RAILROAD WEEK IN REVIEW
July 19, 2019

"One of the reasons why second quarter earnings are going to be key is the fact that economic growth has really started to slow this year. Unfortunately, the slowdown accelerated in the second quarter" — Leo Nelissen, Seeking Alpha. July 10

"People truly don't understand what PSR means. But as some of the rhetoric goes away, the facts prove out this is the right way to run a railway for long-term sustainability — from a capacity standpoint, from a safety standpoint, from a productivity standpoint, from a customer standpoint, and a shareholder standpoint. It truly is a win-win." — Keith Creel, President, Canadian Pacific, during the Q&A, 1Q2019 earnings call.

"Financialization – profit margin growth without labor productivity growth – has become the water in which we fish swim. We don't just take it for granted … it has become completely unnoticeable even as it has transformed our capital markets into a wealth inequality machine." — Ben Hunt, Epsilon Theory

"The corporate sector has gone on a massive debt orgy — one of the largest increases of debt we've ever seen. This debt has been basically used for one thing: equity buybacks. They bought back more equity than any other time in history. And by now more than half the US bond market is BBB, essentially one large notch above junk bonds." — Raoul Pal, Global Macro Investor

Canadian Pacific second quarter revenue units increased six percent to 716,800 and freight revenue gained 13 percent to C$1.9 billion, thanks in part to the seven percent RPU gain to $C2,694. Merch carloads increased six percent, turning a 14 percent revenue gain. Potash volume was the big winner, up 18 percent, followed by energy/chemicals/plastics (11 percent) and forest products (10 percent).

Total revenue including ancillary charges was also C$1.9 million, operating expense gained a mere three percent, and operating income rose to C$822 million, a very respectable 31 percent for a 58.4 OR, down 575 basis points. Reported net income was C$724 million, up 66 percent, though after taking out some one-time tax benefits the net was C$603 million, up a third over last year.

Six-month cash from operations increased two percent to C$1.1 billion. Free cash flow after capex and dividends was C$269 million, off eight percent. FCF after share repos came to negative C$195 million, a 27 percent improvement. Share prices gained 26 percent for the year, pushing market cap $C6.1 billion, representing a $12 gain in market cap for every dollar gain in retained earnings. My standard is at least one-for-one over 12 months, so this is exceptional.

On the other hand, it was a little disappointing not to have more detail on anticipated merch sector second half results and how they will be achieved. In his introductory remarks on the call, Creel said, “the opportunities that John [Brooks, Chief Commercial Officer] and the team put together for 2020 and 2021 will not only hit our 2019 guidance but will carry this strength and momentum in 2020 and 2021 as well.” But there was little follow-through. The slides were mostly history and the Q&A the analyst comments did not press the issue.

That said, Brooks commented that grain traffic would be weighted toward canola and that, in the US, “grain volumes were down double digits at the PNW” due to trade-related uncertainty. In the energy/chemicals/plastics group “we expect volumes will continue to increase as the production and curtailment balance stabilizes, and our new contracts and existing customers continue to ramp up the second half of the year.”

In metals/minerals/consumer, CP is sharpening its approach to frac sand, shifting the focus to the Permian from the Bakken; “This market diversity yields higher revenue per carload, single-line haul efficiencies and improved margins. We currently have two unit trains facilities in service, and we're adding a third unit train facility in this region by the end of the year.” No comment on forest products or fertilizers, together representing five percent of vols and contributing nearly C$300 million in annual revenue.

CSX total revenue units decreased four percent in the second quarter. Merchandise carloads, including auto, increased one percent; coal gained two points and intermodal plummeted 11 percent. As a result, total revenue was off one percent to $3.1 billion even though system RPU was up three points. Operating expense was down four points, trimming operating income to $1.8 billion, up less than two percent. The OR shed 127 bips to 57.4, a respectable number.

Below the line, net income dropped eight tenths of a percent to $870 million. CSX reported per-share earnings of $1.08, up seven percent, entirely a function of the seven percent reduction in diluted shares. Without the repos, EPS would’ve been flat at a buck even (see *financialization* quote in italics above). Cash from ops gained 13 percent to $2.3 billion while capex dropped seven percent to $769 million. Free cash flow after dividends but before repos increased 30 percent to $1.1 billion; after repos FCF goes to a negative $546 million.

Investors have noticed. Shares have been trading in a narrow $76-$80 range since early April. There have been more down days than up days, and — even though shares are up 24 percent year-to-date, barely beating $SPX — the stock price is losing momentum. The fact that after the call shares dropped nearly $10 —crossing the SMA 200 on the way down — hurts.

