RAILROAD WEEK IN REVIEW

May 8, 2020

"We continue to believe that the amount of investment gains/losses included in earnings in any given period has little analytical or predictive value." Berkshire Hathaway first quarter 10-Q on the IRS-mandated inclusion of unrealized equity gains/losses on the income statement

"Berkshire Hathaway remains a broadly diversified conglomerate, with a collection of moaty businesses…Aside from having economic moats built on cost advantage, efficient scale, and intangible assets, most of these businesses have operated essentially as private companies under the Berkshire umbrella--while still taking advantage of the parent company's strong balance sheet, diverse income statement, and larger consolidated tax return." Morningstar, May 4

BNSF first quarter revenue units declined five percent to 2.3 million loads, freight revenue dropped six percent to $5.1 billion, while RPU came down a mere 60 basis points to $2,200. Operating income was off ten percent, and the OR shed 278 basis points to 66.3, highest of the Class Is reporting (KCS was lowest, 60.5). Below the line, net income was $1.2 billion, down five percent, largely on $131 million less "other income."

You'll note there are no eps games or share buy-backs. That degree of cleanth shows up in the cash flow statement. A cool $billion free cash flow. Nobody else even comes close.

Cash Flow Stmt	3/31/20	4/1/19	Change
Net income	$ 1,190	$ 1,253	-5.0%
Ops Cash Flow	$ 1,749	$ 1,909	-8.4%
OCF as pct Net	**147%**	**152%**	-3.5%
Capex incl Equip	$ (687)	$ (619)	11.0%
FCF	$ 1,062	$ 1,290	-17.67%
Capex/Revs	12.7%	10.7%	

BNSF uses a broad brush to aggregate commodities: Industrial Products, Agricultural Products, Coal, and Consumer Products — essentially automotive and intermodal. Because of this, it's useful to look at the Week 13 (ending March 28) YTD AAR carloads report. That's only two days short of the quarter close, so commodity trends there are a pretty good indicator of what's buried in the *de minimis* report in the 10-Q.

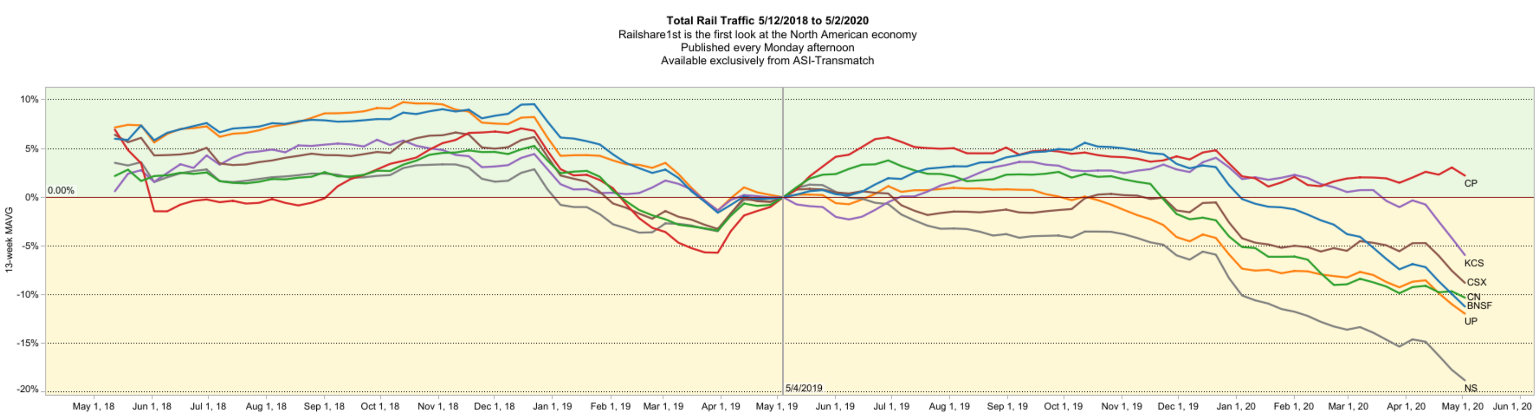
You'll find, for example, that grain (5.9 percent of total revenue units) was off a point, chemicals ex-petroleum but including ferts (5.2 percent of units) gained two percent, sand/gravel (2.5 percent) sank 23 percent, pulp/paper (2.5 percent) lost nine percent, and lumber (0.9 percent) was up four points. According to the 10-Q,

▪ Consumer Products volumes decreased primarily due to lower international intermodal volumes as the COVID-19 pandemic contributed to lower U.S. West Coast imports. Volumes further decelerated late in the quarter in the domestic intermodal and automotive segments as the COVID-19 pandemic's impact to U.S. consumers intensified.
▪ Industrial Products volumes decreased primarily due to lower sand volumes driven by increased competition from locally-sourced ("in-basin") sand and due to lower liquefied petroleum gas volume attributable to increased pipeline takeaway capacity. These decreases were partially offset by higher demand for petroleum products.
▪ Agricultural Products volumes increased primarily due to higher domestic grain and soybean meal shipments, partially offset by lower grain exports.
▪ Coal volumes decreased primarily due to the effects of low natural gas prices, mild winter weather, and plant retirements.

