RAILROAD WEEK IN REVIEW
May 14, 2021

"If the number of currency units in the system goes up way more than the availability of goods and services in the economy, then we can get supply shortages and price increases." — Lyn Alden, The Ultimate Guide to Inflation

"The doctor is in. Copper futures prices reached $10,417 per ton in London this morning, eclipsing the prior record high set in 2011 with a 30 percent year-to-date gain and more than doubling from their March 2020 nadir." — Almost Daily Grant's, May 5

"We estimate that higher steel prices have placed a 15-25 percent premium on the price of newly manufactured railcars relative to this time last year. This peculiar dynamic should continue to steer railcar demand fulfillment toward leasing, thus spurring further rate increases in coming quarters. We estimate that lease rates have risen by low-to-mid single digits sequentially in the last three quarters." — The Car Conundrum, Cowen & Co., May 7

"Confirmation bias is the investor's worst enemy. It's a far bigger problem for the bulls than the bears, because their chorus is quite a bit bigger and their sound and echo chamber is quite a bit bigger. By its very nature, short selling is a lonely path" — Jim Chanos, Jan 24, 2018, Real Vision interview with Jim Grant

The first quarter earnings calls were instructive. On the one hand, we see rosy predictions of future earnings yet little comment on what drives those earnings: revenue units. I've noted here before that the Class I railroad revenue units and total revenue CAGRs for the past five years have been essentially flat. Operating income has grown on revenue per unit increases and cost-cutting; net income growth has been a function of below-the-line events.

At the same time Class I railroad share prices have increased at a faster trailing-12-month rate than the S&P 500. PE ratios are now in the high 20s vs. a 15-20 range not that long ago. How high is too high? I like to use what Benjamin Graham called a *margin of safety*: the spread between share price now vs. intrinsic value. Here, Morningstar's "fair value" is a good guide:

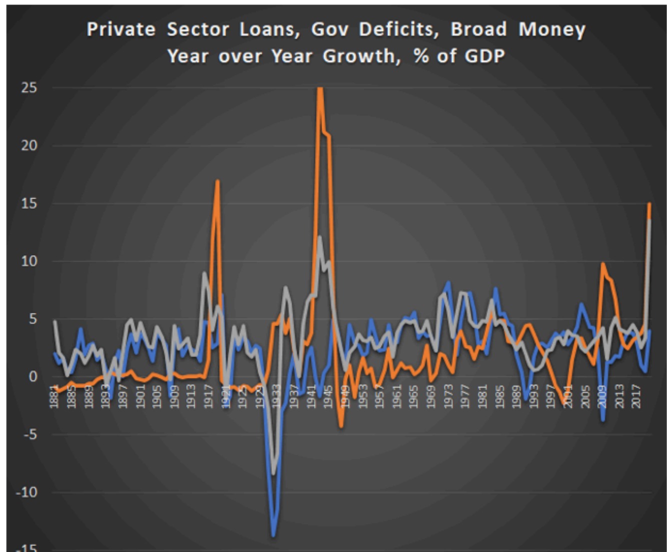
> At the heart of our valuation system is a detailed projection of a company's future cash flows, resulting from our analysts' independent primary research. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into our globally standardized, proprietary discounted cash flow, or DCF, modeling templates.

Class I railroad margins of safety range from zero (KCS) to minus 0.54 for Norfolk Southern. By this measure, if I pay a dollar for a share of KCS, I'm getting a dollar of value. Zero margin of safety. On the other hand that same dollar of value in NS shares will cost me $1.54 — a negative

54 percent margin of safety. What I'm really looking for is the chance to buy a dollar of value for fifty cents.

Share prices almost everywhere appear to be trading in excess of fair value, and I think Lyn Alden (quote above) has hit on the reason: too much money chasing too few goods. Her graphic of loans, deficits, and money growth puts the argument succinctly (the orange line on the right-most vertical is superimposed on the grey one).

Not only are railroad shares overpriced, but so are commodities. I've written here about lumber; Monday's WSJ tells the same tale in other commodities, for example:



Corn has been one of the sharpest risers in the broad rally in raw materials that is prompting companies to boost prices for goods and fueling concern among investors that inflation could hobble the post-pandemic economic recovery.

The paper also cites copper, beans, and crude oil, saying copper hasn't cost so much since 2018 and beans "are trading at their loftiest level since 2012."

