RAILROAD WEEK IN REVIEW

August 9, 2019

“Capital is moving around the world faster and faster; markets are continuing to become more integrated. In manufactured goods I see labor becoming less important to the supply chain and I see supply chains becoming shorter.” — Ian Bremmer, president and founder of GZERO Media and the Eurasia Group, on RealVision

The lowest investment grade tier, BBB, now constitutes half of all issuers. All these are just one downgrade away from being high-yield “junk bonds.” The best data I can find shows that there are roughly $3 trillion worth of BBB bonds and another roughly $1 trillion worth of lower-rated bonds that would still be called “high-yield.” — John Mauldin, Thoughts From the Front Line, August 3, 2019

Mexico has the 15th largest economy in the world measured in U.S. dollars. Australia ranks just one spot above Mexico, and countries like Spain, South Korea, and Canada are not too far ahead either. — Geopolitical Futures, August 6

The reason companies aren’t investing more aggressively in plant and equipment and technology is BECAUSE we have the most accommodative monetary policy in the history of the world, with the easiest money to borrow that corporations have ever seen. Why in the world would management take the risk — and it’s definitely a risk — of investing for real growth when they are so awash in easy money that they can beat their earnings guidance with a risk-free stock buyback.” — Ben Hunt, Things Fall Apart (Part 3), October, 2018

I really enjoy doing the BNSF quarterly results because they’re clean. No share buybacks, no non-GAAP numbers, no ebitdas, no foreign exchange considerations. What we do lack is quarterly carloads by commodity. BNSF does present a full set of financials for the quarter.

We can get a sense of quarterly carloads from the weekly AAR reports, however, and kind of back into an RPU, which I have done. Total Q2 revenue was $5.9 billion on 2.3 million revenue units, for an RPU of $2,299, up four percent. Of 17 commodity groups reporting, only four saw YOY gains — chems, metallic ores, grain mill products (sweeteners, meals, ethanol), and petroleum products — mainly crude oil.

Chems and petroleum products alone comprise ten percent of BNSF carloads, so that’s a plus. Merch carloads accounted for 30 percent of total revenue units; consumer (intermodal + auto) continues to dominate at 53 percent. Quarterly ops expense was $3.4 billion, down three percent, operating income rose seven percent to $2 billion even, and net income was $1.3 billion, up two percent. The OR was 65.9, down two points.

Year to date, revenues increased 1.5 percent to $11 billion on five million revenue units, down 4.5 percent, with system RPU up 6.4 percent to $2,194. Operating income increased 4.3 percent and the OR was 67.5, down 92 basis points. Free cash flow after capex was $2.5 billion, up 76 basis points.

Commodity detail from from the Berkshire 10-Q: Consumer products revenues reflect higher average revenue per car/unit for both periods offset by volume decreases of 6.3 percent in the second quarter and 6.0 percent in the first six months. The volume decreases were driven by reduced consumer demand and higher available truck capacity, as well as from lower international intermodal market share and decreased imports.

Industrial products revenue increases were attributable to higher average revenue per car on flat volume in the second quarter and a 0.6 percent volume increase in the first six months of 2019. Volume changes were primarily due to strength in the energy sector, which drove higher demand for petroleum products and liquefied petroleum gas, offset by lower sand volumes and reduced car loadings due to the challenging weather conditions in 2019.

Revenues from agricultural products in 2019 increased on higher revenue per car, offset by volume decreases of 4.2 percent in the second quarter and 5.7 percent in the first six months. Volumes decreased due to export competition from non-U.S. sources, trade policy, and the challenging weather conditions in 2019.

Coal revenues decreased thanks to lower average revenue per car, a volume increase of 1.1 percent in the second quarter, and a volume decrease of 4.8 percent in the first six months. Volumes in the first half of 2019 were impacted by the weather conditions, and volumes in the second quarter of 2019 increased due to customer demand.

What I see here is a focus on creating customers and maximizing vols while getting top dollar per load. Operating expense is what it is, and the OR falls where it may. Equipment rents — mainly car hire — had the biggest percentage change in both the quarter and half. Not a prob. You need cars to create loads. As for "PSR," Hunter first broached the idea of scoring cars not trains when he was at the then BNI 30 years ago. Rose, Ice, Dealy, and Bredenberg carried the scheme forward to today's scheduled BNSF — a superb environment for strong short lines.

The Ben Hunt quote above is critical because it explains why the Class Is are behaving as they do with respect to the manifest carload business. If you run fewer trains, you need fewer assets and less capex to support them. Less capex means more free cash flow with which to buy back shares and get earnings per share up even when operating income isn't growing that much. And the cheapest ways to increase revenue is to do so by charging more for moving less, i.e. higher rates for fewer cars, and, ergo, fewer trains. That's why Class I sales forces are shrinking.

The void created by less Class I sales presence in the field creates opportunities for short lines to create customers. You can chat up potential customers at industry meetings like NARS and their regional divisions. Ideally, you can get some new facilities on your railroad. Alternatively, you may be able to entice customers to transloads on your railroad so they can ship around the non-performing class one "serving" their extant facilities.

Assuming you can get reasonable rates and transit times from your connecting Class Is, you can bring new business to those Class Is at little incremental cost to them. All the Class I railroads have said on earnings calls that they have capacity to add cars to existing trains at little incremental cost. What a great opportunity for short lines to fill that capacity. With any luck, more cars will command more train starts, shorten transit times, and let customers manage their supply chains at lower working capital. And, who knows? Shorter, more frequent trains might just let manufacturers shorten supply chains.

Tracking hours of service for a short line can be a particular headache where covered employees work different jobs or even different railroads from day to day. Watco has developed the "Crew Connect" software solution to address the matter. As it was, dispatchers spent a significant amount of time on the phone providing bulletins and verifying crew activity. Watco had the option of either hiring more dispatchers or automating crew tracking.

They chose the latter. Most locations were already using a tablet or laptop for crews to mark up for work, so it was just a matter of getting the devices to communicate with each other and provide the information to Crew Connect. Now that they have started collecting that information, general managers and trainmasters can see who's rested and ready.

Moreover, managers can see where each T&E member stands against the maximum work hours of 276 a month, set by federal regulations. When a team member hits 250 hours, a green light by that person's name on the Crew Connect computer screen will turn yellow; at 200 hours it drops to red, signifying that the employee has limited hours left to work in the month.

Says Coomes, "The system is going to help us in the area of crew calling, too. We can identify crew members who are rested and available for duty, simplifying the whole process." In an environment like Watco's, where there are multiple railroad names in relatively close proximity, a T&E guy staffer who has finished a job on Railroad A can, after rest, go to work on Railroad B. I can see how this will simplify the entire process and make everything more efficient.