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A bluffers guide to rental rates

The economic recovery in many markets has so far brought only limited improvements in rental rates. But what causes rental rates to go down and be so resistant to increase? What can rental companies do about it? Is there anything that industry associations can do to help? In Part One of a two part article Jeff Eisenburg takes a look.

Calculating rental rates

A common calculation methodology is useful as a starting point. In the USA, the American Rental Association (ARA) helpfully publishes a guide and software on 'Rental Market Metrics' with a particular focus on standardising rental utilisation calculations. This means that figures are comparable between companies. Some large European rental companies have already adopted this method in their investor presentations.

American Rental Association RENTAL MARKET METRICS™

Most measurements of rental rates compare the rental rate per year with the cost. But which cost? The replacement cost is most widely used, with 'Payback' given in months or years. A 36 month payback means a machine that costs £10,000 generates £3,333 a year in rental revenue. Some rental companies use a 'financial utilisation' that takes the annual revenue as a percentage of the replacement cost. So, that £10,000 machine earning £3,333 a year will have 33 percent annual financial utilisation.

Payback and financial utilisation are almost always calculated net of expected physical utilisation, so at 75 percent utilisation in order to generate the £3,333, the rental rate would need to be £17.80 a day, which multiplied by 250 working days equals £4,444 at 100 percent utilisation - £3,333 at 75 percent.

In the USA, the Rouse Analytics' Rental Metrics Benchmark Service compares rental rates by equipment class, and analyses trends so that investors can check that company managements are not putting a spin on rental rate trends to paint a more positive picture.

How are rental rates set in the first place?

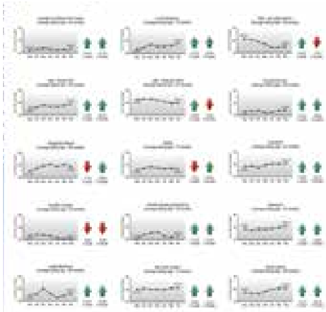
In an established rental market where multiple competitors supply similar equipment, competition determines the rates. While there is room for a niche offering, additional services or equipment advantages, most prospective customers will ask for the price very early in the conversation.

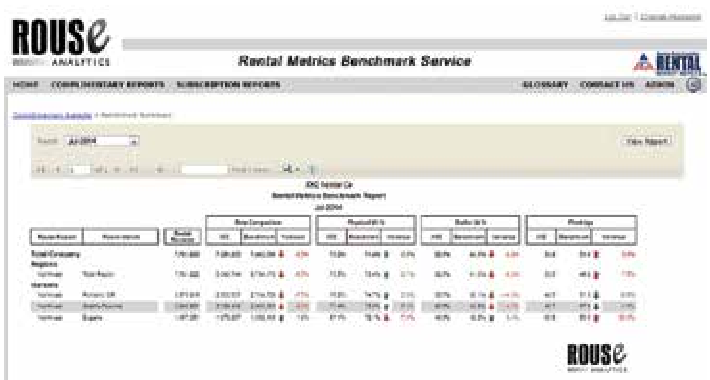
If a rental company has a truly unique offering - be it product, service or combination of the two - they can avoid the commodity type pricing that affects so many equipment categories. Many early applications for powered access provided huge efficiency gains compared to scaffolding, which allowed rental companies to charge very high rates, making the business very lucrative. Sadly those days are long gone, but volumes are higher now and machines less expensive in relative terms.

In the back of a customer's mind are always several questions: "That's expensive to rent, perhaps I should buy instead?" Countered by: "what is the total cost and risk of ownership, how often do I need the machine, can my capital be better employed elsewhere?"

"Should I rent the equipment or sub-contract the job?" Rent a car or take a taxi? In some countries such as India, you rarely have a choice, nearly all cars - and now platforms - are rented with a driver.

In more developed markets, the question has moved on to: "I need to rent several 45ft diesel booms, who has the best price?" All too often product quality and service are 'assumed' to be acceptable. One rental company owner in London declared: "Today you can't win business with good service, you can only lose it with bad service."



