

KEY POINTS

- Lease rentals of new rolling stock have fallen by more than 30% over the last three years.
- As a result, some relatively young fleets are being replaced and pushed off-lease.
- Options for re-leasing may be limited for reasons including physical and regulatory factors. Financiers may revisit their financial models to contemplate these risks, resulting in market rental rates increasing.
- Existing and new legislation and regulation could mitigate some of these issues.

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Brand new trains being pushed off-lease: implications and options for financiers

The cost of purchasing and leasing new trains has fallen dramatically over the last three years, due to factors including lower manufacturer prices and the availability of cheap, long-term financing. A number of train operators are taking advantage of this attractive combination. One side-effect has been that the leases of some relatively young fleets have been allowed to expire as a new fleet may be materially cheaper to lease. Extraordinarily, in March 2017 it was announced that a fleet ordered in September 2014 – and which is so new that it is still being built – will be pushed off-lease in around 2019.

THE LANDSCAPE

Rail has been enjoying a renaissance. Globally, across the industry, passenger and freight demand has continued to grow, driven by a wide range of factors. As a result, new rolling stock is being ordered to:

- increase capacity on existing routes to service this increase in demand;
- provide services on new lines where existing rolling stock is not available; and
- replace existing rolling stock.

On rail services subject to concessions or franchises, the term of the rolling stock lease will generally match the term of the concession or franchise – it will then be up to the successor operator to decide whether to continue leasing existing rolling stock or to replace it with other rolling stock. Yet rolling stock typically has a useful economic life of between 30 and 40 years and, until recently, it was generally considered unaffordable to replace before this span ended.

However, a confluence of “pull” and “push” factors has emerged to change this context in the form, respectively, of various non-financial considerations and the availability of much cheaper rolling stock.

THE PULL FACTORS – NON-FINANCIAL CONSIDERATIONS

Within the industry, the demands and interests of three groups – passengers, governments and operators – have been

aligned in pursuing the advantages to be gained from replacing existing fleets with new rolling stock.

Passengers are becoming more demanding regarding the quality of services delivered. There is increased focus on the safety, environmental impact and reliability of rolling stock, as well as on journey times.

New rolling stock tends to be safer, both in terms of crashworthiness and internal layouts such as end-to-end open gangways.

In terms of environmental impact, legislative and political pressure is already resulting in diesel road vehicles being banned from some cities. It may only be a matter of time before diesel trains are similarly phased out, and the hydrogen fuel cell trains due to enter service in Germany in 2017 may accelerate this.

In relation to reliability, passengers frequently cite journey time predictability as a key factor in transport decisions, often more important than the actual journey time. New fleets tend to be more mechanically reliable, particularly those based on existing designs. In addition, the improved acceleration and speed of some new fleets may provide an additional buffer to achieving the timetabled service, or improved journey times, or a combination of both.

These expectations have often been normalised by governments, in their coordination of national train procurement and, where relevant, franchising of train

operations. One facet of this has been an increased focus by governments on the quality aspects of the passenger experience, including the level of comfort and the services provided. Service improvements could include additional seats, improved air conditioning/ climate control, disabled access, Wi-fi connectivity, video streaming, the availability of on-board lavatory facilities, enhanced passenger information systems – and the ability to charge phones and other electronic devices.

For operators, new fleets tend to require less maintenance and the costs consequently tend to be correspondingly lower – particularly where the original procurement considered the increasingly important “whole life costs”. In addition, new trains tend to be lighter (sometimes as much as 25% lighter than the trains they replace) and in some cases are also capable of re-using energy from braking, resulting in reduced fuel/power consumption and reduced track wear – and correspondingly reduced track access charges. Adopting homogenised fleets also provides a range of further benefits, including drivers being able to operate a greater proportion of the total fleet, streamlined maintenance arrangements, reduced spares inventories, consistency of passenger experience – and possible economies of scale on the initial manufacturer purchase price.

There are undoubtedly numerous advantages of new fleets, but simply modifying existing rolling stock has historically tended to be a more cost-effective option. This is, however, all changing.

THE PUSH FACTOR – GREATER AFFORDABILITY OF ROLLING STOCK

These demands remain subject to wider affordability considerations and costs have decreased markedly over recent years. When comparing the leasing costs of different rolling

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stock fleets, including comparing the costs of new and existing fleets, operators tend to focus on the rental amount “per vehicle per month” or “pvpm”.

For new rolling stock, the pvpm amount derives from various factors, in particular:

- the manufacturer’s price; and
- the financing costs (typically expressed as the cost “per million per month”, or “pmpm”).

