THE RAILROAD WEEK IN REVIEW

October 10, 2014

"As the world is beginning to realize that the economy is not accelerating and that economic headwinds may be more than offsetting tailwinds, market volatility has increased." — John Larkin, Stifel-Nicolaus

View from the Peak is an independent investment research shop with a focus on investment implementation. From "No Change in Stance," Sep 18:

> The core of my thinking for the next six to nine months is that I believe that it will be impossible for the Fed to transition from the most extraordinary period of monetary easing in history to normalization in interest rates without a hiccup.
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> A 10 percent correction in the S&P will be minor by historic standards and yet there are many who naively believe that asset markets, being forward looking, have already priced this event. What the equity markets are doing now is simply grabbing their last sip from the punchbowl. Equity markets in the US appear too drunk to run because the sirens are blaring and this party is about to be shut down sooner than equity people expect.

What this has to do with railroads is simply that railroad share prices seem to be getting ahead of themselves in terms of actual earnings. Of the 15 rail stocks I follow from American Railcar to Union Pacific, not one has an earnings yield (eps as a percent of today's street price) greater than eight percent and most huddle in the four-five percent range. Add dividend yield and total yield runs from nine percent (KOP) to three percent (CP).

Variant Perception, a buy-side investor advisory shop that uses Leading Indicators exclusively, sees a narrowing of market breadth as measured by the ratio of share price highs to share price lows, currently 0.78 for the Sep 10-Oct 10 trading sessions. The argument is that the current picture, with more shares seeking new lows than seeking new highs does not bode well for future share prices.

Furthermore, says VP, share buy-backs and expanding multiples have helped push share prices higher.

> Stock buybacks have been an important feature of the equity rally. Companies have used low interest rates and easy credit to borrow money and used it to buy their own shares back. An identity for a company's share price is: S = (revenues * margins * P/E) / # of shares. Buying back shares reduces the denominator in this equation, thus (all other things equal) boosting the stock price. But buybacks are waning; we've seen a 27 percent decline in buybacks

> between 1Q14 and 2Q14. YoY it is down 1.6 percent. (Interestingly, the peak in buybacks was also the peak in the US stock market in 2007.)
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> Revenues are closely linked to nominal GDP, and our US leading indicator sees this as lackluster at best going forward. Our leading indicator for wages has turned up, and this tends to lead to lower profit margins. Finally, multiple expansion has been a big driver of equity returns in 2012 and 2013, accounting for about 75 percent of returns. However, already in 2014 it is slipping, down from 67 percent in May to barely 50 percent today (bottom chart). In short, the pillars of equity performance are crumbling, making it difficult to see how equities can remain supported between now and into early next year.

To which Estimize Research adds, "Last season saw quarterly stock repurchases decrease to their lowest level in almost two years. And as companies lowered share buybacks, they put more of their money into capital expenditures, which hit their highest level in years, a more worthy use of corporate money from our perspective."

My takeaway is that some rail industry share prices have gotten ahead of themselves not only in terms of multiples and yields but also in terms of discounted cash flow intrinsic value. Using the same sample, six names are trading at prices sufficiently below their IVs to provide at least a ten percent margin of safety (Union Pacific and CSX are the only railroads). American Railcar, CN and KCS are right at their respective IVs. The rest fail the margin-of-safety test.

The technicals support a market view of deteriorating rail industry prices. The Market Edge technical service lists only NS as a strong buy, eight names as Avoid, and the rest as "deteriorating." Even the IYT transportation ETF is listed as Avoid. Getting back to leading indicators, share prices reflect where Mr. Market thinks companies are heading. Downward drifts are not encouraging.

The latest unemployment report is somewhat upbeat, though the number of people actively seeking employment still trends downward. As a result, what goods we consume are manufactured by a smaller percentage of the population. Yet those goods still have to get from the producers to the consumers, the latter comprising the entire population whether part of the labor force or not. Railroads are in the business of moving stuff, and they're not going away. But it concerns me when rails are trading at multiples more usually accorded high-tech firms.

As noted above, share buy-backs and P/E multiples can push up share prices, and that's why WIR continues to focus on revenue unit volumes, freight rates, and operating incomes. Cowan's Jason Seidl says the 2014 fourth quarter rail shipment estimates are looking up, despite service wobbles:

> Shippers expect their respective businesses to expand at an average rate of 7.6 percent over the next 12 months. This is 70 bps better than the 6.9 percent result recorded in our 2Q14 survey, represents the fourth consecutive quarterly improvement, and marks the first time

> since 1Q11 that the index broke 7.0 percent. All industry segments are expected to grow. In order of magnitude, the outlook for transportation, agricultural products, petroleum products, other traffic, and metals improved from 2Q14. The outlook for building products, forest products, consumer products, and chemicals declined from 2Q14 but remained positive.

That said, Jason reports that more customers are worried about the railroads' ability to handle everything that's coming at them according to plan. It's instructive to note customers are paying attention to the details: a third of respondents say equipment availability is their biggest concern, a third worry about train-crew staffing, and the balance wonders if there's enough track to run everything according to plan. The customer consensus is service will be a lot better by the end of June, 2015.

I'm not convinced. Too much depends on the accuracy of rail shipper demand forecasts, consumer behavior, and the world economy in general. The rails' robust capex and hiring programs are putting the assets in place, but achieving the balance between too much and not enough is always a tricky proposition. I say give it a year.

RailTrends 2014 is shaping up nicely. BNSF's Matt Rose will address the group at the close of Thursday's program and I expect coal, crude oil, grain and intermodal will be at the top of the Hot Topics list. Through Week 39 (Sep 27) all but crude-oil vols were essentially unchanged year-over-year; I expect lack of track space, crews and power are all contributing factors. I'm looking forward to hearing Matt's observations.

Don Broughton and Tony Hatch will do the Analyst Take. I like the way these two play off each other and bring fresh perspectives beyond pricing, operating ratios, and earnings per share. Inquiring minds want to know what's driving the numbers and how operating practices, infrastructure availability and manning play off each other. It'll be a spirited discussion, I'm sure.

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