RAILROAD WEEK IN REVIEW

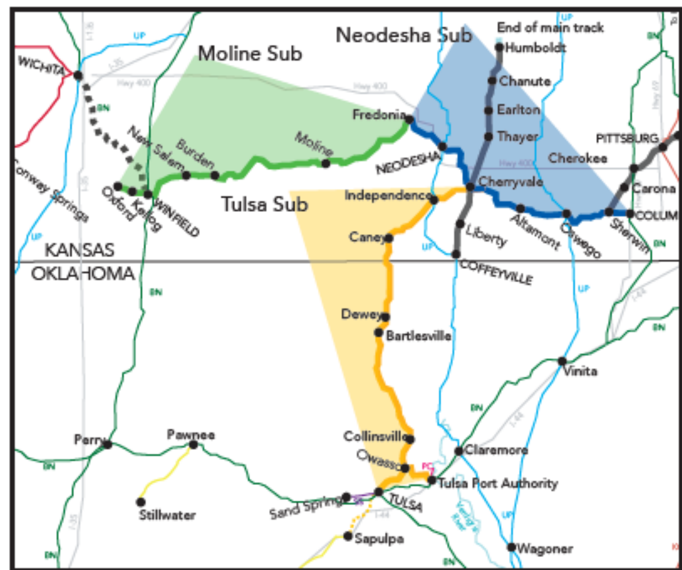
April 3, 2020

“Global spending on oilfield equipment and services this year will fall 21 percent from 2019 to $211 billion, the lowest level since 2005 as oil and gas producers slash spending. Oilfield segments with the greatest share of North American revenue will see the biggest hits, with hydraulic fracturing spending down 44 percent from last year and land contract drilling down 29 percent” — Reuters, April 1

“The implication is that the hurdle rate for a V-shaped recovery to prior highs has gone up considerably. We can’t definitively rule one out, but this latest market crash episode (and, yes, we'll call it a crash) has presumably quieted the animal spirits that were stirring in the fourth quarter of 2019 and early 2020.” — briefing.com, April 1

“Despite significant short-term supply chain disruptions, we don't predict any long-lasting changes to company supply chain structures, but capital equipment demand will likely take some time to recover.” — Morningstar, March 27

Watco’s South Kansas & Oklahoma Railroad (SKOL) has won a $27 million CRISI (Consolidated Rail Infrastructure and Safety Improvements) award from the FRA. The Oklahoma Department of Transportation as a match participants. The goal of the project is to enhance track infrastructure to eliminate capacity inefficiencies and increase track speed from 10 mph to 25 mph on the SKOL’s Tulsa, Moline and Neodesha Subdivisions of the railroad.



This will be achieved through upgrades to track structure and substructure such as rail, ties, ballast, surface, turnouts and bridges. With the completion of this project, 95 percent of the SKOL will be able to handle the 286,000 lb. railcars.

Infrastructure upgrades are the most costly constraint on short line railroads. The heavier 286s rapidly replacing the older 263s are now the industry standard. This is especially important for the SKOL as the heavier cars can cause operational chokepoints due to insufficient operating capacity on main lines, in rail yards and in locations where railroads interchange with each other.

With the track upgrades, including up to140,000 new crossties, the SKOL will become FRA Class 2 track good for 25 mph. As is, the Tulsa Sub, for example, averages 35-40 track-caused slow orders a month, and a fully loaded train of 100 railcars can take more than 26 hours and require three crew-starts to make the round trip between Owasso, Oklahoma, and Cherryvale, Kansas. Post-construction, trip-times will be cut in half and slow orders by 75 percent.

The SKOL is yet another example of how money spent today can increase operating income tomorrow. That's why it makes me sad to see short lines parking locomotives and laying off crews because they won't make the financial investments to handle a growing customer base. As we saw last week with the TNW in Texas and the Reading & Northern in Pennsylvania, projects such as the SKOL upgrade bring on multiple levels of benefits. There should be more.

The Coronavirus event is taking its toll just about everywhere as buyers are staying home, unemployment goes up, and consumer discretionary sales are shrinking. The North American Class I roads total revenue units as of March 28 were down 7.4 percent year-over-year (merch vols lost but 1.0 percent, buoyed by crude oil and chemicals). I fear operating earnings will take a hit as will cash from operations, meaning less cash for capex. Says a note from RW Baird,

> Week 13 rail carload growth began to reflect recent deterioration in demand trends, with the four-week moving average growth deteriorating to -11.4% year-over-year (versus -6.0% in 1Q20 and versus a -6.9% year-over-year the week before). Weakness was most notable in Auto (-66.8% yoy), while Ag and Coal were relatively stable.
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> Industrial (-6.3% yoy) and Intermodal (-14.4% yoy) both deteriorated versus recent weeks' and 1Q20's overall trend, consistent with weakening underlying industrial and retail/consumer end-market demand in the latter half of March.

I've already commented on the amount of money railroads have spent buying back shares and what it's done to debt levels (WIR March 20). We new see debt-equity ratios approaching 100 percent (I don't do EBITDA for all the reasons enumerated in past WIRs), which calls into question the ability to field resources needed to capture new business in a changing economy.

The buy-side is taking notice as debt levels go up. Moody's has rated all the railroads but CN "lower investment grade" with Baa1 and Baa2 for the long term. CN scores an A2 ("upper medium grade") and Berkshire Hathaway (my proxy for BNSF) earns the Aa2 ("high grade") ranking.

I seem to recall it wasn't that long ago the major railroads were all on the upper "investment grade" categories. I'm hoping the hue and cry set up by airline buybacks in the press and by politicians will encourage the railroads to reel in that category of capital deployment.

Here's a little table I cooked up to compare BNSF and UP across commodity lines through Week 12. I've made no attempt to show the relative importance of each commodity to the individual franchise. Rather, the table is meant to get a sense of direction for the commodities you interchange with these railroads. I'm figuring Week 12 is a good indicator of how the quarter is shaping up for each.

The rightmost column simply subtracts the UP percentage from the BNSF percentage to show the point difference between the two. It shows, for example, BNSF did 4.7 percentage points better than UP in Ag Products; UP did 7.4 points better than BNSF in Automotive. Please let me know if you have any questions or take issue with any of this.

BNSF/UP Comps Week 12

Commodity	BNSF	UNP	BNSF v UNP
Ag prods	1.2	-3.5	4.7
Grain	-1.5	-10.2	8.7
Farm ex-grain	30.3	-9.5	39.8
Grain Mill	7.3	2.1	5.2
Food & kindred	-1.9	2.9	-4.8
Chems	0.5	9.5	-9.0
Coal	-9.0	-24.5	15.5
Forest Prods	-2.0	1.7	-3.7
Met Ores & Mins	2.5	8.5	-6.0
Automotive	5.8	-1.6	7.4
Non-met mins	-13.7	-7.6	-6.1
Other	1.8	13.7	-11.9
Intermodal	-7.7	-12.7	5.0
Total rev units	-5.7	-7.7	2.0
Source: Cowen Mar 27			

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