RAILROAD WEEK IN REVIEW

January 10, 2020

“Industry growth rates have not yet bottomed, with weak readings across modes, highlighted by weak rail volume growth and expectations for a competitive truckload season. That said, we continue to believe this current freight cycle bottoms during 2020. Consumer demand trends are stable and retainers are normalizing inventory positions.” — RW Baird client note, Jan 6

“Overall, the operational efficiencies with our class 1 interchange partners have been positive for our customers and our railroad. We have been able to improve on our transit and reliability to and from our gateways throughout New England. Our improved transit and less dwell have afforded the opportunity to reduce the volume of cars on the network and keep serving yards fluid.” — Pan Am Railways in-house magazine

AAR North American revenue units finished Week 52 (December 28) down 4.0 percent. Intermodal was also down 4.0 percent, yet carloads excluding coal and auto dropped just 2.5 percent. Every single carload commodity group was in the red except for “petroleum and petroleum products,” which, we all know, is driven by crude oil car counts.

AAR NA Class Is	2019	2018	Change
Total Traffic	36,486,394	37,945,850	(4.0%)
Intermodal	18,245,295	18,975,107	(4.0%)
Total Carloads	18,241,099	18,970,743	(3.9%)
Auto	1,343,050	1,371,254	(2.1%)
Coal	4,402,455	4,781,066	(8.6%)
Merch Carloads	12,495,594	12,818,423	(2.5%)
Source: AAR thru Dec 28			

Susquehanna lead rail analyst Bascome Majors finds “the soft spots” can be explained by “an incremental US macro downshift,” citing volume losses in coal, intermodal, and grain.

On the other hand, Majors “remains constructive on the railroads into 2020,” with volumes returning in the second half.

Happily, short lines and regionals are still out there drumming up business. Channel checks reveal one 300-mile property that increased revenue units by six percent and revenues by double-digits thanks to commodity mix and length of hauls. It doesn’t hurt that the short line guarantees each customer a two-hour service window and a minimum service level of five days a week with trip plan performance in the 99 percent range.

Another operator with a number of non-contiguous lines in close proximity scored a ten percent gain in carloads, six new freight customers, bought 40 more cars for its fleet of local-service equipment, and added new transload facilities. Yet a third operator with a somewhat wider reach has opened a new ethanol transload that will later add bio diesel to the mix. Some 3,000 loads a year are budgeted.

Yet there are times it seems the non-Class I community brings on new business in spite of the Class Is, not because of them. A reader writes,

> Although the railroads tout the fact that PSR drives down costs, thereby providing them with more leverage to compete with trucks, their actions (commercially) show the opposite – they are so focused on driving up rates that they effectively become less competitive and in the long run, less relevant. Theoretically, business which may have been considered "marginal" in past years, should appear far more attractive now since PSR has so radically improved railroad cost structures.
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> The way I see it, the railroads' obsession with driving up rates and focus on operating ratio has existed for years. Add to this the neglect of the sales & marketing functions by many carriers – and absolute disinvestment in this functional area by some. In some places, the commodity portfolios being handled by an individual today were handled by two, three and in one case five people just a few years ago. The field sales function has been similarly decimated.

If the writer's observations are correct, and this minimalistic approach to business development is not addressed, revenue unit counts will continue to fall no matter how successful PSR may be in improving efficiency and reducing costs. I keep going back to Peter Drucker: " The purpose of any business is to create customers." Not doing so is a going-out-of-business sign.

Railroad share prices at the end of the year had drifted back toward "fair value," defined by gurufocus.com from its "the discounted cash flow" valuation model that combines the company's balance sheet value, future business earnings, and earnings growth.

As you can see, four of the six Listed Class Is are trading at less than their DCF-based fair value (I'm using Berkshire as a proxy for BNSF[1]). The MOS, or Margin of Safety, tells how much the share price can increase before becoming equal to fair value.

Tick	Price	Guru IV	MOS
BRKB*	$ 226.00	$286.00	20.98%
CNI	$ 90.45	$87.16	-3.77%
CP	$ 238.24	$320.18	25.59%
CSX	$ 71.34	$80.27	11.12%
KSU	$ 152.42	$162.27	6.07%
NSC	$ 193.50	$172.58	-12.12%
UNP	$ 175.99	$198.21	11.21%
* BRK Book = seeking alpha A est $429000 mm			

[1] Berkshire A book shares are estimated at $429 billion. There are 1,500 B shares per A share. Ergo B share book is $429 billion/1500.

By that measure CP is the most under-valued, with share price roughly three-quarters of fair value — the company is on sale at 25 percent off MSRP. At the other end of the scale, NSC shares are going for 12 percent more than they're worth. And I think valuation creep has a lot to do with it. UBS analyst Tom Wadewitz agrees, writing "valuation expansion was the dominant driver" in his Jan 7 note to clients. Perhaps the buy-side is taking the volume slide seriously[2].

The AAR's "motor vehicles and parts" category "consists of STCC 371; around two-thirds of carloads are assembled motor vehicles and around one-third are motor vehicle parts. Large amounts of auto parts move in containers today, but they are included in our 'intermodal' category and not in the carload data."

Combined US plus Canada motor vehicle carloads were up ten percent year-over-year in summer 2018 and down ten percent last summer. QCS data for STCC 3714, "motor vehicle parts & accessories" were essentially flat for the same period. Which makes sense. I've written before that even though new car sales off the lot are slipping, dealer inventories keep rising —finished vehicle carloads STCC 3711) are also unchanged for the year.

Now comes the WSJ for Jan 7 to report Ford vehicle sales were off 3.2 percent in 2019, "reflecting a broader cooling of demand in the US auto market after a record period of elevated results." Overall, US vehicle sales slipped 1.6 percent in 2019 as "auto dealers grappled with unusually large stockpiles of unsold vehicles." Gotta hit parts suppliers — and the railroads that serve them — sooner or later.

Crude oil futures are creeping above the $60 break-even point for shale drillers (WIR 1/3), closing Tuesday at $62.27 after hitting a $65.65 daily high. Not so fast says Bloomberg's Lisa Abramowicz. The debt load is creeping up as well, On Wednesday, she tweets, "Junk-rated energy companies are taking advantage of higher oil prices and the rally in riskier debt to sell a bunch of bonds. Energy companies accounted for 57 percent of U.S. High Yield bond sales yesterday, with a bunch more on tap, including Range Resources & Transocean."

Whereas Transocean (NYSE: RIG) results don't hit very close to short lines, Range Resources (NYSE: RRC) do, thanks to its presence in the Marcellus and Permian energy fields. They now have long-term debt at 94 percent of equity and Moody's rates their debt as Ba3, "non-investment grade, speculative." Shares are going for under $5 and half the 34 analysts covering RRC rate it underperform or sell. It would behoove regional railroads active in the RRC service areas to watch volumes and demurrage bills very carefully.

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[2] It's not just the railroads. In 4Q2019 the $SPX average dropped 6% while the average share price fell 4%.