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Post-Covid truck stop

Evan Lorenz writes:

The virus that clogged supply chains, shuttered manufacturing production and did its bit to precipitate a global inflation was not without its compensations. Only ask a trucker. "One of the answers to Covid was more trucking," Jeffrey Kauffman, who covers the industry for Vertical Research Partners, LLC, tells me.

How much less trucking the world needs in the freer-flowing, stagflationary, post-Covid era is the question before the house. In preview, this publication is bearish on the trucking businesses Werner Enterprises, Inc. (WERN on the Nasdaq) and Knight-Swift Transportation Holdings, Inc. (KNX) and on the engine-maker Cummins, Inc. (CMI; the latter two on the New York Stock Exchange).

"We had challenges with rail service," says Kauffman, who rates CMI and KNX a buy and WERN a hold. "So goods that normally went rail and intermodal went on the highway. We had some challenges with port shipments. So goods moved to places they normally wouldn't move, which required more trucking. There just wasn't enough truck capacity."

For perspective: From the first quarter of 2019 through the first three months of 2022, an additional 1.2 million 20-foot equivalent shipping containers entered the United States. Yet, over the same span, the number of 20-foot equivalents carried by rail fell by more than 200,000. The truck market absorbed the surplus.

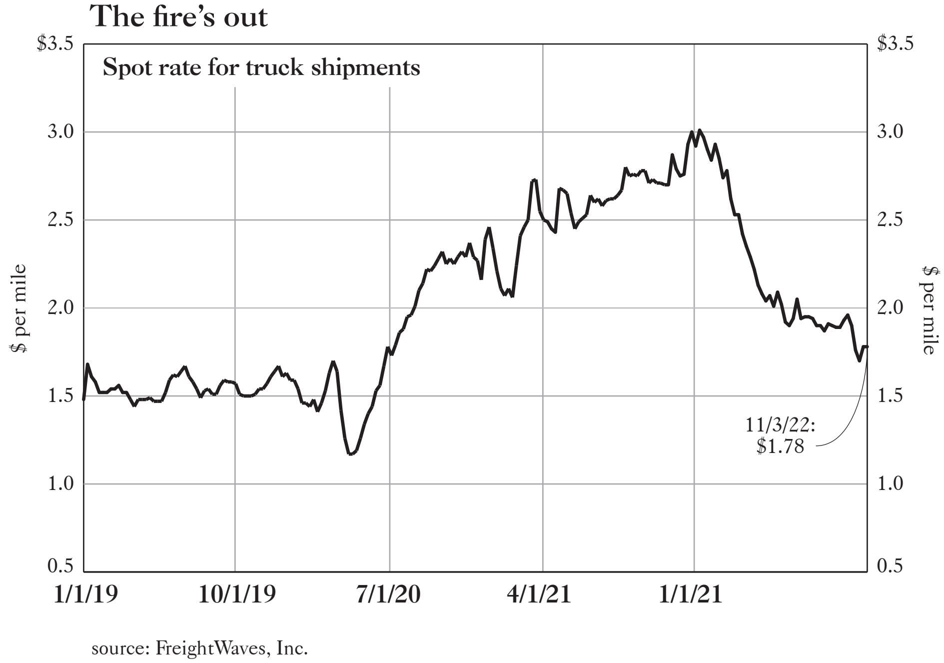
Trucking rates thereupon caught fire. Spot rates, quoted at $1.63 at the close of 2019 and as low as $1.09 in lockdown, roared back to $3.09 on Jan. 8, 2022. "The prior two years were the tightest trucking environment I've ever seen," Tim Denoyer, a senior analyst at ACT Research, tells me.

Heavy-truck makers Paccar, Inc. and Daimler Truck Group Holding A.G., not unlike Ford and GM, strained to boost chip- and pandemic-constrained supply to meet surging demand. The price of a three-year-old Class 8 truck climbed to $142,000 in April from $54,000 in July 2020.

