

2016 Freight Railroad Capex Analysis

Enormous Investment Brings Fruitful Reward

By Tony Hatch, President, ABH Consulting



Rail capex, after a century's worth of growth and interrupted only by the great financial recession (and barely and temporarily at that), has been cut for 2016 by 16 percent. Traffic patterns were not good last year and got worse by the quarter. U.S. and Canadian traffic—carloads and intermodal—was down over 2 percent for the year and 9 percent for Q4/15.

On The Surface

Causal observers saw coal, the baseline product, face a secular disaster as mining companies chose Chapter 11. Volumes were down 12 percent for the year but fully 27 percent in Q4/15.

Cyclical, non-bulk carload traffic was also poor—down 4 percent for the year and 9 percent for the quarter.

The big growth hopes, intermodal and petroleum products, declined in the face of trucking capacity surpluses, in the latter catastrophically so (-15 percent in Q4/15).

Investor sentiment, a key driver of capex, cratered as rail shares significantly underperformed for the first time in the 21st century.

Activist investors re-emerged, pushing an M&A solution, the response to which isn't usually long-term investment.

Capex is also "artificially" high due to Positive Train Control (PTC) spend, ending

by 2020, of \$1.7B (some 13 percent of the total planned spend) and contracted (but not needed, at present) locomotive purchases of \$2.3B (17 percent); the burden of rail car risk has, of course, been shouldered by the leasing industry.

Putting It All Into Perspective

On the other hand, and to put this in perspective, 2016 will be the second or third largest North American freight capex year on record.

Rail earnings' performance in 2015 in the face of the secular and cyclical headwinds was actually astounding—group average operating ratios were below 70 percent, even with record capex, buybacks and dividend levels.

Service levels are at all-time highs and trending upwards with the resultant decrease in shipper/regulatory pressures.

Major big capacity projects are completed.

There are several rail leaders speaking out for long-term investment (CN, which did not cut capex, and Berkshire Hathaway, in particular) or bucking the spending trend despite outside pressures (CSX).

Maintenance-of-way (MOW) spend will still be healthy; spending is shifting in terms of focus and region but hardly "going away."

To be fair, we must factor in the "unfunded mandate" of more than \$10 billion for PTC. Nonetheless, rail spend is massive compared to their customers' industries. In fact, freight rails have invested between 16-27 percent of their revenues back into the rail network, a rate of capital intensity that is unparalleled in the industrial sector. In fact, if you consider "all-in" expenses (operating + capital), the number is almost doubled (from ~\$16 billion to ~\$29 billion for last year, for example).

Big Returns

Public companies require the promise of good returns to justify the expenditure. In the case of freight rail, that has not only happened, but also, over the course of the century, has formed a "virtuous cycle" relationship and created a true competitive advantage. It is no coincidence that during the period of capital expansion, the returns on the invested capital have improved from significantly substandard to cost-of-capital, or re-investable, levels. The subsidized infrastructure of rails' main competitor, the highway system, used to be in better condition than that of the freight network. But, that situation has obviously reversed with significant and positive competitive implications for railroads longer term.

Big Changes

Over the last year, a combination of secular (coal) and cyclical (crude, metals, export coal) forces have buffeted the railroads just as capital spending hit new record levels, leading to a re-thinking of the rail group's capex policy. The major issue is the fundamental change in investor sentiment, as the shareholder stakeholder group views the rail group in a different light. The changes in the rail volume mix and outlook, and hence work output, are revolutionary.

Secular Blow

U.S. domestic coal is enduring a permanent downgrade. Regulatory changes and "cheap (natural) gas" have caused what many call a once-in-a-lifetime change in utility fuel

sourcing, where coal has dropped from 50 percent of the total (as recently as 2008) to below 30 percent today, before reaching a “stabilization point” between 27-33 percent that should last to 2030.

Point Of No Return?

Coal changes bring up the idea of “stranded assets,” reduced heavy-freight volumes, etc.—a possible reduction in overall targeted spend (think Appalachia), reduced segment spending (not just coal cars, of course), and reduced type of spend (reduced GTMs as intermodal “replaces” heavier coal).

Don't Believe The Hype

CBR (crude-by-rail), not long ago over-hyped as a savior for rail volumes in the face of the “war on coal,” has proved mercurial. Rails’ “flexibility” has been proven, but this segment is no longer as exciting as a few years ago.

Cyclical traffic hasn't responded to either the expected economic recovery pattern or the reduced price of oil—auto production has

been strong, but consumer-related volumes (housing, international intermodal) have been sluggish. The drop in oil prices has hurt, rather than helped the economy to date.

For Class 1 rails, 2016 capex planning represented the most important decision period in years.

Coal shipment reductions could lead to further reductions in MOW, but service and safety are more critical than ever. The mix of capex may change with extension of PTC to 2020 and the mix of capex as a percent of revenue is in flux.

At this point, the Class 1s' decision to cut spending in 2016 does not reflect a change from a strategy of “investment/growth” to a “harvesting” policy. But, given the pressures, this bears watching. If these cuts hold, 2016 Class 1 freight rail capex plans would represent the first decline since 2009 and break a six-year “winning” streak. MOW spend is essentially being held flat with “growth” or “expansionary” capital cut significantly this year.

On the other hand, Class 1 rails have produced a full recovery in service levels from the 2013-14 predicament. This has reduced the regulatory threat, but the close relationship between service/capacity and capex has been noted by shippers and their political allies

There is also increased investor activism, which demands a shift cash flow from a “balanced policy (capex/share buybacks/dividends) towards a greater weighting of the latter two direct shareholder payouts.

There are other major issues for consideration. Any changes to the regulatory regime would have a dramatic impact on capex in the future, coming with real risks to the return potential.

M&A, while called off for now, doesn't provide clarity for how consolidation would impact the capital cycle. Then also, some 36 years after the Staggers Act jump-started the short line boom, it isn't fully clear what the short line capex requirements are in areas such as bridges.

Notwithstanding the challenges, it is clear that the rewards of past and current extraordinary investments are a bountiful harvest. ■

GOING THE EXTRA MILE WITH SERVICE
The Industry's BEST

From left to right:
 Richard Piper, Welder/Fabricator for 25 years
 Rick Moore, Welder/Fabricator for 32 years
 Rick “Killer” Yeomans, Hydraulic Specialist for 34 years, 20 in the US Army
 David Piper, Equipment Designer and Sawmiller, 50 years
 David “Dave” Broussard, PLC Automation Specialist, 25 years

MEET THE ROAD CREW

BREWCO, INC.
 CELEBRATES **25 YEARS**
 A NAME YOU CAN TRUST

MADE IN AMERICA

800.237.6880
 www.brewcoinc.com

HEADQUARTERS
 607 Front St. • Central City, KY 42330

BREWCO
 INCORPORATED
 RUGGED • RELIABLE • DEPENDABLE