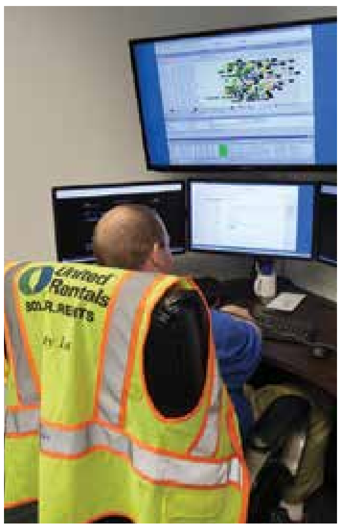


The 'ratchet effect'

Economists talk about the ratchet effect in relation to prices that go up easily with inflation, but are far more resistant to coming down. This works like a ratchet in a mechanic's toolbox or on a hand winch that turns one way but holds firm in the other direction. The equipment rental industry tends to have the opposite problem, rental prices come down very quickly, but recover very slowly.

Discipline and price delegation

But why do prices come down so quickly? Much of this can be explained by the oversupply of equipment either temporary or long term. If a rental company is missing its utilisation targets, especially when rates are soft, the temptation is to try and maintain revenue by discounting the last few machines in the yard. But one company's 'incremental' business, is another's core business and countered by retaliatory discounting and new lows. Rental companies are often highly leveraged, and desperate for cash to meet the payroll or bank payments, and can easily be tempted to discount a few machines for that extra revenue…. And so on it goes.



	United Rentals Inc. 2014	Andrews Sykes Group 2014	Lavendon Group Plc 2014	Aggreko Plc 2014	Ainscough Cranes Ltd. 2014
Rental Revenue	4,819	45,688	225,315	1,529	116,201
Rental assets at original cost	8,527	39,916	494,786	2,599	209,737
Financial Utilization	56.5%	114.5%	45.5%	58.8%	55.4%
payback In years	1.77	0.87	2.20	1.70	1.80
Depreciation Expense	921	4,563	37,186	259	13,363
	SG&A				
Wages and Salaries Expense	758	16,392	67,960	314	51,209
Total Personnel compared to depreciation %	82.3%	359.2%	182.8%	121.2%	383.2%
	US m $; SG&A is used in place of Wages and Salaries (disclosure)	GBP 000	GBP 000	GBP m	GBP 000
	General equipment with significant AWP population, US and Canada	UK, Europe and Middle East, water pump and HVAC specialist	AWP specialist with some telehandlers, UK Europe and Middle East	Worldwide generator rental and power project specialist	UK crane rental specialist, rented with operators or contract lifts

The 'ratchet effect' - on fleet

When rental companies see a chance for growth, they often invest as quickly as they can manage, especially the younger companies with entrepreneurial owners. However, most dispose of the fleet much more slowly. This is one of the keys to rate problems, rates don't move back up because rental companies don't, or can't, reduce their fleets as quickly as they added to them. Rental companies that can are the multi-country operations where machines follow the work to markets in a different phase of the economic cycle.

Australian rental companies suffer more than most with this. When the economy suffered a serious downturn, rental rates plummeted and used equipment was difficult to shift, partly because of distance to other markets and differing machine regulations. While Australia's equipment standards have helped keep prices high in the past, they also hinder de-fleeting in difficult times.

Rates and rental associations

So why can't rental associations do something to fight low rates?

Obtaining a regular supply of used equipment can be a challenge

Most suggestions around setting minimum pricing in an industry are seen as anti-competitive behaviour and illegal. Even where this has been attempted, it rarely works. Managing directors tell their subordinates to raise the prices "everyone has agreed to increase five percent now and five percent in the summer" but remind them that they still need to hit revenue targets. So the discounting continues its downward spiral, sometimes via free rental days, free transport or telling the customer to order a smaller machine and delivering the larger one he really needs etc...

Where rental associations have been particularly successful is by encouraging the adoption of additional charges, such as insurance and environmental fees. The Spanish platform rental association ANAPAT has been particularly successful in this area, although the Spanish market has had more than its fair share of challenges.