Toppy used-truck values plus strong earnings at the fleet owners generated record demand for new rigs. In September, U.S. truckers placed orders for 53,271 Class 8 units, up 96% from a year earlier. "An average month over the past couple of decades is 22,000," Denoyer says. "In 2018, the prior record year, we hit 53,000 when things were really strong. It's about as many orders as the industry can take."

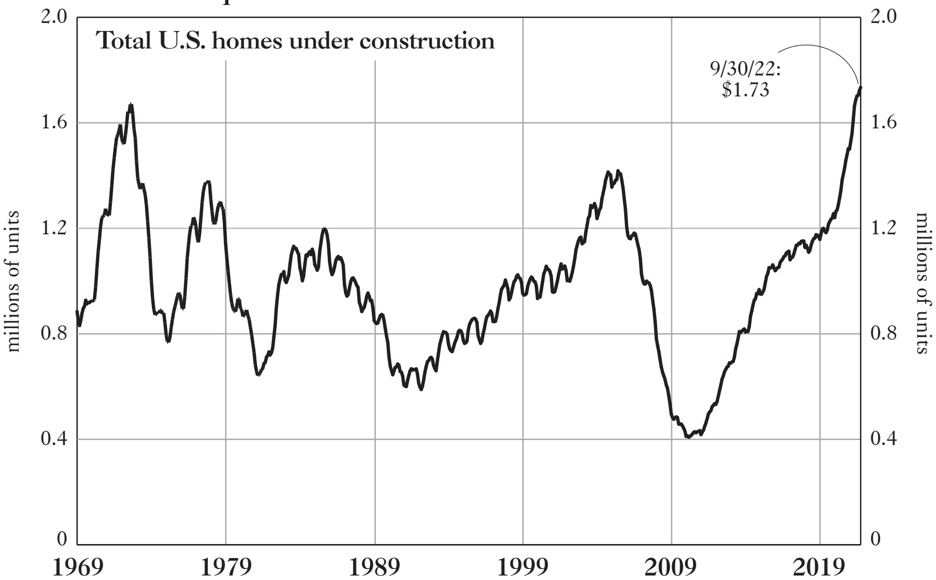
Now the profitability of overland shipment is deteriorating because the speed of shipment is increasing. "It's like Santa Claus on Christmas Eve," as Jay Van Sciver, analyst at Hedgeye Risk Management, LLC, puts it to me. "He can deliver all the presents because he's going at the speed of light, right? If you could move a truck at the speed of light, that one truck would be all you need." As congestion eases and wait times shorten, our friend points out, trucking capacity

The fire's out



source: FreightWaves, Inc.

Trucks required



source: The Bloomberg

effectively expands without the addition of a single truck.

Softening business conditions likewise add to effective capacity. "Product lead times for manufacturers largely improved across most regional Fed districts, based on recent surveys of October activity," Bloomberg reported last week. "A measure of supplier deliveries for producers covered by the Richmond Fed showed the fastest times since 2009, when the U.S. was in a recession."

A sharp decline in containerboard shipments—down by 4.5% year over year in the third quarter—tells the same cyclical story. "More surprisingly and alarmingly, the industry's operating rate dropped to 87.6%, the lowest in any quarter since the Great Recession," Adam Josephson pointed out in an Oct. 30 note for KeyBanc Capital Markets, Inc. In April, for reference, containerboard makers operated at 95.6% of capacity.

"Recession: yea or nay?" remains an open question, but the simple return to pre-pandemic consumer spending patterns can explain the worrying change in trucking fundamentals. Succeeding the goods glut of 2020–21 is a strong demand for services—to create, for example, what the CEO of Delta Air Lines, Inc, Ed Bastian, describes as a "countercyclical recovery in travel." A reciprocal bulge in merchandise inventories—on a year-over-year basis, up 25.5% for Walmart, Inc., 36.1% for Target Corp. and a whopping 44.2% for Nike, Inc.—underscores the point.

