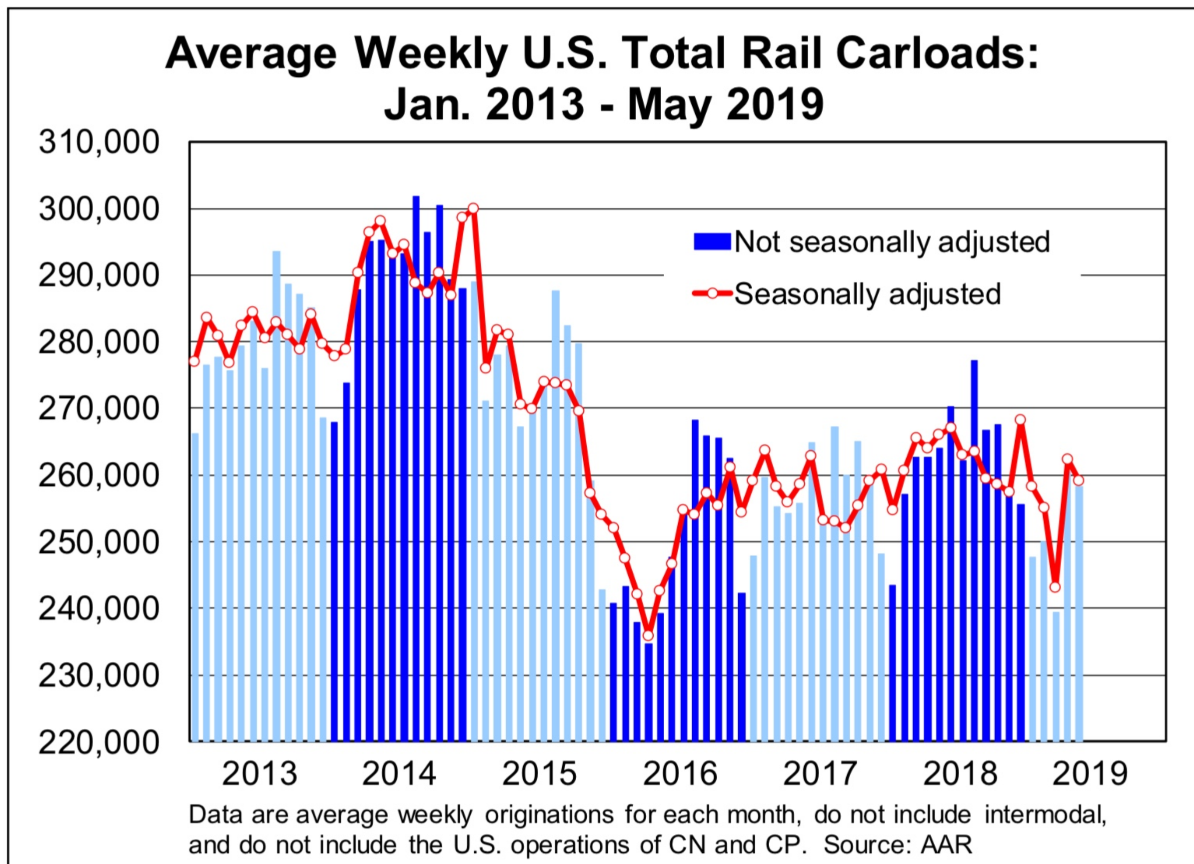
RAILROAD WEEK IN REVIEW

June 21, 2019

"Volume growth is key to generating economic profit, and economic profit is the key to driving the value of your investment." — Robert Goizueta, Chairman, Coca-Cola, 1995 Chairman's Letter

"Net assets is defined as the total assets of an entity, minus its total liabilities. The amount of net assets exactly matches the stockholders' equity of a business." — Accountingtools.com

'The rules now reward management, not for generating revenue, but to drive up share prices, thus making their options and stock grants more valuable." — John Mauldin, Thoughts from the Front Line, June 15



The number of revenue units traversing the US railroad system has been trending down for more than five years. Continue the trend line down and see that, at this rate, the railroads will have no customers left by the year 2023 or so. Of course, that's not going to happen. But the traffic mix is changing dramatically.

Time-sensitive, light-loading commodities traveling in single car lots continue to shrink as a percent of the whole traffic base. How long utility coal will last in significant volumes is anybody's guess. On the other hand, dense, heavy-loading commodities like plastics and other petroleum-based chemicals, steel coils, and ag products from grains to grain mill products moving in large volumes between a limited number of OD pairs will have legs.

The question then becomes whether the diminished number of revenue units can support the infrastructure required to keep them moving. To keep revenues trending upward on fewer revenue units means more revenue per unit, lest operating income fall to the point that even share repos can't keep earnings-per-share up enough to attract new money.

Common knowledge, as Ben Hunt (epsilontheory.com) puts it, is "what everybody knows everybody knows." And the more everybody knows that everybody knows that railroad shares are over-priced and carriers face uncertain times for increasing the revenue base, then all the rosy earnings estimates in the world won't keep institutional investors, who account for 85 percent of trading volume, putting their money here.