The pvpm rental amount can be calculated by applying the financier’s pmpm amount to the manufacturer’s price and payment terms.

The financing costs, in turn, depend on numerous factors, including:

- the debt/equity split;
- the cost and term of the debt;
- the equity’s required rate of return;
- whether there is debt refinancing risk and who is taking that risk; and
- the view of financiers about the prospect of the fleet remaining on-lease for its entire expected economic life, or whether periods during which the fleet is at risk of being off-lease need to be factored into the financial model.

The cost of leasing a new fleet in terms of pvpm can be reduced by a number of factors, including:

- more competitive manufacturer prices;
- more aggressive debt/equity splits;
- taking advantage of current, historic low, long-term interest rates;
- taking advantage of the significant amounts of equity currently seeking a stable, long-term return;
- taking advantage of debt financing on a long-term basis and which does not suffer from the same refinancing risk as shorter term debt, allowing for a more gradual amortisation profile and further accommodating a more aggressive debt/equity split; and
- removing from the financial model some of the slack for off-lease periods.

In relation to financing, the last decade saw periods of much higher costs of borrowing than is the case now. Indeed, during the period from 2008 to 2010 many banks were effectively

closed to the financing of new rolling stock.

Fleets financed at points during the last decade may therefore carry the burden of lease rentals based on the then available financing costs.

In relation to manufacturer prices, these have become more competitive over recent years due to a number of factors:

- the entry of new manufacturers into certain markets intensifying competition – for example, Chinese rolling stock manufacturers are increasingly exporting to other markets (including supplying significant amounts of rolling stock in the USA); indeed this was mentioned in April 2017 as one of the reasons for a possible merger/JV between the rolling stock divisions of Bombardier and Siemens;
- manufacturers offering follow-on fleets using existing, tested designs for which the design costs have already been fully recovered; and
- manufacturers taking advantage of improvements in technology and efficiency.

The effect has been to reduce the cost to operators of new rolling stock (expressed in terms of pvpm) by more than 30% over the relatively short period of around three years. In many instances where previously new rolling stock would have been considered unaffordable, it is now a realistic possibility. This has resulted in operators placing some very significant orders for new rolling stock, but it has also resulted in some relatively young fleets being pushed off-lease – including the extreme example, mentioned earlier, of the fleet which is still being built.

It may be that the position we are currently seeing will be relatively short lived. For example, any rolling stock fleet which is financed now, benefiting from the current low long-term interest rates, is less likely to be displaced by a replacement fleet financed using higher rates of interest – and the risk of long-term interest rates falling significantly below their present levels may be remote. Regardless, for so long as the new landscape continues and the cost of new rolling stock remains low, there is a risk that further existing fleets will be displaced by new-build orders.

WHAT CAN BE DONE WITH A FLEET PUSHED OFF-LEASE?

As with any difficulty, the solutions can be divided between prevention and mitigation.

For an asset pushed off-lease, there are four main mitigations available to the owner/financiers:

- (1) Lease it to someone else.
- (2) Sell it.
- (3) Scrap it.
- (4) Store it before doing one of (1) to (3).

Finding a new operator to lease a fleet may not be easy and it may not be a matter of simply reducing the rent. Prospective operators may be alive to the non-financial considerations mentioned above and may, for example, prefer to have a homogeneous and high-quality modern fleet, which reduces the complexity of driver training and maintenance, as well as delivering a consistent quality of passenger service. As also mentioned above, diesel trains may increasingly become subject to the political and environmental pressures which already affect diesel cars.

There are often infrastructure, physical and regulatory constraints on operating trains on different routes. These include differences in signalling and safety systems, power supplies (eg overhead lines or third rail), platform heights and kinematic envelopes (the maximum space a particular class of train occupies on the track, including as it travels around curves). In addition, existing timetables will require rolling stock to be capable of appropriate acceleration, speed and dwell times at stations – off-lease rolling stock will only be attractive if it can deliver such operational requirements. It may be possible to retro-fit additional equipment to a fleet which has been pushed off-lease, but this is usually significantly more costly than it would be if such equipment had been installed at manufacture (potentially exacerbating the financial issues) and also carries risks – the fleet mentioned above which is being pushed off-lease while still being built has the capability built into it to accommodate modifications to use alternative electrical power sources, but there has already been media comment that installation of such equipment is not as simple as it sounds.

Biog box

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In relation to any particular fleet pushed off-lease, the financing environment which resulted in that fleet being pushed off-lease may also have resulted in other fleets being pushed off-lease as well. There could therefore be significant increased liquidity in the wider rolling stock leasing market, which further exacerbates the problem. Such liquidity issues could relate to particular types of rolling stock – for example, if a country or region has embarked on an electrification programme which has resulted in a focus on new electric fleets (and a corresponding reduction in new diesel fleets), any subsequent scaling back of that electrification programme could further limit the potential re-leasing opportunities for electric fleets pushed off-lease.