Out on the railroad, a worrisome trend in operations consolidation continues. Kevin Boone, Interim CFO pointed specifically to “ongoing train consolidations through continued expansion of distributed power and additional longer crew runs.” He adds,

> This reduces the active locomotive fleet and associated maintenance and repair cost, as well as crew labor and related travel and balancing expenses. Yard reductions enabled by train consolidations and longer runs will reduce labor and overhead costs. Overtime also remains a significant opportunity with a particular focus on its mechanical and engineering. There are multiple emphases across our business functions where overtime as a percentage of straight time is well over 20 percent and in some cases exceeding 40 percent.

But then, with 30 percent of the merchandise franchise in ag, ferts, and minerals — commodities that are largely fungible with little time value, bigger, slower, less frequent trains may not matter. Perhaps summing it all up best was Chief Commercial Officer Mark Wallace, saying, "On the merchandise side, there are signs of slowing the economic conditions for Q3 and Q4, pointing to a less robust economy in the second half." More bulk heat and eat will help offset the trend.

Union Pacific revenue units were off four percent to 2.1 million units in the second quarter; commodity revenue slipped two percent to $5.2 billion but total revenue, $5.6 billion, was down just a point. Ag carloads were even with last year due to slippage in export grain and grain mill products, though ferts gained nicely. Industrial commodities gained two point thanks to strong demand for construction products, non-metallic minerals (clay, phosphate, rock salt) though forest products were lower in both STCCs.

Energy group carloads dropped nine percent as local Texas sand replaced much of the UP-delivered frac sand from the north and coal was seven percent lower; a significant jump in petroleum products and crude oil offset. Revenue units in the Premium product group (auto and intermodal) drifted south by five percent, reflecting intermodal declines in domestic and international boxes while finished vehicles gained a point on the consumer switch to larger pick-ups and SUVs from the smaller, lighter sedans.

Key Performance Indicators for operations — dwell, car-miles per day, locomotive productivity and trip-plan compliance — all improved year-over-year. The network changes and terminal rationalization mandated by the Unified Plan 2020 is playing a crucial role in the KPI success rate, with the most recent terminal changes in San Antonio, the St Louis ADI, KC, Chicago, and Denver being felt system-wide.

Operating expense came down seven percent, which, combined with the one percent revenue slippage, produced operating income of $2.3 billion, up eight percent; the OR came down 340 basis points to 59.6. Net income was $1.6 billion, up four percent. Cash from operations returned $3.9 billion, down three points. Capex was 14 percent of revenues, about even with last year and free cash flow after dividends and capex but before repos was $1.1 billion, down 16 percent.

As for the rest of the year, Marketing EVP Kenny Rocker is calling for further growth in crude oil and petroleum products, plastics, construction materials, and light truck moves. Less promising are grain, coal, lumber, and domestic intermodal. I come away with the impression of a plant running better every day, well positioned to handle the increased commodity loads, and able to minimize the effect of the slower-growth commodities. CEO Lance Fritz puts it this way: “The Unified Plan 2020 transformation at Union Pacific is full steam ahead, and I continue to be encouraged by the great opportunities we see for our customers and for our shareholders.”

Concerning the potential Alphabet Route combinations touched on last week, freight is already moving east over GWR’s Chicago, Fort Wayne & Eastern, thence over the Wheeling & Lake Erie to its connection with the Southwest Pennsylvania short line for beyond. A reader who knows about such things writes that an EDI waybill can accommodate up to 13 railroads in the route. And now that Brookfield controls GWR, maybe the latter will be encouraged to monetize some of the weaker properties, providing more cash to connect more dots.

Which is a good thing. As we’re seeing in quarterly earnings calls and news of the trucking community, the US economy is slowing down. Debt is at all-time levels, earnings are down even though share prices keep rising, and there is simply less stuff moving around. Yet the US is just the tip of the global iceberg.

The world PMI appears to be heading into recession territory. And anything going wrong is going to turn this from a slowdown into something much uglier. Take Germany. It’s the largest economy in Europe and one of the largest in the world. So the fact that their PMI rate of change could be headed for negative territory puts a damper on the whole of Europe. And anybody doing business there, like GWR.

Australia is another matter. Though it’s far too small an economy to matter in the globalized context, the country has a problem with its own domestic economy with its massive house price boom, and the overhang from the mining boom as well. All of which suggests a shrinking demand for transportation, and that will affect GWR.

That’s why I think the Brookfield relationship is going to be a good one for GWR. They can get rid of their non-performers in the US, use the customer dissatisfaction with Class I service and pricing to create a more competitive product, and ease out of Europe and Australia to further bolster its domestic holdings. Wins all the way round.

KCS reports today with NS and CN rounding out the earnings calls next week. GWR will not report due to its new relationship with Brookfield and the BNSF numbers will be bundled with Berkshire in early August. Film at 11.