North American Rails: On The Right Track

INDUSTRIALS SECTOR REPORT

Companies mentioned in this report --

Followed by Edward Jones:

- **Berkshire Hathaway** (BRK.A - $467,650.00) - Hold
- **Berkshire Hathaway** (BRK.B - $310.94) - Hold
- **Canadian National** (CNI - $117.27) - Hold
- **Canadian Pacific** (CP - $75.18) - Buy
- **CSX Corp.** (CSX - $32.11) - Buy
- **Norfolk Southern** (NSC - $244.66) - Hold
- **Union Pacific** (UNP - $224.00) - Buy

Prices are as of market close on 6/3/22 and are subject to change. Source: Reuters.

For more information:

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- Rail shipping volumes were negatively impacted during the initial onset of the coronavirus, with the most significant declines occurring as manufacturing facilities shut down for periods of time and people were self-quarantining. While the industry has rebounded from the lows, carloads have not gotten back to pre-pandemic volumes. While near-term volatility in shipping volumes could remain due to virus uncertainties, supply-chain disruptions, and labor issues, we expect a longer-term rebound as concerns about the virus abate and the economy grows.
- U.S. railroads are in the process of overhauling their operations with PSR (Precision Scheduled Railroading). PSR involves running longer and faster trains to improve efficiency. We believe improvements in efficiency across North American railroads will help them navigate the near-term volume pressures caused by the coronavirus. A PSR focus and other efficiency improvements are expected to drive earnings in the coming years.
- Railroads have distinct advantages over trucks, including being cheaper, more efficient and "greener." Also, they do not face many of the headwinds that trucks face, such as highway congestion, emissions regulations and driver restrictions.
- Pricing power, which is the ability to raise prices over time, is an attractive driver of earnings growth and can help to offset weaker volumes.

The U.S. railroad system is an important part of the overall economy, transporting nearly 40% of total freight tonnage in the country. The Canadian railroads also play a vital role in the Canadian transportation industry, with ties to every part of the Canadian economy. Currently, half of Canada's exports and roughly 70% of all intercity surface freight are moved by rail.

After a series of acquisitions and mergers over the years, the North American railroad industry is dominated by a few large players. In the U.S., the industry is now dominated by five large players: Burlington Northern Santa Fe (owned by Berkshire Hathaway) and Union Pacific operating west of the Mississippi; CSX and Norfolk Southern operating in the East. In Canada, the industry is dominated by just two railroads – Canadian National in the eastern part and Canadian Pacific in the western areas of Canada. Overall, the rail industry has transformed tremendously over time, from one that struggled to compete to an industry that has steadily increased returns over time.

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Industry Volumes Improving

An uncertain macroeconomic environment led to pressures on freight volumes for North American railroads over the last few years. In the second half of 2019, volumes were impacted by continued trade uncertainties in the U.S. and slowing North American manufacturing demand. Ultimately, new trade agreements were negotiated between the U.S. and China and also between the North American trading partners (U.S./Canada/Mexico). Unfortunately, volumes took another hit in 2020 due the impact of the coronavirus. Businesses shut down for periods of time and people stayed home to self-quarantine. Additionally, some manufacturing facilities, such as the automakers, suspended production for several weeks. This resulted in declining volumes of shipments for autos and commodity products such as metals and forestry goods during the first half of 2020. Volumes have improved, although we anticipate near-term volatility due to the lingering impacts of the coronavirus, which have caused supply-chain disruptions. Over the long-term, we expect shipping volumes to grow in conjunction with economic expansion. With the volume pressures over the past few years, railroads have focused on improving operational efficiency. The railroads have been taking out idle cars and reducing expenses, which we believe puts the companies in a much better position today to navigate through future challenges.

Industry Drivers

The North American rails benefit from several tailwinds that we believe will drive growth and profitability:

