TD Greystone Asset Management

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Supply Side Constraints in Trucking

Pros and Cons

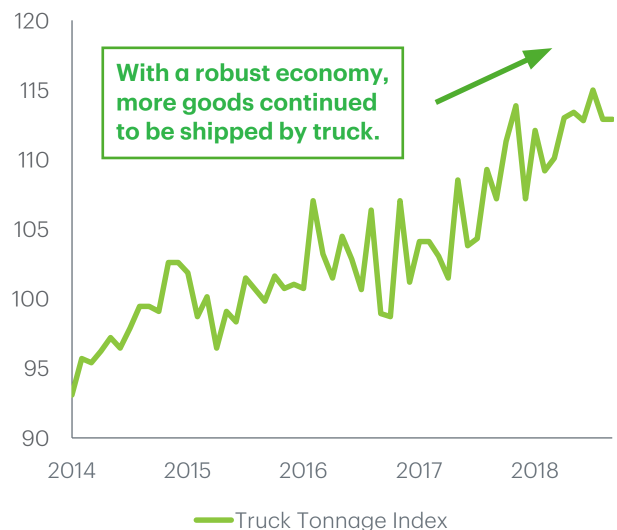
As the business cycle matures and cost pressures escalate, which is typical in the later stages of the business cycle, we are diligently monitoring how companies in our portfolios and on our research list manage this environment. Our focus is on company margins and how a company is able to manage and, to the extent possible, mitigate rising cost pressures. One rising cost trend that appeared on our radar earlier in 2018 was rising freight costs in the U.S.

Trucks deliver approximately 70 percent of freight domestically in the U.S. Coupled with a robust economy, trucks must move more freight (see Figure 1). At the same time, regulators have implemented Electronic Logging Devices or "ELDs" in an attempt to improve road safety. ELDs record driving time, as well as rest periods, and monitor and enforce hours behind the wheel more accurately than traditional paper-based log books. These regulatory measures effectively put more pressure on supply capacity.

Regulatory oversight of the trucking industry is the responsibility of the Federal Motor Carrier Safety Administration. Regulatory oversight of trucking hours in the U.S. began in 2004, when the federal rules changed to determine a maximum work day - defined as driving 11 hours in a 14 hour period. A paper-based log system tracked this until regulation changed in 2018 to mandate ELDs. The new rules changed so that the 11 hours begin the minute a driver gets behind the wheel. Prior to that, the clock stopped whenever the driver was idle. The new regulation is expected to reduce accidents caused by driver fatigue, as well as provide applications that can boost productivity.

Similar ELD regulation is being considered in Canada.

Figure 1



Source: American Trucking Association. Bloomberg Finance Three L.P.

This is all coming at a time when the average age of truck drivers is rising and new entrants are not being hired fast enough to offset the retirees, which also adds to pressure on supply capacity. The American Truckers Association estimates that the driver shortage reached 50,000 by the end of 2017 and predicts the shortage could grow to more than 174,000 by 2026 if the current trend holds.

One of the reasons behind the driver shortage is that the U.S. economy is running at full employment and more lucrative alternatives to trucking are available in construction, manufacturing and ride sharing services such as Uber or Lyft, which have far fewer barriers to entry and less regulatory oversight. Trucking companies have responded by raising wages since 2016, but it has not been enough to retain truckers and attract new entrants given the tight labor market (see Figure 2).

