RAILROAD WEEK IN REVIEW
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"Leveraged loans are structurally senior to high-yield bonds, have a floating rate structure, and offer more protection against higher rates." — Almost Daily Grants, May 14

One company used to issue all their debt as 'Senior.' When everyone is senior it is the equivalent of everyone being in the same asset class so no protection."— a WIR reader

"If everybody is somebody, then nobody is anybody." — Gilbert & Sullivan, The Gondoliers

It worries me to see companies get all leveraged up, where there is more debt than equity, where operating income barely covers debt service, and where outstanding debt is some multiple of cash flow. I have company.

John Mauldin, in his May 11 *Thoughts from the Front Line,* writes that credit cycles are now replacing the classic business cycles, and that that the next financial crisis will bring a major debt crisis. Moreover, the inevitable debt crisis could be "the opening event, of a rapidly-approaching train wreck."

He argues that the usual boom-bust-recovery-boom cycle broke down as the recent decade gave way to an extraordinarily weak two percent GDP growth rate, not the more expected five percent rate, and the Fed rate cuts have been partly to blame. As a result,

> We no longer have economic cycles. We have credit cycles that ebb and flow with monetary policy. After all, when the Fed cuts rates to extremes, its only function is to encourage the rest of us to borrow a lot of money and we seem to have been very good at that. Thus, in reverse, when rates are being raised, when liquidity rolls away, it discourages us from taking on more debt. And, over time, debt stops stimulating growth.

To make matters worse, the banks we borrow from are far more leveraged this time. They made loans with money the banks themselves had borrowed, confident that low interest rates and defaults would keep risks manageable. It's gotten to the point where, according to S&P Global Market Watch, three quarters of corporate bonds that are leveraged are what's known as "covenant-lite."

Not to put too fine point on it, Stephanie Pomboy at Macromavens writes that the cov-lite market share has grown steadily as investors "have flooded the market with cash, looking to take advantage of the floating rate asset class amid rate hikes by the Fed." As a result, Cov-lite loans' market share has more than tripled —from 20 percent ten years ago to more than 60 percent today.

She concludes, “Detractors say these deals – which are structured akin to high yield bonds, offering less protection to lenders – could significantly impact recoveries when the current, long-running, issuer-friendly credit cycle turns.”

Class II and III railroads are in a particular bind. Their customers are mainly small-cap firms that invariably borrow when sales are down but there are still employees to pay and facilities to be upgraded. Ditto the small railroads themselves. Revenues go down, debt service as a percentage of operating income goes up, net incomes shrink. (Don’t get me started on the evils of EBITDA.)

The reason railroad customers’ revenues go down is they’re selling less, and so there are fewer goods to move. That’s why we see maybe a third of the North American short lines both leveraged up and stuck in a rut. They’re stuck with a franchise of single-carload commodities where vols shrink as customers retrench — the very commodities the Class Is are de-marketing.

What to do about it? I keep going back to the CSX Core Value Number One: It starts with the Customer. There are four elements: reliable service, understanding and addressing customer requirements, being easy to do business with, and owning their transportation challenges. But it goes farther than that. Customer satisfaction depends on what happens to their cars beyond the short line’s tracks.

Here, Class I behavior can make or break any customer relationship. I think the first question when taking any customer concern to your connecting class I is this: Do you want this piece of business? It’s an absolute yes or no, if only for Core Value Number One: It starts with the customer. These actions are what it’ll take to convert opportunity into cash. Yes or no. End of discussion.

Tis the season for the spring round of investors conferences sponsored by the banks and investments houses. Tuesday, Bank of America Merrill Lynch held its 25th Annual Transportation Conference in Boston, ably hosted by senior rail analyst Ken Hoexter, who’s been doing these for most of those years. I like to tune in, not so much for key insights and who’s doing what and why, but to hear how the projections from late April’s earnings calls are progressing. Some highlights:

Kansas City Southern CFO Mike Upchurch zeroed in on new Canadian crude oil moves to the Gulf Coast, increased volumes of plastics out of the same place (nice balance: goods in, goods out — certainly balances the assets), refined petroleum products into Mexico up double-digits, intermodal continuing the upward growth trend. Same-store is pricing up three percent, renewals are running a bit better.

Canadian National CFO Ghislain Houle says they’re working their way out of the recent winter unpleasantness, with year-over-year April and May RTMs up five and 14 percent respectively. He expects Canadian west coast terminals to be very busy this year with new trans-Pacific carriers calling starting now; strong demand for frac sand and metals; catching up with the forest

products backlog; Canadian grain recovering enough to project 5,000+ weekly car spots (U.S. grain flat); and the return of crude by rail — but slowly. Service metrics (car miles per day, order fulfillment, terminal dwell, etc) are returning to what we have come to expect from CN. Capacity investments are running to C$900 million, most of which goes to the critical Winnipeg-Prince Rupert Corridor.

At CSX, Frank Lonegro, CFO, says the push is on managing cars, not trains. Car trip plans are dock to dock and embrace local trains, yard jobs, core trains, and locals at the other end. [A caveat here: CSX said at the March shortline workshop that trip plans for cars for/from shortline stations begin and end at interchange, thus losing car days interchange/on-off. Hope they fix that soon. - rhb] Lonegro avers that good customer service goes a long way, and with the merch carload trade running at two-thirds of total units, it's imperative they take out route miles, and reduce handlings. And CSX is still sorting out which line segments they can live without long term — which to keep, which to shortline, which to abandon.

Norfolk Southern CEO Jim Squires maintains NS is less concerned about hitting certain OR targets and more interested in generating top line growth, saying this is the "most conducive" environment for doing so they've seen in years. They acknowledge the need for shorter transit times and less terminal dwell. To get there, NS is adding T&E personnel, putting more locos in service, and reopening the Chattanooga hump for local customers and block swaps. The merch carload franchise has the highest incremental margins, and the Q2 volume gains have been mainly raw materials in the industrial products group. The plan is in place to address customer concerns.

Union Pacific CEO Lance Fritz did the closing honors. Quarter to date revenue units are up five percent, led by industrial products at seven percent, though ag products are still down a point. Network performance measures are all heading in the right direction, even with record merch car-counts in the Southern Region. The 2018 outlook calls for low single-digit volume growth, another few points off the OR, and core pricing "above inflation" (which I take to be in the four percent range).

When all is said and done, my take is the merch carload business is alive and well; the challenge is to do what we say we'll do consistently and reliably. Remember, It All Starts with the Customer.

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