**CSX Investment Memo**

CSX is a Class I U.S. freight railroad primarily operating east of the Mississippi river. The company serves a diversified mix of end-markets and operates within what is effectively a duopoly alongside its main eastern competitor, Norfolk Southern (NSC). Both railroads also compete directly with the trucking industry via their intermodal franchises, though also face indirect competition from trucking in other business lines as eastern rail networks are generally shorter-haul (and thus more truck competitive). Class I railroads had, up until COVID-19, been embracing an operating model known as Precision Scheduled Railroading (PSR), which shifted their focus towards cost cutting that they achieved primarily through running longer but fewer scheduled trains and trimming headcount. CSX began adopting this strategy in 2017 when the godfather of PSR, Hunter Harrison, became CEO of the company. Operating ratio improvements from this strategy often came at the detriment of service and network capacity (and thus volumes), which was clearly displayed during the early innings of the pandemic, when rails failed to capitalize on surging demand for goods and lost share to the trucking industry as a result.

**Investment Thesis:**

1. CSX is well positioned to drive highway conversions during the next freight cycle through improved service and higher truckload rates. CSX, and railroad service in general, has vastly improved versus pre-COVID, as evidenced by their service metrics, conversations with both IMC’s and shippers, and the fact that, throughout the current freight recession, CSX’s merchandise business has performed in-line with industrial production after underperforming in the past few freight recessions, while intermodal volumes are growing even as the Cass Shipments index continues to contract, which we see as a sign that CSX is recouping lost share. Better service not only begets share gains but frees up capacity on the network to support greater volumes, which should allow CSX to avoid choking on a surge in demand like they, and the rest of the industry, did during the pandemic. Additionally, barring a true economic recession, truckload rates have likely bottomed at unsustainable levels as overall freight demand has begun to stabilize (and will soon improve again as looser monetary policy works its way through the manufacturing sector) while excess trucking capacity continues to exit the market. Rate increases would not only improve intermodal margins, as intermodal RPU would stand to benefit, but also could catalyze greater share shift towards CSX’s intermodal and merchandise businesses, as the cost savings shippers would achieve by using rail look much more enticing in a more normalized truckload rate environment. CSX identified 2.6m+ potential annual carloads that still use a truck for 500+ miles, and though they will almost certainly only be able to capture a fraction of this opportunity, converting even 10% of this volume to rail would provide meaningful volume upside.
2. CSX has a diversified secular growth opportunity that can drive volume growth irrespective of macro conditions. CSX is positioned to be a beneficiary of outsized investment in U.S. manufacturing capacity, as much of this investment is being concentrated east of the Mississippi river. According to management, CSX’s industrial development pipeline has the potential to deliver 150-300k of annual volume accretion by 2027, and there are currently ~540 projects already in progress that could contribute 150k of this incremental volume (which alone would result in LSD volume growth). Additionally, CSX sees a potential 600-700k incremental volume opportunity from the strategic expansion of its physical network via new acquisitions such as Quality Carriers, Pan Am Railways, and the MNBR, as well as improvements to its existing physical network capacity such as the revamp of the Howard St. Tunnel to allow for double-stacking containers. Volume accretion from these initiatives is likely to accelerate over time as more pipeline projects come online and certain network projects are completed.
3. The bar is low and long-term guidance could thus prove conservative especially if there is a demand tailwind. CSX made it a point to emphasize that their three-year targets of a LSD volume CAGR, LSD-MSD revenue CAGR, MSD-HSD EBIT CAGR, and HSD-LDD EPS CAGR do not underwrite any help from better freight conditions and rely entirely on self-help initiatives. The sell-side is baking in similar assumptions. We think that CSX’s volume targets are achievable even if CSX is only able to execute on half of its disclosed secular volume opportunity. Based CSX’s current TTM volume run-rate, we calculated what CSX’s volume CAGR might look like if CSX is only able to execute on one out of its three primary secular opportunities. If CSX only executes on its industrial development pipeline, this could lead to a 0.8-1.6% CAGR. If CSX only captures volume from network expansion, this could lead to a 3.1-3.6% CAGR. Finally, if CSX only captures 10% of its potential intermodal opportunity, this could lead to a 1.4% CAGR. Fully capturing all three opportunities would result in a 5.1-6.3% CAGR, and any improvement in freight conditions could lead to even better results. All told, we think there is a good chance long-term guidance is revised higher.
4. Stable pricing growth provides downside protection, while operating leverage can drive upside. Like other Class I rails, CSX has been able to raise prices to more than offset cost inflation, which has helped them offset declining volumes and has greatly limited earnings downside throughout past freight recessions, and we expect this to continue for the foreseeable future. Unlike most of the other rails, CSX has continued to grow headcount to prepare for the eventual freight upturn, which has been a headwind to near-term operating ratios but should provide strong incremental margins (as high as 50-70%) with additional volumes.
5. CSX consistently has an outstanding free cash flow profile versus the rest of the industry, which should continue to support capital returns and strategic investments to expand the network. CSX has been among the most consistent dividend growers in the industry (growth even accelerated this year) and was the only railroad that maintained their buyback program during the early innings of the current freight recession. During their Investor Day, management made it a point to emphasize that buybacks and dividend growth would continue for the foreseeable future, as capital expenditures are to remain similar to 2024 levels for the next three years (notably, CSX does not believe it needs to add new locomotives to the fleet to support growth, as they have been making investments throughout the current downturn to support higher volumes after the industry as a whole choked on the demand boom of 2020-2021) while the superior free cash flow generation they have achieved over the past few years provides them the flexibility to maintain the current pace of capital returns while investing in growth.

