RAILROAD WEEK IN REVIEW

March 20, 2020

"It is becoming increasingly obvious that this pandemic will cause a worldwide recession and the worst has yet to come in regards to number of people infected in North America. The headlines and news are creating many dislocations in the market that can be taken advantage of. That said, we are in for much more volatility in the coming weeks but it is important to remember that the markets will find a bottom." — PFL Petroleum, March 17

"A total quarantine is impossible, but the more aggressive the quarantine is, the more pressure it puts on vulnerable supply chains that sustain life. The systems require staff, and the staff cannot avoid contact with the public." — George Friedman, Geopolitical Futures, March 17

The coronavirus has yet to take its toll on the railroads, but it's coming. My guess that it will first be in international intermodal and then in automotive, the common thread being the number of SKUs in the global supply chain. My favorite "heat and eat" category — everything from fertilizers to frack sand to beer and beans — will be least hit as they are produced and consumed at points within reach of the North America railroad system.

Commodity	Jan 20	Jan 19	Chg	H&E
All Other Carloads	71,181	78,136	-8.9%	
Chemicals	57,764	53,399	8.2%	17.0%
Coal	16,309	21,140	-22.9%	
Crushed Stone, Sand and Gravel	21,530	22,974	-6.3%	
Food and Kindred Products	11,068	11,548	-4.2%	3.3%
Grain	23,384	25,482	-8.2%	6.9%
Grain Mill Products	8,982	7,542	19.1%	2.6%
Lumber and Wood Products	8,723	8,936	-2.4%	
Metallic Ores	2,760	3,307	-16.5%	
Metals and Products	18,632	19,514	-4.5%	
Motor Vehicles and Equipment	10,043	9,281	8.2%	
Nonmetallic Minerals	2,833	2,535	11.8%	
Petroleum Products	2,312	2,330	-0.8%	0.7%
Pulp, Paper, and Allied Products	21,580	21,127	2.1%	
Stone, Clay and Glass Products	12,800	11,872	7.8%	
Trailer or Container	39,950	42,482	-6.0%	
Waste and Scrap Materials	10,434	10,279	1.5%	
Total	340,285	351,884	-3.3%	30.4%
Source: Railinc				

It what's in the non heat-and-eat group middle that worries me. This table is a repeat of the Railinc January carloads that I used last week, only this time it shows the percentage of non-Class I carloads that loosely fit into the heat-and-eat group. I've omitted coal because it's not a big part of most non-class I franchises; petroleum products is included for LPG, asphalt shingles, and others in the STCC 29 group.

Here's the source of my concern. The New York Federal Reserve's latest Empire State Manufacturing shows that business conditions have fallen to their lowest level since 2009; the survey's decline from February to March was its largest on record.

> Delivery times lengthened slightly, inventories increased, employment leveled off, and the average workweek declined. Input price increases were little changed, while selling prices increased at a slower pace than last month. Optimism about the six-month outlook fell sharply, with firms less optimistic than they have been since 2009.

Obviously, a slowdown in manufacturing activity precedes a decline in freight demand, especially if you're not in the heat and eat business, and so my chart above. Some 70 percent of Class I carloads are outside the heat and category. Thus, if this coronavirus phenomenon is going to shrink demand for everything that is not heat and eat, so will it also shrink demand for transportation services, especially for the non-Class I one railroads.

Headline: "The biggest U.S. airlines spent 96 percent of free cash flow last decade buying back their own shares." They are pikers compared to the North American Class I Railroads. I don't know how they computed "free cash flow" for the airlines, but I say FCF is cash from operations less capex less dividends paid. By this measure, the seven NA Class Is in 2019 paid $12 billion for share repos out of $6 billion of free cash flow.

Here again, I risk censure for this market-speak, but it's important for non-Class I railroad operators to keep tabs on their Class I connections' fiscal health. Moreover, the accelerated pace of share buy-backs has made corporations themselves the largest buyers of shares in the whole stock market, and that's going to hurt not only cash flow but also retail investors. I think Real Vision CEO Raoul Pal sums up the hazard eloquently. From his March 6 comments:

> The propensity for Baby Boomers to want to protect their life savings so they can retire is going to be extremely high because they're going to be extremely nervous. That kicks off their selling as the pensioners panic out of positions and then have to crystallize losses. But lowering the future growth rate means retirees will crimp consumption going forward.
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> There's another dynamic at play here, which is the doom loop which concerns me even more greatly because it hits the pensioners yet again. The doom loop is essentially that US corporations, due to a ridiculous tax regime, buy back their own shares and issue record amounts of debt. And eventually they become the only buyers of equity left, further dooming the poor Boomers.

Call me old fashioned, but I still use the so-called "Graham Number" to estimate the proper price of any stock. The premise is the proper price of any share assumes shares are trading at no more than 15 times trailing 12-month earnings per share and no more than 1.5 times book value. Yes, I know railroad shares have been trading north of those multiples for some time, but it's still helpful to know where each railroad's share price stands above or below the Graham Number.

Even with the current slide in share prices, I calculate that each of the seven Listed railroads trades at a premium to its Graham Number, from as little as a dime for NS to five times that for the Canadians. As revenue falls due to shrinking supply chains, GAAP operating and net earnings will shrink, and so will the Graham Number. If share prices fall proportionately, we could be back to a place where railroad shares are reasonably priced and worth a second look.

If, on the other hand, free cash flow has been so diminished by excessive share repos, then all bets are off. The asset base has shrunk to what's needed for present traffic levels, so as business returns as we get past the present downturn, where's the operating cash flow to provide the capex and personal needed to win back customers? It's something to think about.

Mark Wallace, EVP for Sales & Marketing at CSX, has written a Customer Letter telling how CSX is coping with the COVID threat and what customers can do to help themselves as well as CSX. I think it is worth calling out because it's a display of candor and understanding one seldom sees from a railroad. With respect to customers, he writes,

> You can also help us ensure we are able to provide timely and efficient service. If you are anticipating any supply chain adjustments as a result of the COVID-19 situation, please let us know. With advance knowledge and planning, we can position our resources accordingly to continue to safely move our customers' freight.
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> This is a developing situation and CSX will adapt our business operations as needed to ensure our employees, families and customers are safe, and to provide our usual high level of service for your railroad needs.

That level of candor and support must be applauded. I'm hopeful all customers on CSX connecting feeder railroads see it as well, and that the feeder lines themselves pick up on the leadership Wallace is providing.