CSX Corporation (CSX)

Updated July 18th, 2018 by Josh Arnold

Key Metrics

Current Price:	$66	**5 Year CAGR Estimate:**	4.5%	**Volatility Percentile:**	77.7%
Fair Value Price:	$49	**5 Year Growth Estimate:**	9.0%	**Momentum Percentile:**	69.4%
% Fair Value:	135%	**5 Year Valuation Multiple Estimate:**	-5.8%	**Valuation Percentile:**	9.4%
Dividend Yield:	1.3%	**5 Year Price Target**	$76	**Total Return Percentile:**	17.7%

Overview & Current Events

CSX can trace its roots all the way back to 1827 when the B&O Railroad was first chartered. From just 13 miles of track, CSX has grown to cover 23 states and 21,000 route miles. CSX provides rail, rail-to-truck and intermodal transport services. The company's market cap is $58 billion, and it should do about $11.7 billion in revenue this year.

Q2 earnings were reported on 7/17/2018 and the report was a very good one. Revenue rose 6% while adjusted operating expenses fell 8%, resulting in a 34% surge in operating income. The company's continued focus on operating efficiency while growing revenue is bearing fruit, as evidenced by its operating ratio rising 490bps during the quarter to 58.6%. Overall, CSX's Q2 was another example of a very strong quarter, validating the company's transformation efforts.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$1.17	$0.96	$1.36	$1.67	$1.79	$1.83	$1.92	$2.00	$1.81	$2.30	***$3.30***	***$5.05***
DPS	$0.26	$0.29	$0.33	$0.45	$0.54	$0.59	$0.63	$0.70	$0.72	$0.78	***$0.88***	***$1.40***

CSX' earnings-per-share has grown somewhat unpredictably over the past decade as its fortunes are tied to rail volumes and pricing strength, both of which are heavily dependent upon particular industries and economic conditions. Its leverage to the coal market as well as intermodal transport are both positives for 2018 as volumes are improving for the former on an export basis, and a very tight freight market is helping the latter with pricing. CSX stands to gain in the form of low single digit revenue increases in the coming years as a result, helping to fuel our estimate of 9.0% earnings-per-share growth. The remainder will come from improved operating efficiency leading to higher margins as well as a sizable $5 billion buyback allowance. We see the share count declining in the low single digits annually as CSX generates strong free cash flow and puts it to use. Q2 results are a good indication of what the future should look like.

Likewise, we see the dividend increasing at roughly the rate of earnings, reaching $1.40 in five years from today's level of $0.88. CSX has put buybacks first in recent years but with a much-reduced capex budget for 2018 as part of its operational efficiency initiatives, more cash should be freed up for dividend increases. CSX should be more of a dividend growth story in the coming years than it has been of late as earnings growth improves.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	15.0	12.9	13.2	14.0	12.1	13.6	16.1	15.7	15.5	21.8	***20.2***	***15.0***
Avg. Yld.	1.5%	2.4%	1.8%	1.9%	2.5%	2.4%	2.0%	2.2%	2.6%	1.6%	***1.3%***	***1.9%***

CSX's price-to-earnings multiple has moved sharply higher in the past couple of years as it sits at 20.2 today versus a long-term average of 15, implying a 5.8% annual headwind to total returns. We see the stock moving back towards this historical average as recent optimism on operational efficiency improvements cannot be sustained. CSX's cost-cutting program is yielding strong results but as is the case with any such initiative, gains are necessarily finite. With this being a primary source of earnings growth going forward, investors will almost certainly see the price-to-earnings multiple move back down to historical levels as CSX's profit growth levels out in the coming years.

The lower price-to-earnings ratio, combined with high rates of dividend growth, will see the yield move back towards more normalized levels as well. The current 1.3% yield is very low by historical standards, owed to a very high valuation. As that situation is rectified, dividend payout growth should lead to a much higher yield.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	---	---	28.9%	29.5%	29.5%	28.9%	28.5%	30.0%	30.2%	33.1%	***33.5%***	***34.5%***
Debt/A	69%	67%	69%	71%	70%	67%	66%	66%	67%	59%	***58%***	***56%***
Int. Cov.	6.0	4.2	5.6	6.4	6.3	6.3	6.6	6.8	5.8	6.9	***7.2***	***7.8***
Payout	21%%	30%	24%	26%	30%	32%	33%	35%	40%	34%	***27%***	***28%***
Std. Dev.	45.2%	46.7%	26.4%	27.5%	18.0%	16.2%	18.0%	19.9%	23.6%	32.2%	***28.0%***	***27.0%***

