RAILROAD WEEK IN REVIEW

September 30, 2016

"The energy business saw a rebound in the price of natural gas and natural gas liquids." — Cumberland Advisors

George Friedman's *geopoliticalfutures.com* reports that China has imposed anti-dumping duties on U.S. distillers' dried grain (DDG). H says we already know that the U.S. has imposed anti-dumping duties on Chinese steel exports and wonders if there's a trade war brewing here.

I did a little digging and found that, according to the US Grains Council, DDG exports have exploded from 1 million tons in 2006 to more than 11 million tons in more than 45 countries in 2014. China received the bulk of DDG exports, consisting of 38 percent of the export market, while Mexico (14 percent) was the second largest importer. Korea (6 percent), Vietnam (5 percent) and Japan (4 percent) round out the top five.

The Council says that all-in, U.S. ethanol plants possess the capacity to produce more than 14 billion gallons of ethanol and 39 million tons of DDGs. An embargo on US DDGs (STCC 20823 and 20859) could hurt the rails. 38% of 11 mm tons is 4.2 mm tons; 38% of that is 1.6 million tons, which means roughly 16,000 carloads at 100 tons each are at risk.

My *USRailDesktop* waybill sample shows about 100,000 carloads of DDGs per year, roughly a quarter of the total output. BNSF is the number one carrier by far, averaging more than 10,000 carloads a quarter during the 2013 peak ethanol year, and thus the most vulnerable; UP was a distant second and everybody else was flat in the 1-3,000 range.

AAR Week 37 carloads (through Sep 17) remain well below last year's levels on sharp declines in coal, metals and crude. 3Q16 traffic is down 5.9% y/y. Backing out coal, auto and intermodal, manifest carloads are down 5.2% YTD vs this time past year.
CSX kicks off Q3 Earnings Season Oct 12. My sense is it's not going to be pretty.

	2016	2015	% Chg
Total	28,598,306	30,807,332	-7.2%
Coal	3,574,565	4,767,682	-25.0%
Auto	1,465,401	1,404,428	4.3%
Intermodal	13,317,972	13,790,031	-3.4%
Manifest	10,240,368	10,845,191	-5.6%

The Sep 26 note from Cumberland Advisors, "MLP: Third Quarter 2016 Review," provides some important observations about the oil and gas exploration business. The opening argument is that in Q3 "the energy business saw a rebound in petroleum prices, and in the price of natural gas and natural gas liquids. With drilling and service costs down and the price of products up, we did see a tentative recovery in drilling activity and rig counts in North America."

In addition, MLPs and midstream companies reduced leverage/mended balance sheets by "increasing liquidity facilities, reducing or postponing capital spending, combining pipeline efforts or forming joint ventures, raising equity capital, or (when necessary) reducing distributions or dividends."

In sum, the energy business is at least part of the way through the process of adjusting to lower prices and lower volumes. Consequently, MLP performance of late has lagged both the broad energy sector and the broad US stock market. That said, Cumberland remains "optimisitc." Specifically, Cumberland is "positive about new investments in MLPs, as long as the investment makes sense in light of a client's investment objectives and risk tolerances."

For the railroads, if Cumberland is right, we should see some resurgence of inbound drilling supplies, if not any recovery in outbound crude oil.

Trends in railroad share prices are an excellent indicator of how the investment community views the outlook for rails, and from that we in the short line and regional railroad space can get a feel for relative strengths and weaknesses. I have before me a computer screen with 1-year stock performance curves for the 8 publicly-traded rails, using BRK/B as a proxy for BNSF.

Every single one shows a run-up to early Sep, a dip and then a slight increase. Most are showing the SMA 20 crossing the SMA 50 to the downside, with shares at or below the 50. All are comfortably above the SMA 200.

The Market Edge technical analysis tool carries all the rails as LONG, though all show signs of share price deterioration. For a closer look, I use Recognia on Schwab's StreetSmart Edge, as Market Edge tends to lag the action by a week or so. With the exception of BRK/B, the Big Six Class Is all carry bullish indicators; GWR and KSU lag.

The price/value relationship is a mix. I use PE=15 as sort of a middle-of-the-road point. Only CSX and UNP meet that test. Finally, gurufocus.com uses a discounted cash flow model to estimate the fair value of companies. Here again, only UNP and CSX meet the test. The consensus fair value for BRK/B is in the $150 range. If you buy that, we're there already with little "margin of safety."

Frankly, I am at a loss as to why rail shares are trading at these levels. The tea leaves point to a two percent economy and the rails can't get too far ahead of that. We hear on the calls about "inflation-plus" pricing in the four percent range, suggesting operating income gains in the two percent range. The institutional investors who own 85 percent of the shares are looking for returns in the six percent range, which doesn't seem to be in the cards for the rails. The answer can't be in dividends — only UNP and NSC are north of 2.5 percent — and no rail meets a 10 percent hurdle for dividends plus earnings yield. (Buying back shares to bump eps by a lousy two percent is cheating.)

Message to short lines and regional railroads: All the rails but BNSF are under the Wall Street microscope and scrambling for ORs that please the street. If the past is any prolog, OR reductions are driven more by price increases than ops expense reductions. But we have to earn price hikes (see NS' Mike McClellan at NEARS re a better customer experience, WIR Sep 23), and there is a limit to how far you can cut costs and still maintain competitive advantage.

Therefore we must push for vols that at least cover variable cost plus an overhead contribution. Look for ways to lower variable cost by blocking outbounds by destination, so that cars can go directly to the departure yard from the receiving yard. Get trip plans for everything coming at you and measure trip plan compliance. If you have an ISA, measure Class I compliance as well as your own to cut dwells.

This week's note from John Larkin at Stifel suggests the gloom may be lifting: Rail revenue unit volume was up sequentially by nine percent the week ending Sep 23, after increasing a like amount the prior week. Overall total unit volume (i.e., commodity carload and intermodal units) was down three percent year-over-year. So the week was better; is there a continuing trend?

Perhaps not. Truck spot demand is up a third over last year, which suggests orders for goods are coming in at a faster rate. The thing seems to be there's no time to wait around for the rails — I'll pay the higher spot rate and be assured of delivery rather than paying less for intermodal and not knowing. And for good reason. Larkin shows that dwell deltas still stink, which is one reason for the "demand destruction" of railroad transportation, as one wag put it.

The first-mile/last-mile carriers can't do much to fix any of this. But by tracking trip plan compliance, you'll probably know where cars lose time better than your sales rep or market manager. Then you can provide time/place facts to start the wheels in motion to get stuff fixed.