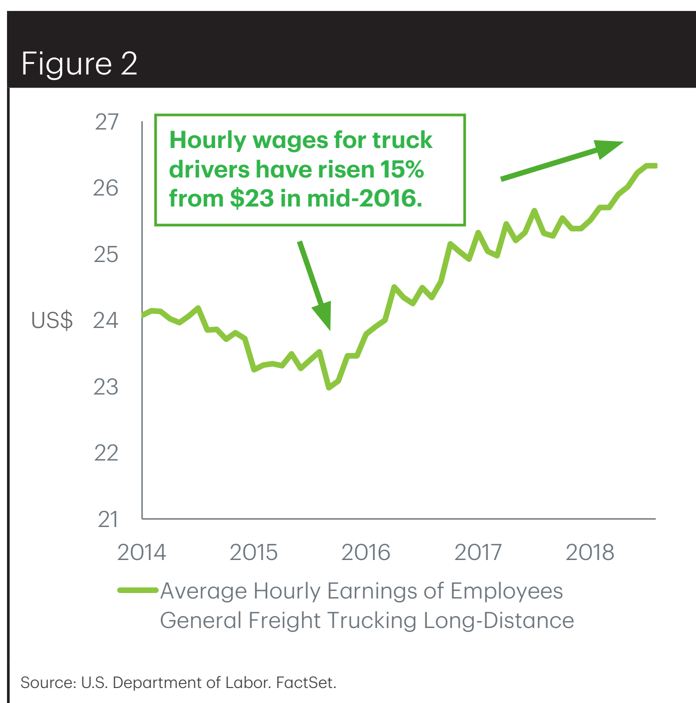


Figure 2

Source: U.S. Department of Labor. FactSet.

Truck operators are also replacing trucks faster - every three to four years rather than the previous industry norm of seven to eight years - to benefit from new technologies, to gain efficiencies and also as a means to help with driver recruitment.[1] Improving technology such as driverless trucks may help with the issue, but is not likely to solve the industry problems in the near term. The Class 8 truck backlog-to-build time is almost 10 months, much higher than the 10-year average of five months.[2]

Trucking operators continue to face mounting cost pressures (see Figure 3), squeezing already meager margins and, as a result, are passing on the costs to consumer goods companies and consumers. Consumer companies had been highlighting increased freight costs in quarterly earnings calls during 2018, which our fundamental research team noted and reviewed in our internal discussions.

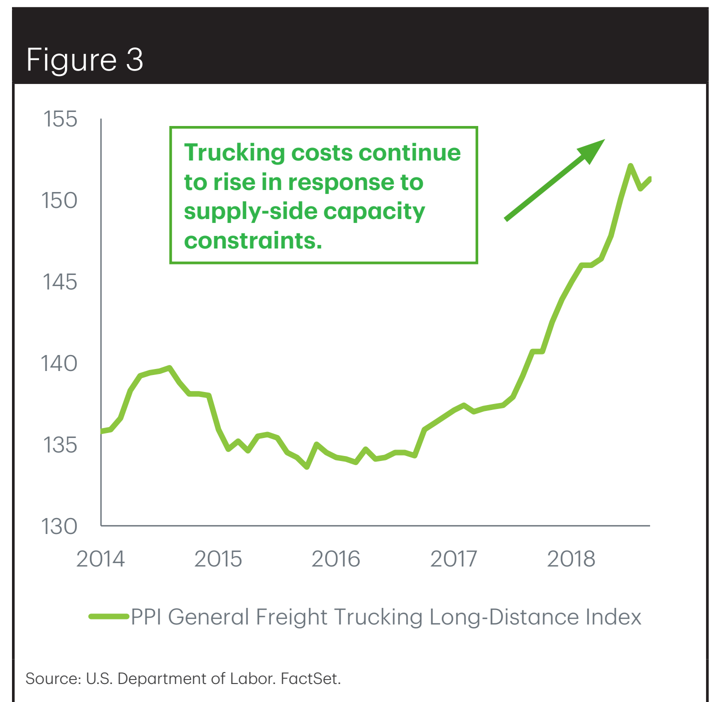


Figure 3

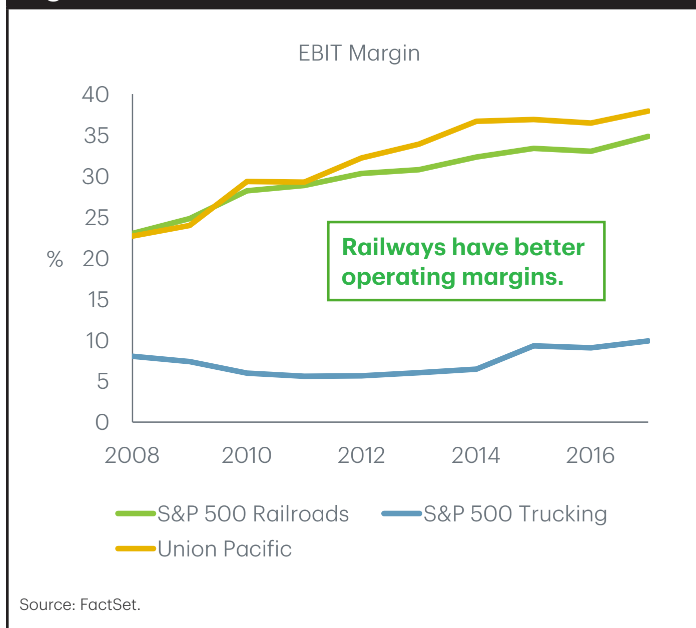
Source: U.S. Department of Labor. FactSet.

