RAILROAD WEEK IN REVIEW

June 14, 2019

"The primary function of private equity firms is financial engineering (and charging egregious fees) rather than expanding the capital base of the economy [through] opaque and illiquid market structures... 85% of leveraged loans are borrowed by private equity firms." — The Credit Strategist, June 1, 2019

"Financialization is squeezing more earnings from a dollar of sales without squeezing at all, but through tax arbitrage or balance sheet arbitrage. Financialization is the zero-sum game aspect of capitalism, where profit margin growth is both pulled forward from future real growth and pulled away from current economic risk-taking." — Ben Hunt, Epsilon Theory, April 19

"The current weakness in the rail traffic numbers is due to a combination of factors, the most important of which is the heightened economic uncertainty that's being made worse by increased trade-related tensions; higher tariffs leading to reductions or disruptions of international trade; and lower industrial output." — John Gray, AAR Senior VP of Policy and Economics

"Leverage is the ultimate two-edged sword: it doesn't alter the probability of being right or wrong; it just magnifies the consequences of both." — Howard Marks, Oaktree Capital

North American rail volume for 2019 through May came in at 14.7 million units, down 1.4 percent from where they were a year ago, per the AAR. Total carloads ex-intermodal, including coal, were 7.4 million vs. 7.5 million a year ago, down 1.2 percent. Merch carloads, ex-coal, including automotive, were 5.5 million, down two percent year-over-year.

Looking strictly at the merchandise carload sector, where most non-Class I carriers earn their keep, the percent change column is a sea of red. The chemicals group, which includes industrial chemicals plus crude oil plus refined products — such as the raw material for plastics — led the pack, up seven percent. But industrial chemicals, again where short lines live, was up less than a point, whereas crude oil and the STCC 29s jumped 25 percent. I should add that, volume-wise, industrial chems carloads outnumber the petrol side two to one.

Though the official Narrative blames weather and flooding, the main drivers of the rate of change in the railroad revenue unit growth rate are the slowing economy and the tariff follies. The AAR's Dan Keen writes in his June 7 *Rail Time Indicator*s,

> Many economic indicators are saying the economy is slowing based on new job creation, the Purchasing Managers Index from the Institute for Supply Management (ISM) dropping to 52.1, and falling manufacturing output. All of which affects railroads.

> Though rail traffic in May left much to be desired, not every indicator is flashing yellow. Consumer confidence in May was the highest in six months and close to an 18-year high. Consumer spending in April wasn't terrible and auto sales in May matched their highest level this year. The Non-Manufacturing Index from the ISM was 56.1, well into its "expansion" range.

He concludes, however, that "tensions surrounding international trade are the biggest question marks for the economy. The tariffs and threatened tariffs, supply disruptions, and general uncertainty are imposing major costs on businesses and consumers alike."

CSX now has the definitions of how they use the AAR Performance Measures on their website. *Train velocity* is much more meaningful: for a given train ID, it's total miles divided by hours of total travel time including intermediate dwell times. For Week 23 (ending June 8) system average train velocity was 19.8 mph, boosted by intermodal at 26.2. All others were below average.

Dwell time is measured at the single-car level: the total time, in hours, that a car spent in a given terminal. Aggregated dwell is calculated by dividing the total number of hours cars spent in terminals by the total count of car-dwell events (excluding bad-order cars, maintenance of way cars, and stored cars).

As of February 2, 2019, CSX updated its list of the ten largest terminals, reflecting changes to the volumes handled at terminals following the implementation of scheduled railroading. Rocky Mount was removed from the list, and Baltimore added. The historic data file will continue to reflect CSX's previous list of ten terminals through the week of February 1, 2019, and has been updated for the revised terminal list from that date forward. For Week 23, system-wide dwell average is 9.1 hrs.

Finally, *cars online* counts the number of active freight rail cars on lines operated by CSX, as determined by Raillnc, excluding rail cars that are being repaired, are in storage, those have been sold, or are private cars dwelling at a customer location more than one day. Cars online is a weekly average of the total number of active cars reported on CSX lines each day from Saturday to Friday.

Having the definitions of these terms clearly spelled out will be a great help in measuring single carload performance: how long it takes between OD pairs, where the hangups occur and how fluid CSX is — same vols, fewer cars online equals fewer delays en route. One caveat: different railroads' definitions of these three measures can vary. Thus one can't say NS is slower than CSX or CSX dwell times are longer than BNSF. And when we see week/week changes, that's by individual carrier, nothing else. Thanks, CSX for posting these definitions.

Beware financialization. Without using any names, I took a sample Class I that's undergoing significant change to see where those changes were manifesting themselves. I took a three-year sample 2016-2018 of straight percentage changes in total revenue, revenue units, system RPU, earnings per share, and shareholder equity.

As I suspected, revenue units increased by low single digits whereas revenue jumped 11 percent and RPU was up eight percent. Tells me the focus is on high RVC multiples while de-marketing the other end of the scale. Below the line, earnings per share doubled and cash from operations increased by half, and shareholder equity increased eight percent. But customers aren't being taken care of, and that's what the recent STB hearings were all about.

I'm also concerned about the use of ebitda in putting a value on an M&A target. You buy a piece of equipment or fix the track today and you figure it'll need replacement at some time in the future. Stuff wears out on the railroad and depreciation lets you expense what you wear out as you wear it out. And taxes are always there.

In the example above, reported net income was $3.3 billion; ebitda was $5.6 billion. Shares were priced at 20 times reported earnings per share but only 11 times ebitda per share (which is also in the neighborhood of the ebitda multiple short line sales see). So if I buy a railroad for 11 times earnings based on no depreciation or taxes, and I later see that those numbers cut in half the income used in the sale price calculations, have I not overpaid?

At the recent Berkshire Hathaway meeting Q&A, the question of PSR on BNSF inevitably came up. From the transcript — Question: Do you and current BNSF management believe that it's now a good idea for BNSF to adopt precision railroading playbook?

Buffett: The railroads that have adopted PSR dramatically improved their profit margins, and they had varying degrees of difficulty with customer service in the implementing of it, and we watch very carefully. We've learned a good deal learned by watching these four [PSR] railroads, and, if we think we can serve our customers well and get more efficient in the process, we will adopt whatever we observe.

We don't have to do it today or tomorrow, but we do have to find something that gets at least equal, and hopefully better, customer satisfaction and that makes our railroad more efficient. And there's been growing evidence from the actions of these other four railroads that we can learn something from what they do. Union Pacific is doing a somewhat modified version and we are not above copying anything that is successful. [end]

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