RAILROAD WEEK IN REVIEW

November 15, 2019

"The Cass Freight Index is the most comprehensive, high-frequency indicator of this. It tends to lead the economy by a few quarters but has signaled almost every economic turning point. So the fact its year-over-year change has been negative every single month since December 2018 is more than a little concerning." — Thoughts from the Front Line, John Mauldin, Nov 9

"The movement of forest products like lumber has long been a bellwether for the American economy. Freight rail movements are largely dependent on the demand for the products railroads haul. Data indicates there is a strong correlation between freight rail lumber movements and housing starts, a critical indicator of economic strength." — AAR Fact Sheet

Kansas City Southern Directors have set a new capital allocation policy. Available cash is to be split 40-50 percent to capital projects and strategic investments; a 50-60 percent goes to share repurchases and dividends. The Executive Compensation portion of the 2019 Proxy Statement makes no mention of rewards based on EPS. Rather, "The company will continue using operating ratio, operating cash flow [aka EBITDA] and return on invested capital as the core metrics used to define incentive payout."

Credit-Suisse analyst Allison Landry awards the new capital allocation policy high marks. She writes, "Confidence and cash flow are on the upswing courtesy of PSR. The fact that the company upped both its buyback and dividend gives us further confidence in its ability to execute on what we believe to be substantial opportunities for outsized top line growth — and consequently, the future trajectory of the financial results."

She concludes,"KCS continues to target a debt/EBITDA ratio in the low 2x range, which is consistent with its BBB and Baa2 ratings. This signals that increased shareholder returns will likely come from lower capex spend and robust free cash flow, which is consistent with PSR principles as fewer resources are needed."

But there's always somebody to rain on the parade, A Seeking Alpha contributor is calling KCS a Sell and his write-up is mostly opinion with little fact to back up the negatives. I've italicized what I deem to be the opinions in his conclusions.

> Shipments to Mexico are *helping KSC stave off headwinds* in the railroad industry. Price hikes are also helping. The 13x ebitda multiple is *difficult to justify*. Chemical/Petroleum revenue represented 27 percent of total revenue. *As long as* Mexico Energy Reform revenue shows outsized growth, then it *should continue* to spur the company's total revenue.

> KCS' rising shipments to Mexico remain a moat. However, rail traffic for the entire industry is falling and *could eventually stymie* the company's other segments. Given that backdrop, 13x EBITDA *appears too robust* for a company whose operations are cyclical in nature.

I'm with Allison here. I can't do business with a company based on shoulds and coulds and seems-tos. The new KCS capital location program, with its absence of any compensation based on share price, tells me KCS is moving into under-promise, over-deliver mode.

"The best days at Canadian National are over," writes the same Seeking Alpha commentator. Here, he picks up on reported facts and embellishes them with *opinion*, to wit, "CN Q3 rail traffic was flat. It raised prices to drive revenue growth. The days of rising rail traffic and rising prices *could be over*. CNI's best days *could be long gone*. Sell Canadian National."

Right off the bat two of the three points in the summary are speculative -- could be. Not fact. Opinion. But wait, there's more (emphasis added):

> Through the first 44 weeks of the year, combined Canadian rail traffic of carloads containers and trailers grew only 0.5 percent yer-over-year. This *could create* headwinds for CN at some point. In Q3 2019, the company reported revenue of C$3.83 billion, up 4.0 percent. Total freight volume was flat, while average selling price [RPU to you and me] was up 4.0 percent.
>
> Canadian National's operating ratio was 200 basis points less than that of the year earlier period. As a result, EBITDA of C$2.0 billion bounced by double digits. Via cost containment efforts, the company *could potentially* grow EBITDA *even if* revenue declines in Q4 2019 or in the first half of 2020.
>
> For now, double-digit EBITDA growth *gives the appearance* that Canadian National is still a growth company. Cost cuts are great, but *I question the quality* of the company's earnings.

Fine. He questions earnings quality and says sell. I say JJ and his gang are doing just fine and we must cheer them on. After all, increased volumes are what the non-Class I partners need more than earnings growth. Grow the car-counts and RTMs will grow with them.

Norfolk Southern on the other hand, garners some positives from Seeking Alpha. This writer argues that the growth prospects for the states in the NS service territory are top-of-the-heap and NS is bound to capitalize on that. Excerpts:

> Arguably no company has a deeper moat than a railroad. Population and economic growth in NS' footprint are formidable. There is compelling evidence that macroeconomic trends will work to this company's advantage for the foreseeable future. The South is experiencing an increase in population that far outstrips that of other regions of the US.

> Railways consume up to 9x less energy per tonne-kilometer [why the writer eschews RTM is a mystery] traveled than trucks. On average, trains are 4x more fuel efficient. They carry more freight per crew-start and so are cheaper for long distances.

My take is a little different. Yes, the south is growing, especially in terms of services as opposed to manufacturing. For the goods producers remaining, supply chains have to be reliable and efficient. Carriers have to be both and carrier managements must have the incentives to make it so. Customers don't really care that trains can carry more stuff at less direct cost per unit of stuff moved. They want stuff where they want it when they want it.

The NS focus is a little different. From the 2019 proxy statement: "Norfolk Southern's goal is to achieve an operating ratio less than 65 percent by 2020 and double-digit compound annual earnings per share growth over the plan period" (page 30). There's nothing in there about revenue or volume growth. Management increases its payday with OR down and EPS up.

The way to cut expense is to cut service levels and the way to increase EPS is to have fewer shares every year. And since that's where the NS management focus lies, being in the midst of all the market potential in the world won't help them take a larger slice of the available pie. They must be good supply chain partners first.

Pinsly has agreed to sell its three Florida lines — Florida Northern, Florida Central, Florida Midland — to Pennsylvania-based Regional Rail LLC, as noted in WIR November 1. Last weekend I was visiting a friend in the Tampa area and we drove over to see the 68-mile FCEN. We started at the top in Tavares, drove the extensions to Eustis and Mount Dora, and then chased to core route back to Orlando.

The FCEN business base is concentrated between Orlando and Zellwood (the Mt Dora and Eustis lines are dormant). Chemicals, aggregates, and fertilizers are dominant. The FCEN core is a beautiful piece of railroad — 115-pound CWR, Pandrol clips, good ties and ballast. It has to be good for 286 and I'm guessing FCEN runs it as FRA class 2 for 25 mph running. (Pinsly could not comment given the pending sale.)

FCEN technically has to do 6,800 cars a year to meet Rule of 100. But if all the business is on the first 30 miles out of Orlando, and they do 5,000 cars year, it's 166 cars a mile — a healthy density, especially if they don't have to spend much on the other 38 miles. The sales comes at a good time, too. With the PE and pension fund guys looking for infrastructure buys, all this cheap money sloshing around means a more favorable risk/ reward ratio.

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