So if prices for corn and beans are going up, so is the price of and demand for fertilizer and farm equipment. Since what goes up typically goes down, farmers wanting to capitalize on the current supply/demand picture will want to get their crops in the ground, harvested, and moved out in the shortest possible order. And that could be good for the railroads, too, perhaps bringing back a *margin of safety* between share price and enterprise value.

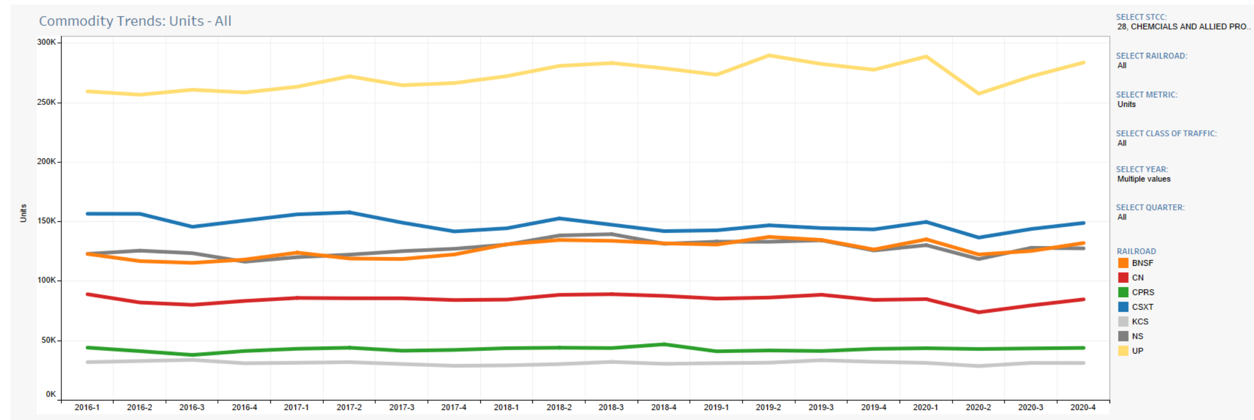
CSX will acquire Quality Carriers, the largest provider of bulk liquid chemicals transportation in North America, for an undisclosed amount. The seller is Quality Distribution, a Tampa-based bulk carrier that has roots going back to 1913 as a milk carrier in Lancaster, Pennsylvania. Quality Carriers will become a stand-alone entity within CSX and remain headquartered in Tampa.

According to Quality's press release, the transaction will give quality's customers "access to a wider range of cost-effective shipping options" by adding a truck-rail product that had not previously been available through a single name. The resources are considerable. Quality Carriers operates the most extensive bulk tank trucking fleet in North America, with around 2,500 drivers and a network of more than 100 company-owned and affiliate terminals throughout North America.

The CSX press release quotes CSX' Jim Foote as saying, "The acquisition of Quality Carriers further demonstrates our commitment to the strategic growth of our business and *deepening our relationships with customers* (emphasis added)." The transaction is expected to close in the third quarter of 2021, subject to regulatory review and certain customary closing conditions.

This could very well open new doors for non-Class I railroads with direct CSX connections. By offering locations adjacent to major markets, the regional carriers can provide a level of customer service and coordination that CSX may not be able to provide. Quality says they and CSX already have "seamless rail-to-highway" relationships in many locations. Which means the regional carriers will be building on existing relationships rather than creating a new product.

As you can see, CSX is the dominant STCC 28 carrier in the east, second only to Union Pacific in North America. Norfolk Southern trails CSX by roughly 100,000 carloads a year.



The timing seems right, too. The AAR *Rail Time Indicators* says that even though March 2021 chems comps were down, and petrol-based chems are still in a funk, fertilizers and alcohols are not, and the Texas Gulf chemicals situation will resolve over time. In fact, CSX chems are up six percent year-to-date through May 1, leading all Class I railroads per the weekly note from Susquehanna's Bascome Majors. Chems account for nine percent of CSX revenue units vs. six percent for NS. Thus I am encouraged by the CSX-Quality Carriers transaction.

This just in: KCS going with CN's offer of $325 per share total consideration. In addition, CN will reimburse KCS up front for the $700M break-up fee it must pay to CP, which effectively adds another $8/share to the total consideration. CP has responded, saying that they're not surprised "and it only highlights CN's recognition of the risks of its anti-competitive bid." I will elaborate on my views in this space next week.

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