Further in the 10-Q, BNSF warns that the COVID-19 pandemic continues to evolve and the effects thereof "cannot be predicted with confidence." Yet BNSF avers that "the fundamentals of the Company remain strong, and BNSF believes it has sufficient liquidity to continue business operations during this volatile period."

On a related note, the popular press is having a field day over Berkshire's reported $49.7 billion net loss for the first quarter. But that's largely due to the IRS rule that makes one show unrealized gains and losses in the share prices of one's equity holdings. The Berkshire balance sheet shows $181 billion in "equity securities" that had been worth $248 billion three months ago. The 10-Q puts it thus on page 39: "We continue to believe that the amount of investment gains/losses included in earnings in any given period has little analytical or predictive value."

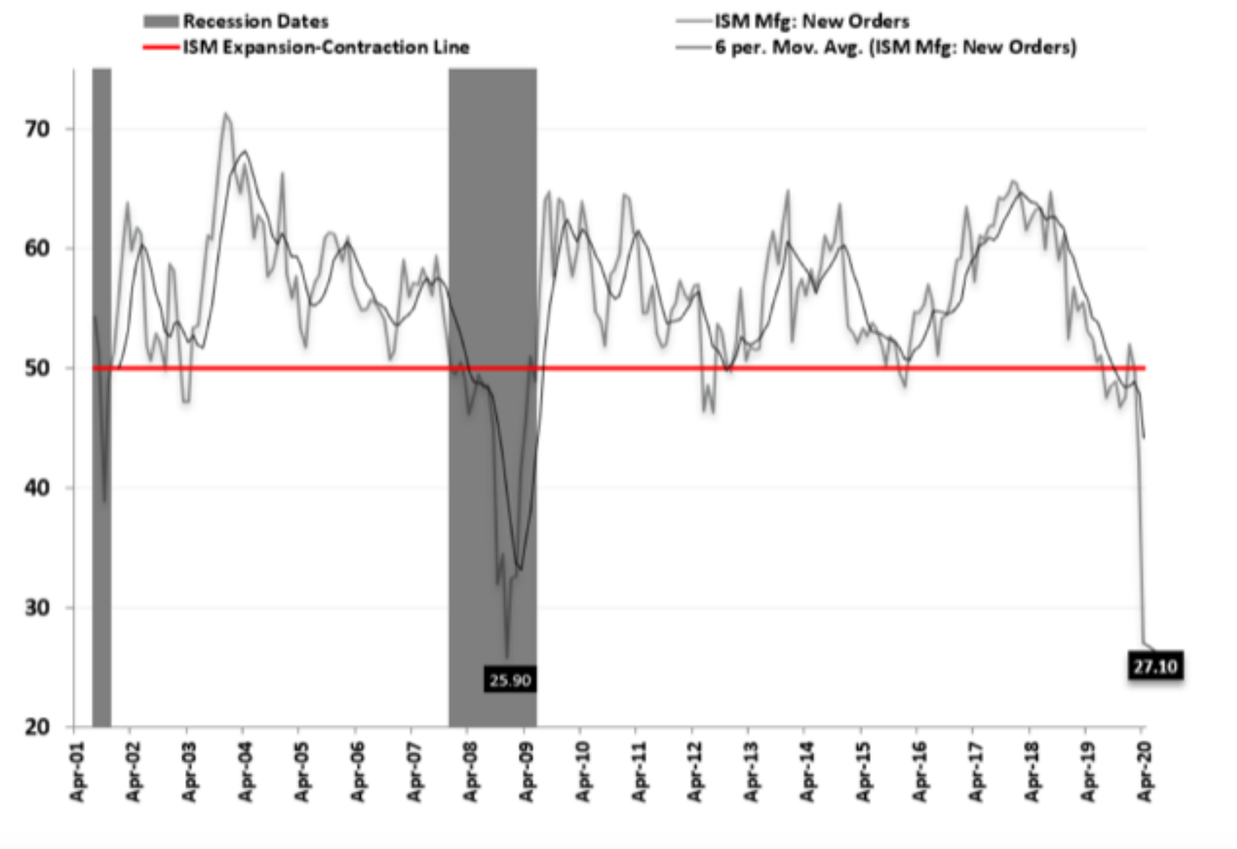
This chart from ASI-Transmatch shows the rapid decline in YTD railroad volumes.



It shows everybody but CP drastically down year-to-date and knowing why could be very useful. The ISM Manufacturing Index, which used to be called PMI, measures manufacturing activity based on a monthly survey, conducted by ISM, of purchasing managers at more than 300 manufacturing firms.

An index of more than 50 indicates expansion of the manufacturing segment of the economy in comparison with the previous month while a reading of 50 indicates no change and a reading below 50 suggests a contraction of the manufacturing sector.

The monthly announcement of the ISM Manufacturing Index can greatly influence investor and business confidence as purchasing managers are in the best position to assess the ebb and flow of business conditions. Because of this, railroad managers find this report incredibly useful in estimating future demand for their services. This chart from hedgeye.com helps.



The downtrend started two years ago and dropped like a rock when the Coronavirus hit. I don't think a rapid recovery is in the cards, either. Once the economy starts to open up, local businesses will be this first to recover; supply chains will lengthen only when consumers get more comfortable reaching father out for staples and discretionary items. I think as the ISM recovers, the outlook for railroads will follow suit. It'll be a bumpy ride till then.