Such things go far to explain the 43% decline in spot trucking rates, to $1.78 per mile from the aforequoted $3.09 in January, a time of respectable GDP growth (up by 2.6% in the third quarter) and a record-high rate of home and apartment construction. "They dropped rapidly from the middle of January to the beginning of May, pretty much a straight line down," says John Paul Hampstead, strategic analyst for FreightWaves, of those trucking rates. "They were steady really until September and then just took another step down." Corroborating evidence of a cyclical pause is the flatlining of gainfully employed truckers between August and October and the drop in the average price of a three-year-old Class 8 truck, to $112,000 from a high of $142,000. Needless to say, a recession wouldn't help matters.

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You can tell it to Mr. Market, however. Our trio of stocks boasts a collective 64 ratings from Wall Street analysts, of which we count 33 buys and only three sells. While short interest has climbed to middling levels of the equity float for Werner (6.6%) and Knight-Swift (7%), it is still a rounding error for Cummins (2.4%).

The bull case for the trucking industry begins with the fact that most freight is shipped under longer-term contracts and not at spot rates. Just about everyone we queried offered their own estimate, but guesses for the proportion of the market on spot clustered on the low side of a 15%–30% range.

Then, too, trucking services are not identical. Intermodal, in which truckers transport containers to and from cargo ships and rail, and less-than-truckload (LTL), in which operators schedule routes for odd lots of freight (e.g., to replenish convenience-store shelves), command more pricing power than truckload does. Within truckload, dedicated contracts with large retailers such as Walmart and Dollar General Corp. provide shelter from the volatility of the spot market.

Knight-Swift operates the largest full-truckload fleet in North America. In the third quarter, its truckload segment delivered 58% of revenues, followed by LTL (13%), logistics (13%; which includes third-party truckers pulling KNX trailers and asset-lite freight brokerage), intermodal (8%) and other (8%). Only 26% of the truckload division was under dedicated contracts. The balance sheet is lightly leveraged with 0.9 times net debt to trailing Ebitda. The stock is priced at 8.4 times trailing earnings and 11.4 times the guess for next year.

On the Oct. 19 earnings call, Knight CEO David Jackson ventured a bullish prediction. He said that his company, thanks to its diversified business mix, would earn at an annual rate of no less than $4 a share even in a business downturn. That would be almost double the $2.10 registered in 2019 and only modestly lower than the $4.82 booked in 2021 ($5.20 a share is the expectation for 2022).

Werner focuses on the truckload segment—it produced 75% of third-quarter revenues—followed by logistics (23%) and other (2%). Within the truckload unit, 63% of company vehicles work under a dedicated contract. As of Sept. 30, Werner's balance sheet showed net debt equal to 0.8 times trailing Ebitda; the shares are priced at 10 times trailing earnings and 12 times the 2023 estimate.

There wasn't much sugar-coating on the Nov. 2 Werner earnings call. "Ninety percent of this industry is made up of carriers of 20 trucks or less," said the chairman and CEO, Derek Leathers, "and [their earnings] are negative as we speak and not just year over year, but just flat negative in many cases." And while Leathers insisted that Werner's portfolio is "different" and its "defensibility is stronger," he demurred from providing 2023 earnings guidance. Neither did he offer a floor below which earnings would likely not fall. Werner, too, had a good pandemic, as its profits rose to $2.61 per share in 2021 from $2.36 in 2020 and are on track to reach $3.68 in 2022.

Because shipping contracts are written to provide wiggle room for each contracting party, they afford only so much protection from the vicissitudes of the spot market. "So when spot rates go above contract, the carriers tend to go into the spot market," Denoyer explains. "Because the shippers can do the same thing when rates are below contract, like they are now, there's this sort of freedom to move into whichever is most efficient for either side." And with trucks, as with other economically sensitive assets, the desirability of a contract depends on the nature of the terms. Lock in bull-market pricing and you're a hero, but—as the boilerplate in the old junk-bond prospectuses put it—there can be no assurances. Most truckload contracts come up for rebidding in the spring.