- Pricing Power: Increased focus on customer service and efficiency has allowed the rails to gradually increase shipping rates over time. Furthermore, rails have negotiating power because there are limited alternatives to hauling large quantities of bulk freight such as grain or coal.
- Growing Global Trade: Over the last few decades trade has grown remarkably, completely transforming the global economy. While trade has slowed recently amid continued trade uncertainties in the U.S., longer-term growth in imports and exports with Asia will likely continue to drive freight volumes, namely intermodal (freight containers), as rails can more efficiently move large shipments than trucks can. Intermodal freight, which is the movement of containers by more than one mode of transportation (rail, ship, truck), consist of freight containers which are primarily used to transport consumer goods, such as clothing items or electronics typically manufactured overseas.
- Continued Productivity Improvements: U.S. railroads are in the process of overhauling their operations with PSR (Precision Scheduled Railroading), pioneered by the late Hunter Harrison. This process involves running longer and faster trains to improve efficiency and profitability. We believe PSR, coupled with other efficiency improvements, should drive earnings in the coming years.
- Trucking Industry Facing Long-term Headwinds: Trucks face several headwinds that the rails do not face, which should help continued conversions to rail. These include continued highway congestion, high turnover of truck drivers, strict work-hour rules, driver shortages, and increasing emissions regulations for trucks.

Solid Business Positions Lead to Pricing Power

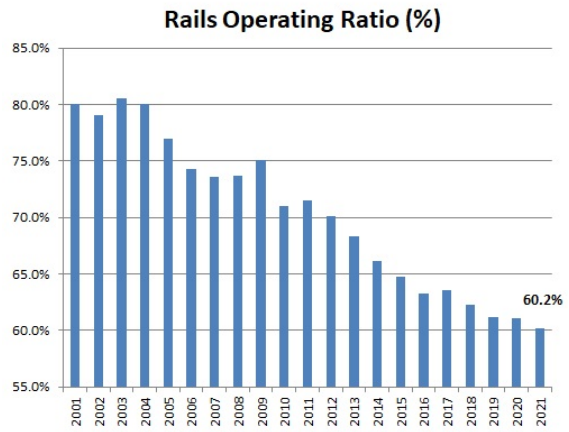
North American rails should continue to have the ability to price their services above the rate of inflation in rail costs. Rails have pricing power due to inherent competitive advantages such as rights of way and thousands of miles of track, and due to regulatory regimes that allow pricing at or above inflation. When combined with continued cost control, this pricing power should allow the North American rails to continue to grow their earnings.

Industry Focused on Efficiency

The primary measure of efficiency for railroads is the operating ratio, which is simply total costs divided by total revenue, with a lower ratio being better. The industry has made tremendous strides since 2001 when the average efficiency ratio for the industry was approximately 80%. Since this time, management teams across the North American rails have focused on cutting unnecessary costs while increasing train speed and decreasing the amount of time that cars sit in yards (terminal dwell time).

As illustrated in **Figure 1 on the next page**, the push for efficiency has resulted in a more streamlined rail network, with an average operating ratio across the industry in the low-60% range. Although efficiency has been negatively impacted by the coronavirus, we expect the North American rails to continue to focus on efficiency, resulting in lower operating ratios over time.

Figure 1: More Efficient Operations



Source: EDJ models, company reports. The operating ratio depicted here is the average of the ratios of the following rails followed by Edward Jones: CNI, CP, CSX, NSC, and UNP. Past performance is no guarantee of future results.

Investing in the Railroads

We view the rails as a core holding of a well-diversified portfolio of industrial stocks. In our view, the rails are attractive not only for capital appreciation, but also for attractive dividend growth opportunities. We expect the rails to continue to return capital to shareholders in the form of share buybacks and increased dividends over time.

We currently follow five North American railroads. Canadian Pacific, CSX, and Union Pacific are our Buy-rated names. Canadian National and Norfolk Southern are rated a Hold because we believe that their current share prices already appropriately reflect our positive industry outlook. All of the North American rails stand to benefit from some of the same future long-term tailwinds, including U.S. economic growth and continued pricing power.

Valuation

Methods we use to evaluate the attractiveness of rail stocks include traditional ratios such as price-to-earnings (P/E), both on an absolute and relative basis; PEGY ratios (P/E vs. estimated growth and dividend yield); and discounted cash flow (DCF) analysis.

Risks

There are several risks associated with investing in the railroad companies. In our view, the biggest risk facing the rails is a prolonged economic downturn. We believe another recession or a sustained period of little to no economic growth will negatively impact rail volumes and profitability. Given that coal is still one of the largest freight categories, any additional negative environmental regulation related to coal or emissions, or a switch from coal to another power source for electricity generation, would negatively affect earnings growth in our view. Other risks include loss of pricing power, unfavorable rulings or regulations from the Surface Transportation Board, union-related issues, the capital-intensive nature of the industry, and the overall competitive nature of the freight industry.

Please see the individual research reports for additional information, including disclosures, analyst certifications, valuation and risks specific to each company.

Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.
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