How to influence the rental rate - 'supply side'

Want faster payback times or higher financial utilisation? Buying equipment at a lower price will certainly help, starting with volume discounts and tough negotiation. Careful with what you save on though, it can affect resale value. What about cheaper brands? Are your customers price sensitive - will they pay more to rent a Mercedes than a Renault? Will they pay more for a boom with a jib?

How about used rather than new equipment?

Mathematically the payback is twice as good if you buy used equipment at half the price, all other things being equal. However, you shouldn't calculate payback on the used price, but rather on the new price. It's a rare rental company that can grow on the 'junkyard' model, buying only used machines for the rental fleet. Junkyard is not meant in a derogatory sense - I have been involved with such companies personally, and there are advantages, but they are rarely sustainable. Steady supply of equipment is an issue. Building a 'junkyard rental company in 2016 is challenging, given the lack of equipment produced between the 2008 crash and 2012.

A down side is that running costs for used equipment can be higher, with no warranty and aging componentry. In the car rental industry, the majority of cars stay in fleets for less than a year and are sold on while still under warranty, ideally before the first major service, helping keep costs down. An important lesson given the challenge of recruiting service engineers.

What is a good rate? Benchmarking

Benchmarking against the largest and most profitable rental companies is always interesting and often useful. The payback or financial utilisation for an entire fleet can be calculated the same way as for a single machine. Particularly interesting is comparing general and specialist rental companies and different types of equipment.

The usual benchmarking caveats apply. If you are looking at financial reports from the outside you never see the entire story, but it's still a useful starting point for further analysis. In 2014 United Rentals saw its share price and market capitalisation rise to all-time highs as profitability increased, and as the largest equipment rental company in the world, it's a useful benchmark. Its financial utilisation was 56.5 percent - a payback of 1.77 years

45 ft articulated boom example

Rental Revenue	£175 per week	6,825	£225 per week	8,775	£375 per week	14,625
Rental assets at original cost	75% utilization (46 euros per day)	35,000	75% utilization (59 euros per day)	35,000	75% utilization (98 euros per day)	35,000
Financial Utilization		19.5%		25.1%		41.8%
payback In years		5.13		3.99		2.39

Sources: Company Annual Reports, Annual Return at Companies House (for Ainscough), market intelligence and estimates.

compared to original price (it does not disclose replacement cost).

Lavendon, Europe's largest platform rental company has a slower payback of 2.2 years. What to read into this? The US market in 2014 was arguably further along in its recovery, while Lavendon has exposure to some of the tougher continental European markets which were still in recession.

Andrews Sykes Group is a specialist focussing on water pumps, Heating, Ventilation and Air Conditioning (HVAC) rental. It has much higher revenues compared to the asset values, therefore better payback. Generator specialist Aggreko falls between Sykes and Lavendon in terms of payback, as does Ainscough crane Hire, but it has the highest salary expense to depreciation ratio. It is more of a service business with every asset going out with an operator or a team of operators depending on the job.

Does this mean everyone should sell their platforms and buy water pumps? Financial utilisation and rental rates are NOT the whole story. The aerial lift market is much larger than for pumps which also requires far more personnel. Comparing salary expense to depreciation expense gives us a hint as to the service content of the rental offering. Sykes people-costs are more than three times its depreciation cost, so yes, you get great payback on the assets but it takes an army of people to put all that equipment to work and keep it maintained.

Single machine economics

The ratios of payback and financial utilisation work the same for a fleet or a single machine. Total revenue is made from a multitude of units, so comparing each unit against the total fleet goal is imperative.

Typical rates in the UK construction market for 45ft booms during the downturn averaged £175 a week. At £175 per week payback on the £35,000 machine is five years, leaving precious little for its maintenance and the overheads required to run a rental company. With rates now above £225 a week, payback is four years - still not exciting considering the infrastructure and personnel it takes to support the equipment and provide the service. Even the good old days' of the mid 1990s at £375 to £400 a week was not great compared to the cost of the equipment.

What to do about it? See part II in the April issue of C&A

Jeff Eisenberg has been in the equipment rental industry since the mid 1990s, when he established Genie Financial Services. Since 2000 his roles include rental company director, shareholder, advisor, consultant and even equipment operator.

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