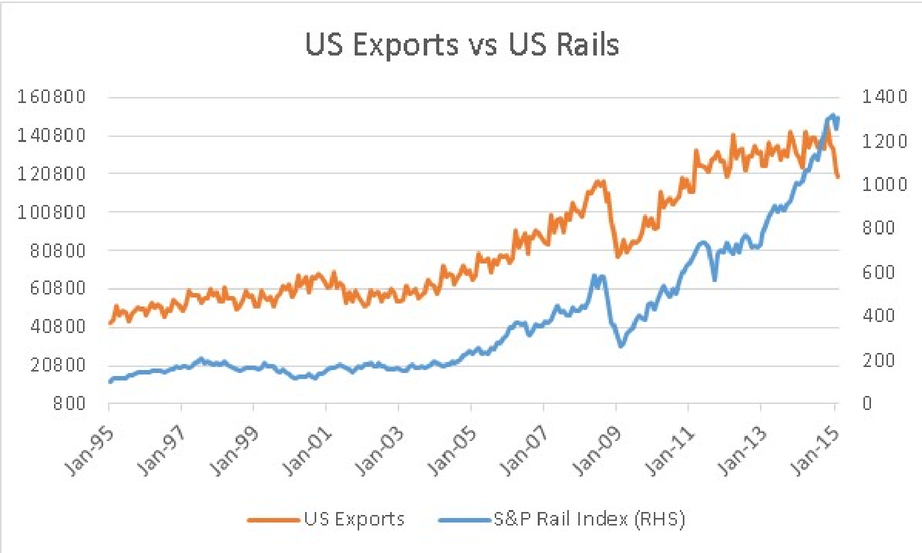
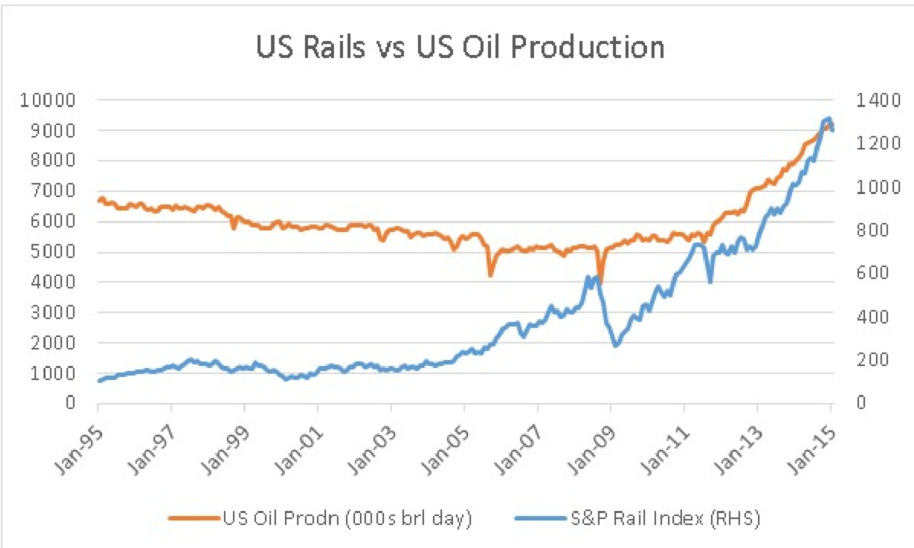
US RAIL – END OF THE LINE?

US Rail stocks have been fantastic investments over the last decade. Traditionally they have been a good proxy for US exports, and growth in global trade. However since the financial crisis, their performance has been strikingly good in an environment of relatively mediocre US export growth.



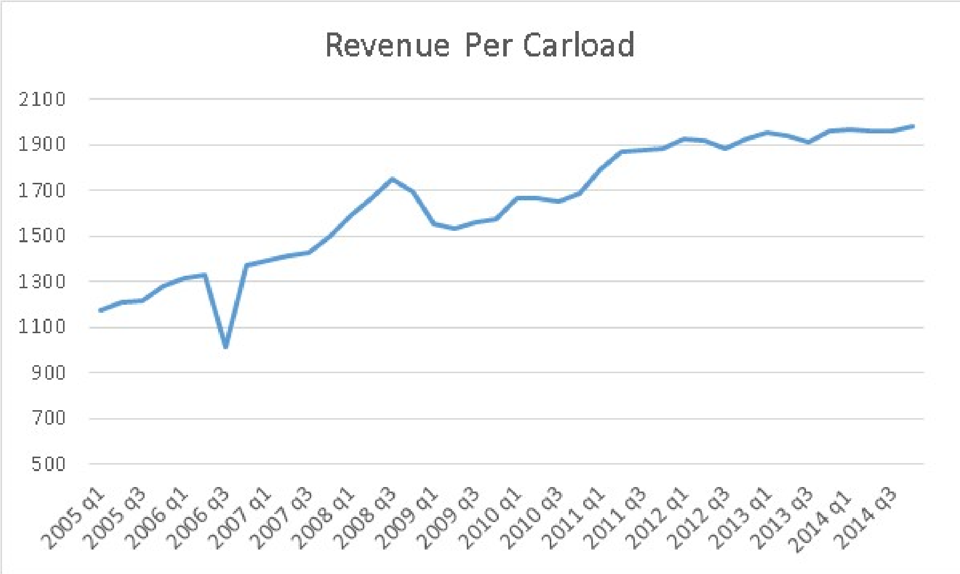
I suspect that the reason for this being a good proxy is that much of the growth in US rail volume has come from moving goods internally - principally for the US oil market.