Reversing the trend means increasing not only the number of revenue units, but also the number of beneficial owners opting for freight cars in lieu of trucks. (See Goizueta, above.) CSX Chief Executive Officer Jim Foote makes the case that better service creates more new and repeat business and at a lower cost to the railroad. In a webcast conversation with UBS lead rail analyst Tom Wadewitz, Foote said not only does better service attract new revenues, but these are revenues that convert readily to free cash flow.

Foote provides exactly the right example. A symbol freight from A to C has enough unplanned events after leaving A that it must stop at B for a new crew, loco service, and refueling. The delay means freight in that train takes twice as long to reach C. Trip plan compliance suffers, service is less reliable, and customers trust you less.

Make that train run A-C every day without fail and you save the extra crews and the mechanical force time at B, delivering an on-time performance that wins the customer's trust. Then maybe he'll be less likely to put that next load on the highway. Moreover, says Foote, if your AAR merchandise train speed averages 25 mph, it implies half the trains are running at 50. Thus the more unplanned events eliminated, the higher the AAR train speed.

Measuring trip plan compliance is crucial. As currently set up, trip plans show the elapsed time from customer release at a CSX-served customer dock to placement at a CSX-served destination dock or interchange to another Class I for movement beyond. Or vice versa. Shortline stations may not yet show up on trip plans, but the interchange points do. Thus trip plan compliance for the shortline customer is the CSX trip plan from/to the interchange point plus the shortline time between the interchange and the customer.

Inbounds put on the interchange today can be placed tomorrow — trip plan plus one. However, if the short line works only Monday-Friday, Friday inbounds don't get placed till Monday and the shortline lag Friday-Monday adds two days to the trip plan presented to the customer. Could be a deal-breaker.

Growth, inflation, and profits are the three horseman of economic growth, according to Keith McCulloch at hedgeye.com. Here's his June 19 *Early Look* chart on the economic outlook:

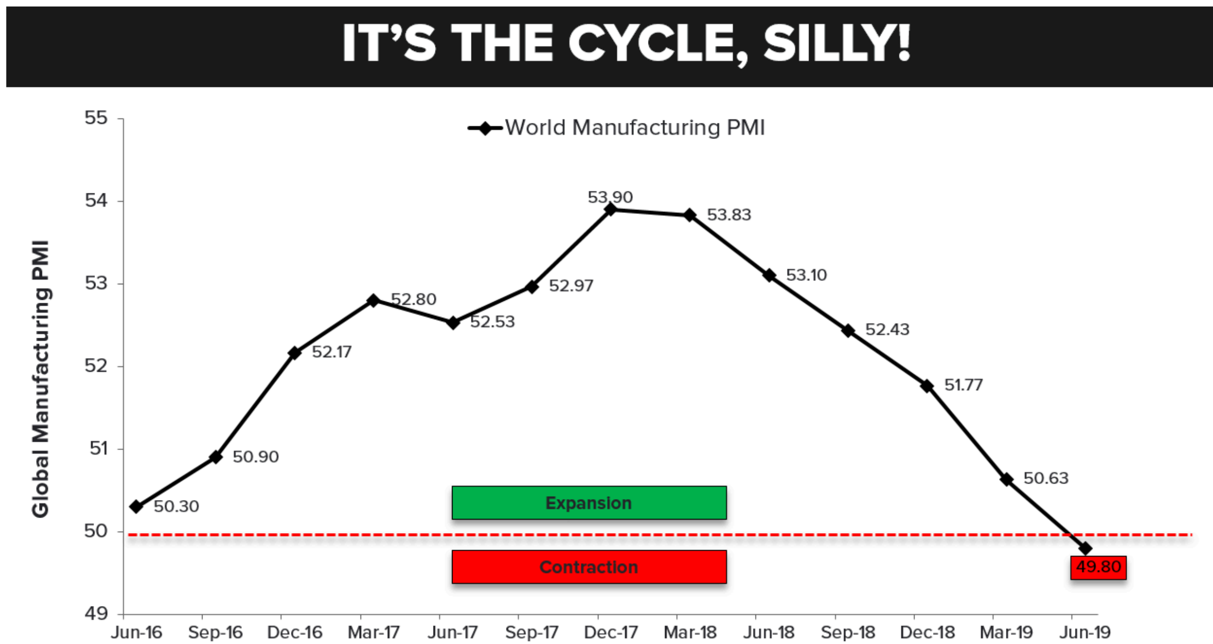


Illustration courtesy hedgeye.com

The PMI (Purchasing Manufacturers' Index), an indicator of economic health for manufacturing and service sectors, is a pretty good predictor of where the economy is headed, never mind the fact that services account for more than half the index. Lay the above over the page 1 chart and see carloads mid-2016 to the present are flat to down.

The key take-away is charts like this tell us what IS, not what somebody thinks might happen at some time in the future. You've got payroll to make, track to fix, and locos to fuel today and you need to know when the next bit of income will show up. Knowing whether your connecting railroads' carloads are trending up or down is crucial. As all the experienced traders say, "The trend is your friend."

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