RAILROAD WEEK IN REVIEW

January 12, 2018

"Heavy leverage turns ordinary business molehills into existential mountains." — Almost Daily Grant's, Jan 4

"*One should be very mindful of risk, bolstering the quality of the portfolio, and focusing on strong balance sheets, minimal refinancing risk, and companies with high earnings visibility and predictability. — David Rosenberg, Gluskin Sheff + Associates Inc.*

"The President is badly wrong on the NAFTA and he is terrifying the "ag" states such as Iowa, Nebraska, Wisconsin, Ohio, Indiana et al that led to his electoral college victory in November, 2016." — Dennis Gartman, January 10

The Q4 Earnings season is upon us. Week 52 year-to-date revenue unit counts are posted to each railroad's web site. I want to start with CSX inasmuch as the changes there have raised many questions. Here's the short form:

* Merchandise carloads including auto comprised 43% of total revenue units ex-intermodal and coal; kick out auto and it's 38%.
* Of 18 commodity groups including auto, only four are flat or up -- 22%, ergo 78%, are down.
* Three out of four flat or up commodities are bulk fungible commodities.
* Of merch carloads ex-auto, nearly half are industrial products, most of which are down.

Now comes a CSX press release saying Ed Harris, long-time EHH confidant, has been tapped as EVP operations, effective immediately. "Mr. Harris has more than 40 years' experience in the railroad industry in an operating capacity, including nearly two decades at the Illinois Central and Canadian National (CN), where he worked closely with Hunter Harrison to transform the traditional operating models of both railroads to Precision Scheduled Railroading models. Mr. Harris ultimately served as executive vice president of operations until his retirement from CN." Will it work? I don't know. Here's why:

An article in Bloomberg reminds readers that, while CSX's press release plays up Harris's overlap with Harrison at the IC and later at the CN, "The CSX release makes just a brief mention of their interactions at Canadian Pacific Railway Ltd. There's a reason for that: Harris and Harrison were on opposite sides of Bill Ackman's battle to install the latter as CEO. The two didn't always see eye-to-eye when it came to the profit potential of the railroad nor did they have the nicest things to say about each other. It raises the question of whether Harris is really the best co-conductor to carry on Harrison's legacy."

Note too that Harris has been Chairman of the OmniTRAX Board for the last three years, and during his tenure revenues increased 48% and casualty spending dropped 78%. He has just

stepped down to take the CSX gig and OmniTRAX CEO Ken Shuba says, “We’ll miss his wisdom, but look forward to collaborating with him in his new role at CSX.”

I expect Harris will bring a fresh view to CSX as regards shortline contributions. The non-class I community excels at creating competitive advantage because they make the effort to understand their customers’ supply chain needs. For proof, just look at the pictures in any 2018 calendar from a non-class I operating company.

Some examples: heavy, welded rail everywhere; short-haul single-commodity and intermodal shuttle trains; contract switching; running local freights on commuter lines; service to customer guaranteed within two hours of commitment; extending and rebuilding a Class I presence in markets the latter abandoned long ago; shortline distributed power on grain trains; a home-built CTC system to double capacity.

These initiatives are designed to capture low-rated commodities that contribute to operating overhead and variable expense. I just wish the Class Is were more responsive to such initiatives. Not doing so creates voids such as we see in the CSX results, above. (The CSX annual Short Line Workshop is in its usual venue March 4 and 5. Short lines: Bring your questions.)

In a separate development, Louisiana law firm Kahn Swick & Foti, LLC (“KSF”), announces that KSF has launched an investigation into whether CSX’s officers and/or directors “breached their fiduciary duties to CSX shareholders or otherwise violated state or federal laws” in hiring Hunter Harrison. By way of background, it was last March 7 CSX hired 73-year old Hunter Harrison as CEO, thanks to a campaign by activist investor Mantle Ridge. Says Kahn Swick,

> Harrison’s compensation for the four year contract included $84 million in reimbursement for pay and benefits forfeited from his prior position, payment of a tax indemnity potentially amounting to as much as $23 million, and tens of millions of dollars in salary and incentive compensation.
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> Notably, Harrison was hired despite refusing the Company’s request for an independent doctor to review his medical records. During 2017, widespread problems reportedly plagued the Company including service disruptions, decreases in operational performance and the exit of several executives.
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> On December 15, 2017, the Company announced that Harrison had died due to “severe complications from a recent illness.” The circumstances have raised questions in the finance sector regarding whether the Company’s executives had prior undisclosed knowledge of Harrison’s health condition or failed to exercise due diligence in the hiring process.

The law firm seeks comment from those with information “that would assist KSF in its investigation,” or long-term holders of CSX shares wishing “to discuss [their] legal rights.”

Continuing last week's thread on cash flow, share buy-backs, and pricing, my railroad finance expert says he's withholding judgement as to what the RVC argument means for "the strategic growth or national market outlook for these railroads. That's another discussion."

> I think the presumption of free cash flows makes good sense if you are analyzing these stocks as divorced from growth aspects. In other words, if you elect to maximize cash flow, and if you're CSX you might actually sell assets, and this could lead observers/investors to set aside growth expectations. But that has its own consequences.
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> One railroad that elected to maximize free cash flow leased its line to a connecting Class I in order to minimize taxes and turned itself into an REIT. It was a rather brilliant move for 1957. Unfortunately but for the dividends (it was obliged to distribute 90% of earnings), it traded thereafter as a bond. Great for patient money, not so good for go-go analysts.

To which a mutual friend adds that the changes in cash flow generated by manipulating carloads, freight revenue, below the line items, and share count may result in "a large improvement in cash flow but it is not clear how much they would be sharing with stockholders." Inquiring minds want to know how much of the improvement and coming tax benefits are already baked into share prices.

He cautions that P/Es are a discounting method reflecting growth in future earnings, which ultimately depend on attracting new business, concluding, "The railroads are well positioned financially to seek new business, but where is the plan? The railroads' record, historically speaking, about finding profitable outlets for excess cash is not so hot."

The metals commodity group rang up a 6.2 percent gain year-over-year in AAR U.S. carloads year-to-date through December 30. Not surprising. The American Iron and Steel Institute says that in November 2017 U.S. steel mills shipped 7.4 million net tons of steel, up from 6.7 million net tons shipped in November 2016, up 10.4 percent. Year-to-date shipments through November 2017 are up 5.3% year-over-year. Though an admirable result, channel checks among short lines indicate it could have been even more with some aggressive pricing and reliable transit times on the part of their connecting Class Is.

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