Looking closely at the US oil industry, the growth in oil production has had two major benefits for the rail companies. First and most obvious is that large amounts of crude oil had to be shipped to refineries, and most of this is concentrated in Texas and Louisiana. The second less obvious was the transportation of frac sand to be used in unconventional drilling. According to US Silica presentations (http://phx.corporate-ir.net/phoenix.zhtml?c=247793&p=irol-IRHome, Events & Presentations) one rig requires 100 railcars and 430 trucks worth of proppant to complete one well. They also show that volume of proppant nearly tripling from 2010 to 2014. Most of US frac sand is mined near Wisconsin, which is located the near the Great Lakes

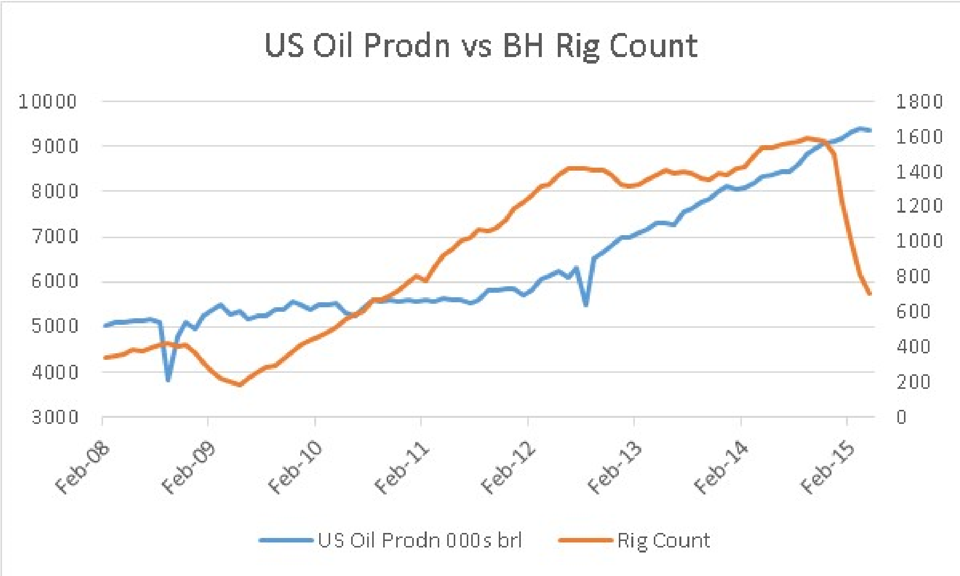
The biggest growth in oil production in recent years has been in Texas and North Dakota. The combination of refineries in the gulf, oil production in North Dakota, Texas and Canada, combined with a growing need for frac sand from Wisconsin has created huge demand for rail transportation.

US rail companies have managed to increase revenue per railcar quite substantially over the years.



To my mind, there are two factors that have driven this increase. First is that the increase in volumes has allowed the rail networks to be more efficient and to reduce the number of empty carloads.

Second, rail companies do compete against trucks in the transportation market. Trucks tend to be more competitive with smaller cargoes and distances up to 500 miles. I suspect that higher oil prices have given room to the rail companies to raise prices. It is difficult to provide an accurate estimate, but CSX disclosed that fuel surcharge revenue in 2014 was 1.2bn USD, or 9% of annual revenue.



Given the significant fall in rig count in the US, I would suspect volume of oil production to as least stagnate and possibly fall. Lower oil prices would seem to imply lower revenue and volumes for rail companies and greater competition from trucking companies due to lower oil prices.

Using CSX as a proxy, we can see in terms of market capitalisation to sales, rail companies have never been more expensive. The risk reward seems skewed to the downside.

INFORMATION

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