Most companies do not record a separate line item for freight costs in cost of goods sold ("COGS"). Our fundamental research team reviewed the U.S. Consumer Discretionary and Consumer Staples names through various frameworks created by third-party research providers to determine the impact of increased freight to COGS and ultimately to company margins. We found that though the companies were impacted, they were able to mitigate the increased freight costs to some extent due to factors such as having an internal fleet, competitive positioning, bargaining power or higher margins.

In addition to reviewing overall exposures to rising freight costs, we also reviewed where we might benefit from this trend. In our analysis of transportation investment options, we prefer railroads over trucking and have owned Union Pacific in the U.S. portfolio since 2010, and in the global portfolio since 2014. We continue to hold the name due to better company operating margins and profitability versus trucking companies (see Figure 4). The rails are an alternative to trucking and benefit from the pressures of rising costs in trucking companies.

[1] August Class 8 orders set new record. Truck News. September 2018.

[2] Is US trucking reaching the tipping point? Intermodal News, September 2018.



Source: FactSet.

Union Pacific is the largest railroad in North America, covering 23 states across the western two-thirds of the U.S. While barges, ships, aircraft, and trucks also haul freight, railroads are a low-cost option where no waterway connects the origin and destination. In terms of freight, Union Pacific's strength is in hauling Asian imports that arrive at West Coast ports. The company is benefitting from a strong economy as well as recent U.S. tax reform. Union Pacific has made progress in decreasing its operating ratio and improving profitability. To gain further efficiencies, it has started to implement Precision Schedule Railroading ("PSR") principles effective October 1, 2018. Through a combination of increasing volumes, pricing keeping pace with inflation, and productivity gains, the company is able to increase cash to shareholders.

At TD Greystone Asset Management, our approach to equity investing is biased towards a growth style. We believe that identifying companies with sustainable growth drivers for their businesses translates into higher future earnings, which in turn leads to higher stock prices. Our disciplined investment process is bottom-up, zeroing in on companies meeting our focused investment criterion. We seek companies with positive business momentum, driving improvements to their earnings generating capacity, such as sales momentum, market share gains, return on equity, EBIT or cash flow improvements and increasing pricing power, where that momentum is sustainable into the future. However, we recognize that capital markets are dynamic and our fundamental research team continually monitors industry, regulatory and other trends in ongoing reviews of the names held in the portfolios or on the focused research list. We believe that fundamental review of these trends is important and incorporate that review into our on-going research. As the business cycle matures, we are aware that cost pressures can build. As described above, we recognized increasing truck freight costs initially through our consumer names and also through industrial transportation alternatives, where we continue to like railroads over trucking. From a portfolio management perspective, building a portfolio of companies like Union Pacific with different growth drivers is important, as we know the market will not reward them all at the same time. We believe that this diversity in the portfolios provides resilience to our longer-term results.

Precision Schedule Railroading Principles

Historically, trains were held until they were completely full; the idea was to benefit railway efficiency at the cost of delayed customer shipments. PSR prioritizes delivery of a customer's shipment from origin to destination – similar to the airline industry where a plane will leave on its scheduled departure time regardless of how full it is. PSR requires a schedule and plan monitored down to the asset level.

Precision schedule railroading has five principles:

1. improving customer services;
2. controlling costs;
3. optimizing asset utilization;
4. operating safely; and
5. valuing and developing employees. It aims to run fewer and heavier trains that are faster and on schedule, ultimately leading to a quicker asset turnover. It was first implemented on a wide scale at CP, a Canadian railway that is owned in TD Greystone Asset Management's Canadian equity portfolio.

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