Over the past 12 months, insiders at Knight-Swift sold 144,860 shares for proceeds of $8.8 million, while the Werner C-suite purchased 2,270 shares at a cost of $98,412.

. . .

Keeps truckin'

source: The Bloomberg

Cummins, of Columbus, Ind., though the largest pureplay engine maker in the world, generates 60% of its top line in the 50 states. Engine sales contributed 30% of third-quarter revenue, followed by components (30%), distribution (25%; a sales, service and support channel for both dealers and customers), power systems (15%; power generators and non-truck engines) and new power (1%; which makes hydrogen- and battery-powered truck components). As of Sept. 30, the balance sheet showed net debt equal to 1.3 times trailing Ebitda; the shares trade at 17.9 times trailing earnings and 12.1 times the 2023 estimate.

Because the pandemic knocked replacement buying for a loop, the bullish argument goes, the national fleet is getting on in years. Just as important, according to this narrative, fleet operators have the wherewithal to make the necessary upgrades. Paccar, for one, expects North American heavy-truck sales to increase to 260,000–300,000 units next year from an estimated 265,000–285,000 this year.

"We continue to see a strong heavy-duty customer-order interest," Cummins CEO Jennifer Rumsey said on the Nov. 3 earnings call. "This has just not been a typical cycle, so all of those fundamentals for the business remain strong. We project that the market will remain strong into next year because they've been using the trucks at a high rate. They've not been able to replace at the level that they want to. . . . These new trucks that are coming out . . . have improved efficiency and as you see, [with] higher fuel prices, that's also attractive."

While the major truck OEMs are sitting on order books that stretch into the second quarter of next year, those commitments may be more contingent than they seem. In its latest 10-K filing, Paccar notes that "orders scheduled for delivery within three months are considered to be firm," but that orders with deliveries outside this window are subject to cancellation.

Light pandemic-era replacement demand notwithstanding, the nation's fleet of heavy-duty trucks has continued to expand, by 6% since the start of the pandemic and by 4% over the past 12 months. "We are growing, which reduces the age," Denoyer says. "The age is falling, by our definition."

The industry did struggle to add capacity in 2020 and 2021, but, of course, that was a period of major shipping slowdowns (which increased asset utilization) and a big shift in consumer spending to goods, especially consumer electronics. Flat driver-employment figures and falling spot rates suggest that the industry has all the capacity it needs. In what may be a straw in the wind, JB Hunt Transport Services, Inc. used its Oct. 18 earnings call to warn that it expects to fall short of its planned fleet expansion this year.

Cummins, the top maker of diesel engines in North America, commands as much as 80%–90% of the market for medium-duty trucks, estimates the previously quoted Van Sciver. The trouble lies in the shifting preference for zero-emission models, he says. Daimler Truck, which makes two out of every five heavy rigs in the United States, is on record as aiming to shift 60% of production to non-diesel engines by the end of the decade and to 100% of production by 2039. (The tax credit of $40,000 encased in the recently passed Inflation Reduction Act pertains to buyers of heavy-duty electric trucks only.)

Because electric trucks can range no farther than 250 miles on a single charge, batteries are better suited to medium-duty trucks, which handle last-mile deliveries. "Cummins doesn't say exactly what their margins are on medium duty, but they are very high," says Van Sciver. While the enginemaker did acquire electric power-train maker Meritor, Inc., for $3.7 billion on Aug. 3, "I doubt very much that it will be margin-competitive with the incredibly high market share they have in medium-duty diesel engines," he adds.

Cummins insiders may not disagree. Over the past 12 months they sold 157,328 shares for proceeds of $35.3 million; no insider bought a share.

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