

RAILROAD WEEK IN REVIEW

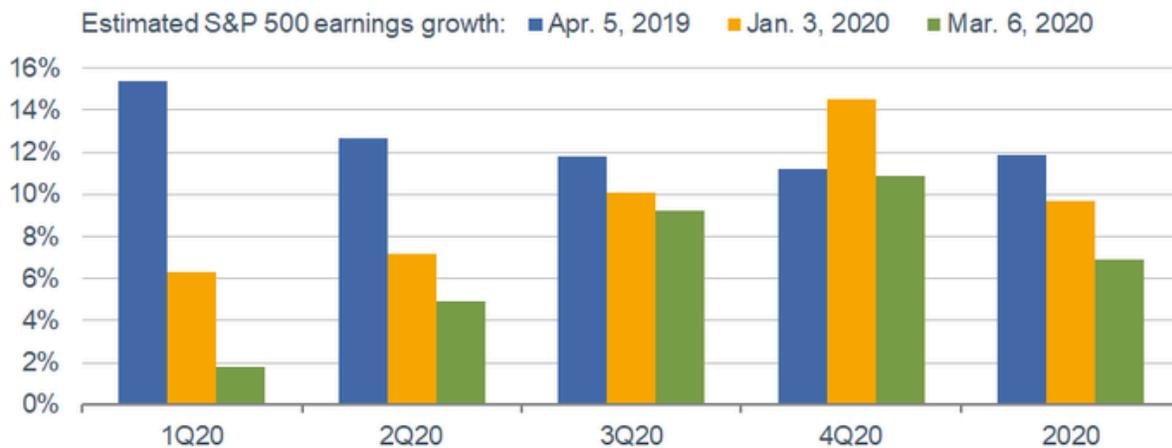
March 13, 2020

“The coronavirus is threatening to expose the Achilles heel of the U.S. economy: heavily leveraged companies. As the economic expansion stretched into a record 11th year, and interest rates stayed at ultralow levels, business debt ballooned... Moreover, the borrowing has increasingly been concentrated in riskier companies with fewer financial resources to ride out virus-driven difficulties. — Bloomberg, March 10

“From a recent high of nearly \$63 last April, WTI crude futures fell below \$30 intraday Monday morning. This is likely to put increasing pressure on the credit markets given that energy companies are the largest issuers of junk bonds. In addition, more than 11 percent of the investment grade corporate bond market sits within the energy sector, with many companies rated BBB—the lowest rung. Increasing cash flow pressures are likely to result in downgrades, which would further weigh on junk debt.” Liz Ann Sonders, Schwab, Mar 9

The stock market is a leading indicator of the general direction of the economy. As you can see from the Schwab chart below, company guidance for earnings estimates has dropped markedly for the present quarter. Only in 4Q20 do the green bars approach last year’s estimates.

More Cuts to EPS Growth Coming



Source: Charles Schwab, I/B/E/S data from Refinitiv, as of 3/6/2020.

I mention this because railroads are a “derived demand” service where demand is a function of economic activity. And I do this at risk because I have been criticized for spending too much time on markets and too little time on carloads trends. In my opinion, however, railroad managers need to know where the demand is coming from before that demand shows up as a rate request. Do you have the resources to handle new business? The answer had better be yes.

That leads directly to the matter of supply chains. In every manufacturing process there are parts and components that have to come from elsewhere. Call the part that goes into the final product Tier 1, the supplier to the Tier 1 part maker Tier 2, and so on down to the supplier of plastic resins to make the handle, the steel to make the car body, the wheat to make the bread.

The railroad niche is increasingly in the lower tiers of the supply chain: coal, limestone, iron ore for steel; soda ash for glass; natural gas for fertilizers and plastics; lumber for housing. So if your railroad serves steel makers, you need to know about the demand for coal, iron ore, limestone, etc. *before* your customer starts asking for cars. And that shoe fits every industry: a slowdown in Tier 5 production affects tier 4, and so on up the food chain to the Tier 1 supplier and the final product that goes to the user.

That's also where first mile/last mile performance is critical. The serving railroad is the Tier 1 supplier of railroad services. The originating or destination railroad and every other carrier in the route is the Tier 2, Tier 3, Tier N supplier of transportation for the end user. The good news is that the scheduled railroad model has cut transit times and can be measured with Trip Plan Compliance. The bad news is the first mile/last mile carrier that is not fleet of foot.

I keep hearing horror stories about first mile/last mile carriers that have lost major customers and then cut back on operating days, payroll, and maintenance to save money, goose the adjusted non-GAAP ebitda, and keep the operating ratio under control. Wrong. The right solution to the lost customer is to enhance service to the core customers and to design new services to attract new customers (transloads, anyone?).

As your revenues rise faster than operating expense, the OR goes down and the un-adjusted operating income increases. And that's why you want to pay attention to the stock charts of your customers' industry and those of their suppliers and customers. Here endeth the first lesson.

Almost Daily Grant's for March 9 advises that "The carnage in junk debt continues apace as the corporate sector is increasingly vulnerable." The S&P unit that tracks this stuff says "a record 58 percent of domestic leveraged loan debt is now rated single-B or lower. Nearly 15 percent of that number is rated single-B-minus, another record and double that of two years ago."

By way of review, S&P Single B and Single B-minus are "highly speculative." Below that, CCC+ carries "substantial risk," CCC is "extremely speculative," and so on down to D for Default. Moreover, 13.6 percent of companies within the S&P 1500 lack sufficient operating income to cover interest expense, up from 12.4 percent three years ago. Closer to home, the fact that some shortline financials use "adjusted ebitda" to exclude so-called "extraordinary" expense lines to enhance ops income and thus interest coverage only makes matters worse. The best route is to have NO debt because it gives you choices.

The Railinc January 2020 summary of non-Class I railroads shows total vols down 3.3 percent vs. the Class Is down 4.6 percent per the AAR. Six non-Class I commodities showed gains whereas the Class Is showed but one -- grain mill. If the non-Class Is had not been up in these commodity groups, the Class Is would have been down even more. Total non-Class I commodity carloads with volume increases came to 7.2 percent of the total cars handled in Jan 2020. And 34 percent of Jan 2020 carloads were in gaining commodities vs. 30 percent a year ago.

Carloads, by commodity	Carloads Originated January 2020	Carloads Originated January 2019	% Change
All Other Carloads	71,181	78,136	-8.9%
Chemicals	57,764	53,399	8.2%
Coal	16,309	21,140	-22.9%
Crushed Stone, Sand and Gravel	21,530	22,974	-6.3%
Food and Kindred Products	11,068	11,548	-4.2%
Grain	23,384	25,482	-8.2%
Grain Mill Products	8,982	7,542	19.1%
Lumber and Wood Products	8,723	8,936	-2.4%
Metallic Ores	2,760	3,307	-16.5%
Metals and Products	18,632	19,514	-4.5%
Motor Vehicles and Equipment	10,043	9,281	8.2%
Nonmetallic Minerals	2,833	2,535	11.8%
Petroleum Products	2,312	2,330	-0.8%
Pulp, Paper, and Allied Products	21,580	21,127	2.1%
Stone, Clay and Glass Products	12,800	11,872	7.8%
Trailer or Container	39,950	42,482	-6.0%
Waste and Scrap Materials	10,434	10,279	1.5%
Total	340,285	351,884	-3.3%
Total Ups	114,393	106,754	7.2%
Pct Up of total	33.6%	30.3%	10.8%
Source: Railinc			

So to see the Class Is pay less and less attention to the single-carload market seems to me irresponsible.

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