

# RAILROAD WEEK IN REVIEW

June 22, 2018

*“CSX Short lines are moving faster than others in taking up Precision Scheduled Railroading... Either the train is where it’s supposed to be or it isn’t; either the car is operating to plan or it isn’t. This is PSR as it’s supposed to be.” — Railway Age, April, 2018*

**Every quarter after the earnings season is over** and has been fully digested, I find it helpful to parse the balance sheets and cash flow statements to determine the relative financial strength of the six Class Is plus GWR. See the table on page 2 for each railroad’s scores.

*Cash flow from operations* is how much cash the company actually took in and is derived from net income through a series of adjustments — depreciation, changes to balance sheet items such as accounts receivable and working capital, e.g. — that is, how cash flows into and out of a company. If more flows in than out, the flow is positive, if not, the flow is negative. In my table, the highest Operating Cash flow as a percentage of Net Income wins.

*Depreciation*, while not truly a cash expense, is an allowance to account for fixed assets wearing out. They are paid for with cash up front, and must be replaced at some point. Depreciation sets money aside to do so, and, ideally, capex should never exceed depreciation. In the example, CN has held closest to the line; UP is pushing the envelope. (As an aside, I object to using EBITDA as a measure of profitability for just that reason. Depreciation is really a savings account reserving the cash to replace stuff, and, as such, is a legitimate expense.<sup>1</sup>)

And of course *debt*. The more debt relative to owner equity and fixed assets, the less flexibility the company has in funding expansion or just keeping the railroad in shape. I look for sudden changes in debt as a measure of financial health. CN reduced YTD debt the most; only KCS saw an increase.

*Share counts* and *dividend payout ratio* are measures of how cash flow above and beyond capex is being returned to the company’s owners. As the number of shares outstanding goes down, the dividend per share goes up. Ideally, one likes to see payout percents increasing as the share counts go down.

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<sup>1</sup> “Trumpeting EBITDA is a particularly pernicious practice. Doing so implies that depreciation is not truly an expense, given that it is a ‘non-cash’ charge. That’s nonsense. In truth, depreciation is a particularly unattractive expense because the cash outlay it represents is paid up front, before the asset acquired has delivered any benefits to the business.” — Warren Buffett

Finally, I like to run the *Value Test*: What is the share price as a percent of intrinsic value? I use the discounted cash flow fair value from [guru.com](http://guru.com):

Unlike basic valuation ratios like the price-earnings ratio and the price-to-sales ratio, the discounted cash flow valuation model combines the company's balance sheet value, future operating income potential, and the probable net earnings growth. This valuation model can determine the company's intrinsic value based on five inputs: the earnings per share, the future business growth rate, the terminal growth rate, the years of terminal growth and the discount rate. Companies with higher margins of safety usually offer higher value potential than those with low margins of safety.

