez (Chairman, CEO):

Well, remember, look, the price of used trucks has gone up quite a bit because of the new technology and all of those things. Remember, what we're baking in here is a percentage drop. It's a percent -- it's 20% on a bigger number versus what -- the drops that we saw in prior periods.

So I guess the answer to your question is yes. Used truck pricing has gone up materially over the last cycle, generally because of new technology. And we are assuming in our forecast a 20 percentage drop-off of that higher number.

Todd Fowler (Analyst - KeyBanc):

Okay. But I guess asking it the same way, was the percent increase, was that similar or -- are you trying to adjust for the absolute price of the vehicle?

Robert Sanchez (Chairman, CEO):

Right. No, the percentage increase would have been higher from over the last several years.

Todd Fowler (Analyst - KeyBanc):

Okay. Okay. Thanks for the time.

Robert Sanchez (Chairman, CEO):

It basically boils down to -- in today's environment, whether you're going to by a new truck or used truck, it costs a lot more than it did 10 years ago. New truck just costs meaningfully more because of all the EPA-mandated changes. So I think, yes, we've adjusted to a higher cost environment in both the new and used truck sales.

Todd Fowler (Analyst - KeyBanc):

Yes. No, we understand, there's a lot of moving parts and it seems the guidance is trying to take into consideration the best factors. Just trying to get some sensitivity around if things play out better or worse, kind of what that could mean. Appreciate the time this morning.

Robert Sanchez (Chairman, CEO):

Okay.

Todd Fowler (Analyst - KeyBanc):

Thank you.

Operator:

Your next question--

Robert Sanchez (Chairman, CEO):

Hang on one second. Before we get the next caller, I think Art's got the answer to the previous question.

Art Garcia (CFO):

Following up on Jeff's question from earlier, relative to our inventory held for sale - about 40% are trucks, 50% are tractors and 10% are trailers.

Operator:

Casey Deak with Wells Fargo.

Casey Deak (Analyst - Wells Fargo):

Thank you. Just had a question, going back to the 3500 lease fleet growth, what are you guys forecasting as far as early termination as we go through the year? Do you anticipate that that is going to ramp up as you've seen some rental weakness here? Maybe foreshadowing that as we go through the year?

Robert Sanchez (Chairman, CEO):

No. We have not forecast a meaningful increase in early terminations. Again, we're trying to paint as realistic a picture as we can and at the same time, also erring on the side of caution. But as it relates to early terminations, no, we have not built in any meaningful increase there.

Casey Deak (Analyst - Wells Fargo):

Okay. So you just assume that it kind of stays around the levels where we have been trending the past year?

Robert Sanchez (Chairman, CEO):

Right, right.

Casey Deak (Analyst - Wells Fargo):

Okay. All right. I'll leave is at that. Thanks, guys.

Robert Sanchez (Chairman, CEO):

Thank you.

Operator:

Due to time constraints, we would like to turn the call back over to Mr. Robert Sanchez. Mr. Sanchez, you may proceed.

Robert Sanchez (Chairman, CEO):

Great, thank you. We're just past the top of the hour, so I appreciate you all being on the call. Good questions.

And look forward to seeing you as we get out and visit at some of the conferences and get out to some road shows. Take care.