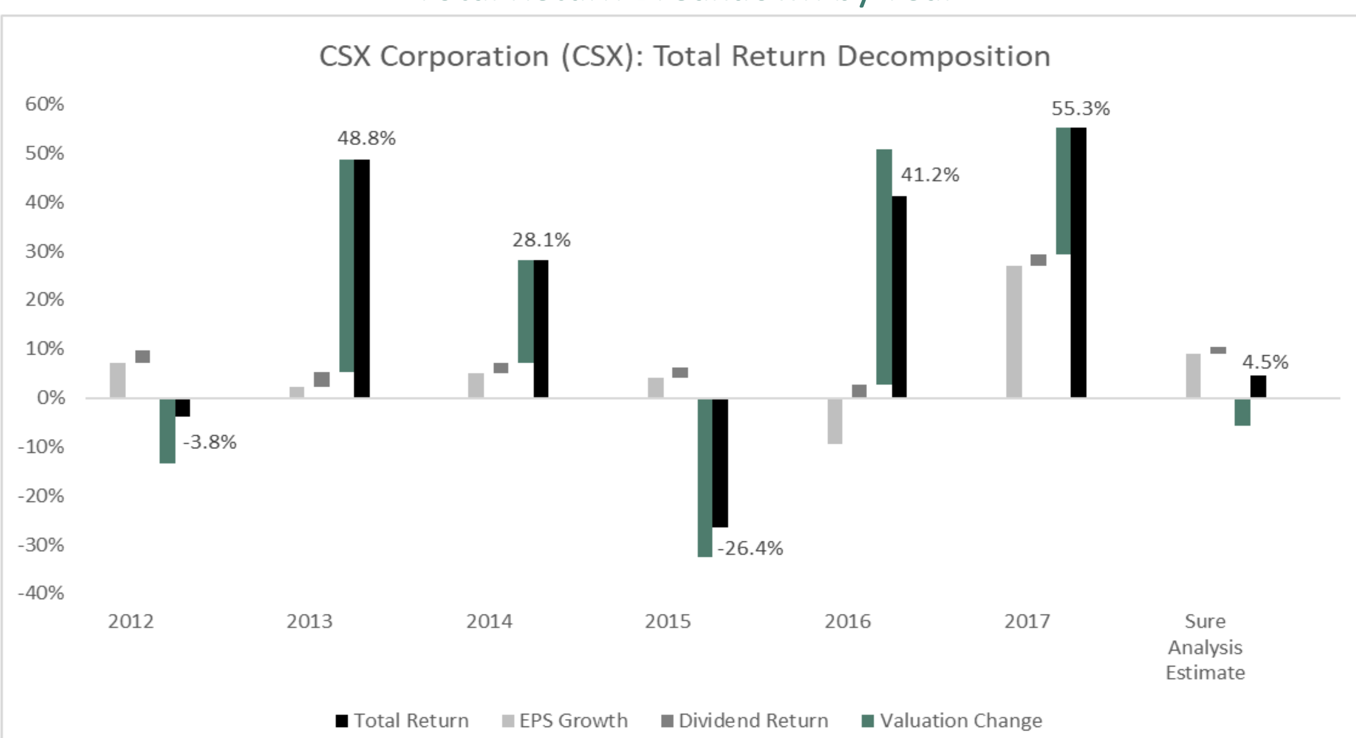
CSX' safety metrics have improved over time as its gross margins continue to tick higher and its balance sheet improves. We see continued gross margin growth from today's high levels due to the company's improving operating efficiency, which will be a key driver of earnings growth. In addition, we see the gradual deleveraging of the balance sheet continuing and leading the already-high interest coverage ratio to even higher levels. CSX' balance sheet and earnings power are both more than sufficient at present, affording the company the luxury of spending billions on buybacks. We see the payout ratio remaining about where it is today as dividend growth roughly keeps pace with earnings growth.

The company's competitive advantage is in its lean operating structure as well as its dominance in its service area. CSX looks poised to gain from its leverage to intermodal transport and the coal export market, although these things will not save it from the next recession; rail operators are particularly sensitive to economic conditions.

Final Thoughts & Recommendation

We see CSX as a stock that is trading well in excess of fair value on optimism about future earnings potential. CSX should see total annual returns in the next five years of 4.5%, consisting of the current 1.3% yield, 9% earnings growth and a 5.8% headwind from the valuation resetting to more normalized levels. CSX would therefore be appropriate for dividend growth investors as well as those seeking growth, but the low current yield and high valuation make the stock unattractive at current prices. We believe investors should wait for a more favorable entry point.

Total Return Breakdown by Year



Disclosure: This analyst has no position in the security discussed in this article, and no plans to initiate one in the next 72 hours.