RAILROAD WEEK IN REVIEW

April 6, 2018

"CSX currently expects total growth in 2018 to be basically flat with last year. So far this year, demand has been largely aligned with expectations." — Jim Foote, CSX President and CEO in his March 28 report to the STB

The Wall Street outlook for railroad shares is quite upbeat, based on operating improvements and earnings-per-share increases. Personally, I don't see it. I've noted many times the AAR stats showing how US total revenue units have declined from 340,000 in the 2006 peak year to 240,000 at the end of 2017. And if volumes wane, can revenues and earnings be far behind?

Take CSX, for example, because they are in a state of flux and because the new owners are convinced the railroad can do better than it has in the past. As you can see from the adjacent table, total 2017 revenue units are the same as they were in 2012 — merch carloads flat, coal down a third, and intermodal up nicely.

CSX 2012-2017	FY 2012	FY2017	Change
Merch (000)	2,688	2,702	0.5%
Coal (000)	1,290	855	-33.7%
IM (000)	2,451	2,843	16.0%
Rev units (000)	6,409	6,400	-0.1%
Rpu	$1,785	$1,783	-0.1%
Revs ($mm)	$11,756	$11,408	-3.0%
Ops exp	$8,299	$7,416	-10.6%
Ops Income	$3,457	$3,992	15.5%
OR	70.6%	65.0%	-5.6
Share price	$19.73	$55.01	178.8%
Share count (mm)	1,040	914	-12.1%
Source: CSX flings			

Revenue dropped because each intermodal unit, at 2017 prices, brought in a quarter of what the average merch or coal carload brought in. And since you can only load two or three containers per intermodal platform, the carload equivalent revenue per revenue ton-mile is only half the conventional carload. That's one big reason RPU is unchanged.

Investors aren't complaining, though. Operating income gained more than 15 percent over the period and share prices jumped by a factor of nearly three times. But remember that CSX gapped up from $35 to $45 when Hunter was announced as coming to town in Jan 2017 and shares have traded in the $50-$55 range ever since, using the 200-day moving average almost as support.

It is striking to note how seldom the financial community mentions volume. It's all about lowering the operating ratio and increasing earnings per share. You can see how cutting operating expense by more than the revenue decline increases operating earnings and cuts the OR. And reducing the share count by 12 percent gives a nice boost to earnings per share, too.

The question now becomes, is the initial rate of change for CSX share prices sustainable? The technical service Market Edge notes that, over the last 50 trading sessions, "there has been more volume on down days than on up days, indicating that CSX is under distribution, which is a bearish condition. The stock is currently above a falling 50-day moving average. A move below this average could trigger additional weakness in the stock. CSX could find secondary support at its rising 200-day moving average," now at $54.

Morningstar maintains a $51 fair value estimate based in part on CSX reporting 4Q2017 flat revenue "on a two percent volume decline from prior-year period, reflecting price increases and greater fuel surcharges, constrained by mix." Susquehanna's Bascome Majors sees 1Q2018 CSX commodity declines across the merchandise group, with intermodal the only bright spot. He concludes, "Downside risk could come from execution missteps or bumps in the cultural transformation at CSX, or a rollover in the U.S. economy, rail volumes, and by extension CSX's revenues." I'll sit this one out, if it's all the same to you.

Norfolk Southern Chairman, President and CEO Jim Squires has responded in writing to the STB's March 16 service outlook request. He begins by citing less-than-stellar operating metrics over the first 11 weeks of the year: system train speed down 16 percent from a year ago, and down seven percent from the 2017 fourth quarter; yard dwell up 21 percent vs. a year ago, and up nine percent over the previous quarter. Re-crews jumped 133% year-over-year in February and local performance was seven percent below target.

Squires writes, "Decreased velocity and increased dwell time add to, in the short term, the need for track capacity, locomotives, and crews, and place a premium on having an effective operating plan and maintaining solid communications with customers." Accordingly, NS is…

Reopening the Birmingham-Columbus-Macon line to through traffic;
Restoring to service and leasing some 190 loco units;
Accelerating and continuing the 500-unit DC-to-AC locomotive conversion program;
Hiring 1,400 conductors in addition to the 459 now in training;
Developing "Go Teams" that can deploy to trouble spots within 48 hours;
Relieving choke points in the deep south, the midwest, and Pittsburgh;
Taking steps to cut yard dwell times and improve throughput;
Creating a more resilient railroad less prone to failures and able to recover quickly;
Re-engineering the train plan with a terminal-centric focus.

There are no plans to dispose of or close main lines, and Squires vows to tell customers "early and often" what NS can do and can't do, "whether in regard to missed switches or delayed shipments." As to auto and grain shipper complaints, NS is making changes in grain train routings and is addressing the auto-rack shortage at the TTX level. Let's see how they do.

The Conrail Shared Assets Operation (CSAO, a wholly-owned subsidiary of NS and CSX) and the Southern Railroad of New Jersey (SRNJ, an independent short line operator) have petitioned the STB for SRNJ "to lease and operate" a potion of the former PRSL Salem branch in southern New Jersey. The line in question extends from the CSAO wye in Woodbury to its connection with SRNJ at Swedesboro, a distance of just over 10 miles.

CSAO predecessor Conrail sold the southern end of the Salem branch, from Swedesboro to Salem,18.6 miles, to the Salem County government in 1985. SRNJ contracted with the county in 1995 to take over operations, thus the present agreement with CSAO to run the entire branch.

The change makes sense. The Salem branch from Woodbury had a few lucrative customers in Swedesboro, and not beyond. Over the last 20 years, as Salem County has become more residential and less agricultural, the railroad business base of packing plants and feed mills disappeared. Customers remaining in Salem include Mannington Mills flooring and the Port of Salem, which SRNJ can serve on an as-needed basis, saving CSAO from making what is essentially an overhead move to Swedesboro from the Woodbury connection with its Camden-Penns Grove main line.

I would not be surprised to see more such CSAO arrangements elsewhere in New Jersey. Both CSAO owners are busily right-sizing their own core routes, so applying the same rationale on their joint properties (CSAO has operations in northern New Jersey and Detroit as well) is only natural. SRNJ has two other branches in southern NJ (hence the name) and exists to run light-density branches. An excellent fit.

Soybean exports could take a significant hit due to retaliatory tariffs from China, says Thursday's WSJ. The trend is already down — 14 percent year-over year in 4Q2017 alone. On its website, the AAR tells us, "Soybeans accounted for 18% of U.S. grain production from 2007 to 2016 and over that period, exports accounted for 45% of soybean use." No wonder soybean futures dropped four percent to $9.85 a bushel, the lowest level since early February.

BNSF leads the industry in beans, hitting 70,000 carloads during the annual fourth quarter peak, nearly double second-place Union Pacific, and five times what everybody else does. The WSJ reports elsewhere that further cuts in exports are "forcing some American farmers to rethink planting and investment decisions," affecting planned purchases of everything from fertilizers to tractors and storage bins. Yet BNSF's Carl Ice says in his March 22 Service Outlook letter to the STB, "Export grain strength is expected to continue throughout the remainder of the year, leading to a projected annual volume record." Could be corn is replacing beans for BNSF.

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