**Valuation:**

CSX’s valuation does not yet reflect the end of the current freight recession and its secular growth opportunity, offering an attractive risk/reward profile. Class I rails in general are not baking in the hockey-stick freight recovery their trucking peers are due to investor skepticism on their ability to consistently grow volumes, as they have failed to do so for over a decade. This can be attributed to 1) the embrace of PSR, which shifted their focus towards operating ratio improvement and away from volume growth and service quality; and 2) their exposure to the secular decline of coal in favor of more emission friendly forms of energy. CSX has long-since completed its PSR implementation and has turned its focus to service ever since they lost share during the pandemic, so we do not anticipate what occurred during the early innings of the pandemic to occur during the next upcycle. The coal headwind is an understandable concern, but we note that 1) metallurgical coal, which is a significant portion of CSX’s coal business, is a key component in steel production and is unlikely to go away anytime soon; 2) the long-term environmental concerns that would constrain utility coal demand would also increase demand for other rail services, as rails are a much more fuel-efficient and emissions-friendly mode of transportation when compared to trucking; and 3) a second Trump administration that has repeatedly promised to roll back emissions regulations and unleash fossil fuels for the sake of U.S. energy independence is likely to support utility coal demand for at least the next two-four years (depending on how mid-term elections go).

While all rails are trading cheaply relative to the rest of the freight transportation sector, CSX trades at an even cheaper than its peers and currently sits at one of the steepest discounts relative to both the S&P500 and the XLI in its history (has been ranging around 0.75-0.8x the XLI on NTM EPS). While eastern rails typical do (and should, given the shorter length-of-haul) trade at a discount compared to UNP and the Canadian rails, we think that much of the currently extreme relative discount is due to shorter-term investors (mainly multi-manager pod shops), who have punished the stock recently due to a number of short-term headwinds that should all subside in 2025: 1) damages associated with Hurricane’s Milton and Helene, which will be a cost headwind through early 2025; 2) rerouting associated with improvements to their Howard Street Tunnel; 3) volume and mix headwinds associated with the disruptive ILA strike; and 4) artificially-elevated international coal prices due to sanctions on Russia and Australian supply disruptions, which have since reset back to a more normalized level. We think that the short-sightedness of these investors provides an attractive entry point for a stable business with several secular opportunities for growth, and we think that there is room for multiple expansion with a volume tailwind (rail multiples tend to move with volumes) especially when considering how low the bar is.

**Risks:**

1. Management may fail to execute on its desired growth initiatives, which could limit volume growth and lead to downward revisions to its long-term guidance.
2. Anomalous events, such as hurricanes and polar vortexes, could disrupt CSX’s network, which could hurt volumes and lead to downward revisions to its long-term guidance.
3. Autonomous trucking technology could progress and scale at a faster rate than anticipated, which could disrupt the railroad industry.
4. A macroeconomic recession could lead to volume declines and lead to downward revisions to long-term guidance