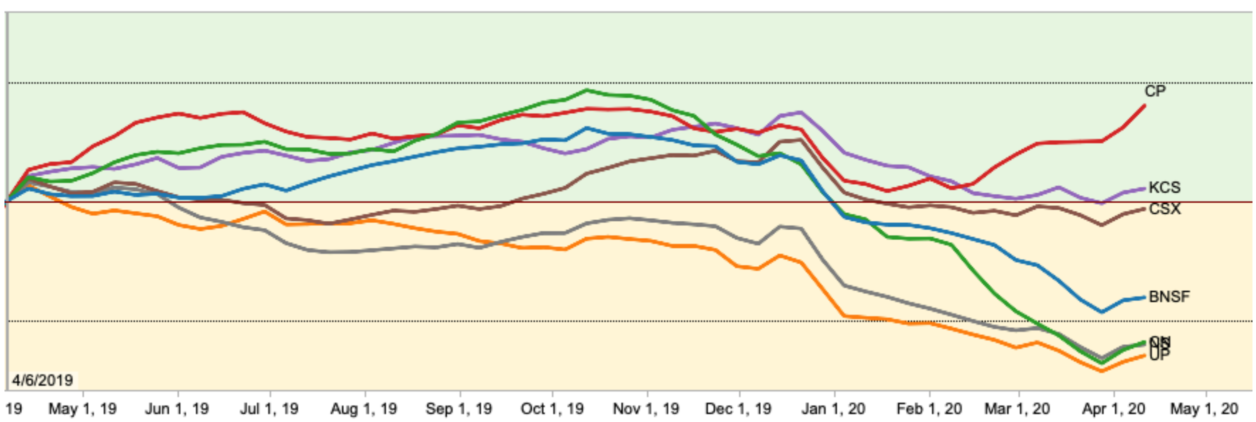
RAILROAD WEEK IN REVIEW

April 17, 2020

The large amount of BBB rated bonds still poses a risk to the market as we expect the number of "fallen angels"—formerly investment-grade issuers whose credit rating has been downgraded to speculative grade—to increase. Kathy Jones, Chief Fixed Income Strategist, Schwab, April 8

"Last week, Greenbrier ended production on its double stack intermodal line due to a surplus of intermodal units in the North American rail fleet and declining intermodal rail loadings. Greenbrier's current food-grade refrigerated and insulated boxcar line will close when current work-in-progress concludes in July." — Greenbrier press release, April 16

First quarter results reports got underway Friday with KCS. But before we get into that, I need to bounce off the readership some concerns I have about revenues, costs and volumes.The sell-side analyst community seems to hold that revenue per carload is more important than numbers of carloads (revenue units). I take the other side of the argument. Here's why:



As you can see from Drew Robertson's Transmatch chart above, every Class I but CP has seen revenue units fall since the beginning of the year. More over, the rate of decline seems to have accelerated since March 1. AAR car counts declined from down 11.7 percent year-over-year in Week 13 (end of Q1) to down 18.2 percent in Week 14 to down 22.5 percent in Week 15. If you back out intermodal and coal, merch carloads including automotive fell 9.6, 17.4, and 20.6 percent sequentially.

I fail to see how falling volumes can be a plus, even if RPU is up markedly thanks to a combination of rate hikes and demarcating low-margin lanes. So even if RPU increases four percent and operating expense drops two percent, it's still a decrease in operating income and perhaps even a decrease in cash from operations.

When you focus on yield and price and drive off certain revenue lanes, you spread the fixed cost over a smaller base, making every revenue unit bear more of the overhead. To simplify, a couple of friends who were in STCC 20 food marketing at a Class I 20 years ago created The One Train Railroad (I can send you the PDF slide set if desired).

The premise was a railroad with one train of four cars: a carload of plastic, one of clay, one of paper and one of kitty litter. The first two move in privates; the second two move in railroad-owned boxcars. Rates range from $4,000 for the plastics down to $1,800 for the kitty litter. The cost per car is $1,000 for the privates and $1,500 for the boxcars. Every car absorbs $500 of railroad overhead.

The operating margin per car ranges from $2,400 for the plastics to minus $200 for the kitty litter. Overhead allocation is $600 each for the plastics and clay and $800 each for the other two. Bottom line contribution is $1,900 for the plastics, $700 for the clay, minus $400 for the paper, and minus $1,000 for the kitty litter. The whole train contributes $1,200 in operating profit.

A new management team comes to town and wants to shed the low-margin business. First to go is kitty litter, driving up the allocated costs and driving down the margin for the three cars that are left. Operating profit becomes $900, a 25 percent reduction. Next to go is paper, shifting yet more costs to the remaining two cars and eliminating any operating income. So much for the One Train Railroad.

Back in the day the Southern had a thriving branchline business in the Carolinas where the two principal commodities were feed corn for the chicken farmers and wood pulp (chips, short logs) for the paper mills. Management decided the wood pulp was a losing proposition, so killed it. Then they discovered corn alone couldn't cover both the variable and fixed costs of the branchline network, and eventually it went away. Chinese curse: Be careful what you ask for.

Last week I commented on the debt levels for the Class I railroad community. A group of readers picked up on the thread and their observations are worth repeating here. One chap who runs a California short line writes, "As a heat and eat commodity railroad, we are going full tilt and had one of our biggest first quarters ever. We are pulling a lot of frozen vegetables with the customers needing to get to the supermarkets.

"On the inbound side is a lot of fertilizers and tractors as farmers are trying to meet the demand. I don't have any data, but my feeling is people are stocking up on frozen and canned fruits and vegetables and no one is buying fresh fruits and vegetables. Normally the farmers get better prices with fresh fruits and vegetables so the last couple of years the frozen market has been hurt by the lack of product. So this is playing into our hands. With our 11 month growing season and both a wet and sunny spring, the farmers are cranking out crops and it seems like fertilizer usage is way up and we are bringing in lots of tractors. LPG business was way up."

But there's a downside. "Lumber and drywall are still going at full tilt, though personally I know this traffic will crumble after current projects are finished." He fears that at some point shortly thereafter the builders and developers will not have capital to keep building. The choice is to add more debt or go out of business.

And so it is that the fall-off in volume causes truer debt to be downgraded from lower medium grade BBB to BB non-investment grade speculative. The parallel with the railroads is eerie. Volumes fall off, revenue slides, margins shrink or evaporate, and the doors close. Ditto the railroads. Volumes shrink thanks to lack of demand and intentional de-marketing of low-margin business. Free cash flow takes a hit, dividends evaporate, and share prices fall still farther.

It also means business development efforts go away. Recall my recent WIR article about the two major manufacturers building DC's without rail access. If this isn't enough of a wake-up call, I'm not sure there's much hope. On the other hand, the big roads can get help from their shortline partners and then get out of the way. A reader writes,

> JIT and now small order delivery isn't going to get cheaper – only more demanding. You need warehousing close to end-use consumers to cut costs. Moving product by truck to a DC, only to be unloaded, stored, reloaded, and delivered by another truck is not the most economical way to run your supply chain.
>
> Maybe the millennials running supply chains these days have never heard of railroads. If only they would learn to keep the 1.6 RVC traffic you have, take more of it out of trucks you don't currently handle, and be glad to have it.

There are no winners in this game. Except for the non-Class Is who can stay in front of their customers and create value-added services to take cost out of customer supply chains. The Class I is spared the first-mile/last mile overhead and a revenue stream is saved. Or so I would like to think.