YTD Ending	3/31/18						
Metric/Name	KCS	CN	CP	CSX	NS	UP	GWR
<b>1. Cash flow from ops &gt; net income</b>							
Ops cash flow	\$ 141	\$ 755	\$ 397	\$ 966	\$ 816	\$ 1,901	\$ 101
net income	\$ 144	\$ 741	\$ 348	\$ 695	\$ 552	\$ 1,310	\$ 76
OCF as % Net Income	97%	102%	114%	139%	148%	145%	133%
<b>2. Capex &lt; Depr?</b>							
capex	\$ 110	\$ 425	\$ 241	\$ 368	\$ 383	\$ 910	\$ 58
Depr	\$ 83	\$ 393	\$ 170	\$ 323	\$ 272	\$ 543	\$ 41
Capex as % Depr	132%	108%	142%	114%	141%	168%	143%
<b>3. Net Debt Change</b>							
4Q2017	\$ 2,141	\$11,670	\$ 8,232	\$11,807	\$ 9,165	\$16,540	\$ 2,195
YTD 2018	\$ 2,219	\$10,758	\$ 7,821	\$11,408	\$ 9,046	\$15,669	\$ 2,170
Change	-3.7%	7.8%	5.0%	3.4%	1.3%	5.3%	1.2%
<b>4. YTD Share count (mm)</b>							
2018	102.98	744.2	144.8	888	285.9	779.6	62.9
2017	106.24	764.5	147.1	929	292.8	811.5	61.4
YOY Change	-3.1%	-2.7%	-1.6%	-4.4%	-2.4%	-3.9%	2.4%
<b>Dividend Payout</b>							
2018	26%	45.34%	24%	28%	37%	43%	0%
2017	24%	35.41%	17%	46%	41%	46%	0%
Pct. YOY Change	na	28%	39%	-39%	-9%	-6%	0%
<b>Valuation</b>							
Metric/Name	KCS	CN	CP	CSX	NS	UP	GWR
Share Price 3/30/2018	\$109.85	\$73.13	\$176.50	\$55.71	\$135.78	\$134.00	\$96.05
Gurufocus DCF value	\$261.34	\$82.67	\$227.84	\$119.06	\$308.14	\$349.30	\$177.24
Margin of Safety	0.42	0.88	0.77	0.47	0.44	0.38	0.54
Source: Company financials							
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The margin of safety in the table is the DCF value divided by the share price, giving you in effect the discount off the intrinsic value represented by the share price. The closer the MOS is to one, the less the discount off the DCF intrinsic or "fair" value. If the MOS is greater than one, you're

paying a premium for the shares. A margin of safety of 50 means you're buying shares for 50 cents on the dollar. You pay 77 cents for a dollar of CP intrinsic value; at UP, you pay 38 cents for a dollar of intrinsic value. (A dollar of Apple intrinsic value, by the way, will cost you 36 cents; conversely, a dollar of ADM intrinsic value will cost you \$1.49.)

**Tracking the Class Is' year-over-year revenue unit** trends by commodity with simple time/volume graphs shows at a glance which commodity car counts are increasing relative to other commodities. I'm looking at six such charts and measuring the upward slope in degrees from January 2016 through April 2018 — the steeper the slope, the stronger the upward trend. Here's what I found for merchandise carloads in degrees of slope from lower left to upper right:

- \*\* Grain — all the STCC 01s: 8 degrees
- \*\* Paper/lumber — STCC 24 and 26: 8 degrees
- \*\* Chemicals — STCC 28 including ethanol and fertilizers: 14 degrees
- \*\* Metals — STCC 33, 34 primary metals including fabricated metal products except machinery and equipment: 13 degrees
- \*\* Petroleum products — STCC 291 plus crude oil, STCC 131 (carloads reported typically are about 80% refined products and 20% crude oil): 17 degrees
- \*\* Minerals and stone (includes aggregates, rock salt, frac sand): 10 degrees

Then you need to look at absolute volumes for each commodity group relative to other commodities. You can get that from the [AAR's weekly rail traffic reports](#). For the week ending June 9, the Number One merchandise commodity is aggregates, followed by chemicals, metals, and grain. For relative financial importance of each group, go to the individual Class I financial page and find the RTMs — [Canadian National's Quarterly Review](#) is tops.

See “Freight Revenue per Revenue Ton-Miles (RTM) (cents)” and match each with its car-count line. You're looking for high revenue/RTM and high volumes. Grain is Number One in car-count but fourth in revenue/RTM; the “metals, minerals, and consumer products” group generates the highest merchandise revenue/RTM and is third in carload volume. Looks like a good match.

**Dennis Gartman, in his June 20 eponymous letter**, compares the Permian and Marcellus fields in terms of size, production and potential. Using producer share price changes YOY as a measure of perceived potential, he shows how the welcome environment in Texas has pushed up prices 16 percent while the more restrictive Marcellus states have seen producer share prices drop by eight percent. This “keep it in the ground” mentality crimps energy supply to the point that spot pricing for nat gas in New England states was the highest in the *world* this past Jan. Imported LPG is cheaper, benefitting area short lines.

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