Selling the fleet presents many of the same issues as re-leasing. There may also be some additional problems including other legal considerations, particularly where a fleet is subject to secured third-party lending, and the attendant restrictions from financiers. Even where the legal and regulatory regime permits the sale of rolling stock, the market may be limited – the costs of exporting can be prohibitively high, particularly where shipping and modification to satisfy local requirements is necessary.

Consequently, scrapping young fleets may soon become a realistic option. Eyebrows were raised a few years ago when some commercial aircraft which were barely ten years old were scrapped – we may soon see rolling stock similarly being scrapped at a comparatively young age. Unfortunately, rolling stock has a low scrap value.

As for storage, this may sound attractive at first, but it results in a double whammy – not only is there no lease rental being received, but in addition the costs generally paid by a lessee now need to be paid by the owner. Sidings or sheds need to be leased. The rolling stock needs to be insured. Maintenance still needs to be performed. There are also additional risks such as graffiti and other vandalism. Depending on the particular market, a new opportunity to lease the rolling stock may not arise for a significant period of time. In reality, if the fleet is stored and then subsequently scrapped, it would have been better to have scrapped it as soon as it came off-lease.

Regardless of the outcome, there is a risk that relatively young fleets being pushed off-lease will result in financiers re-assessing their risk models and the corresponding pricing.

PREVENTION – LEGAL PROTECTIONS AND CONSIDERATIONS

So what is to be done? In order to try and encourage private investment in rolling stock, some governments (both local and national) provide usage guarantees. Typically these guarantee that there will be a lessee for a particular fleet of rolling stock for a pre-agreed period of time on pre-agreed terms including rent.

Although some forms of usage guarantee do not extend to non-payment of rentals or other lessee non-performance, they do provide a degree of certainty that there will be a lease with an agreed rental stream for an agreed period of time. The usual “risk/reward” equation results in reduced re-leasing risk generating rental reductions for the operators. Such usage guarantees may be the necessary sweetener the industry requires to ensure the continuing availability of cheap, long-term financing.

Previously, some lessors have regarded such usage guarantees as double-edged swords, as they fixed lease rentals at an agreed level and therefore prevented increases in rental amounts. The open question is whether this view can persist in our emerging landscape. Interestingly, the fleet which is being pushed off-lease while it is still being built does enjoy the benefit of a usage guarantee, but only until 31 March 2019 – this limited usage guarantee was to ensure the fleet migrated to the new operator of a seven-year franchise, presumably with the expectation that the new lease would be for the entirety of that seven-year franchise term.

For some rail operations, governments are often the “operator of last resort” and will step in to operate rail services if the existing operator becomes insolvent or otherwise ceases to run the services. Particularly where the obligation of a government to act as such operator of last resort is set out in legislation, the relevant government entity will generally require contractual arrangements to ensure it has a contractual right to step in and lease

the rolling stock required to perform the services. Such step-in contracts could provide a degree of comfort to financiers, but as these compulsory lease contracts can also restrict the rights of the financiers to scrap, export or otherwise sell the relevant rolling stock, they too can carry risks.

A further preventative step may be to use legislation and regulation to encourage greater co-operation on wider issues. The roll-out of Technical Specifications for Interoperability (TSIs) in Europe has seen a standardisation of technical specifications alongside a similar move in safety regimes. Progress on these issues at global and regional levels would reduce the need for, and cost of, retro-fitting off-lease assets and provide a larger and more homogenised market for their re-lease or sale.

FINAL THOUGHTS

These suggestions may entail a firmer position across the negotiating table and in government forums. However, the alternative may be less palatable. After years of trying to attract additional financiers into the market, there has been a recent upsurge in financier interest. A combination of competitive manufacturer pricing and the availability of cheaper long-term financing has contributed to the costs of new rolling stock to operators falling by over 30% in around three years. Yet recently we have seen relatively young fleets being pushed off-lease by new-build orders, and finding an alternative operator for these displaced fleets may not be as easy as simply reducing the rent.

If this continues and financiers re-visit their risk models, we may see market rentals increase or the long-desired additional financiers withdrawing from the sector. Interesting times lie ahead. ■

Further Reading:

- Financing assets in a brave new world [2009] 9 JIBFL 560.
- Asset finance in Russia: a brief introduction for the unwary [2008] 5 JIBFL 252.
- LexisNexis Loan Ranger blog: IFRS 16 - a new lease of life?