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Chugging Along: How Transportation Uses Capital

While the industry reinvests heavily in itself, that hasn't necessarily spawned value for shareholders.

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Transportation is a diverse industry, rich in operating cash. It includes, for instance, companies in the railroad, trucking, water and air transport, pipeline (excluding natural gas), and services businesses. What's more, the largest 100 transportation companies traded on U.S. exchanges from 2006 through 2010 generated total gross operating cash earnings after tax of over $340 billion.

With such strong operating cash generation, the strategic deployment of these funds has an important impact on growth and share-price performance.

At the same time, these companies are, in general, extremely capital intensive: maintaining and growing their operations consumes tremendous amounts of capital. At the end of 2010, the total gross operating assets of the industry -- including gross property, plant, and equipment; working capital; and the estimated value of off-balance-sheet assets represented by operating leases – was over $700 billion. That's nearly twice the revenue they generated that year.

Shipping -- and, in particular, oil and gas shipping -- is the most capital intensive of the transportation industries, with Nordic American Tankers (NAT), Golar LNG (GLNG), and Seaspan (SSW) all retaining gross operating assets that are over 10 times their annual revenue. In

comparison, the seemingly capital-intensive airline industry is practically “capital light.” For instance, Southwest (LUV); AMR (AMR), the parent of American Air; and JetBlue (JBLU) all have capital intensities of less than 2 times their annual revenue.

Across the sector, capital expenditures consumed 57% of the gross operating cash earnings over the last five years. The transportation industry’s investment in assets held under operating leases consumed another 32% of gross operating cash earnings. (Our firm’s estimate of assets held under operating leases is based on an estimate of the industry’s annual rent payments and the changes in the implied capitalized operating leases.)

Couple that with an additional 6% of gross operating-cash earnings that’s used to fund cash acquisitions, and you can see clearly that in the transportation industry, the majority of cash generation has been used to reinvest in the business.

Dividends consumed 13% of gross operating cash earnings and gross share repurchases consumed 14 % -- although the latter was mostly offset by share issuance. Net share repurchases only consumed 5 % of gross operating cash earnings. The total distributions to shareholders in the form of dividends and net share repurchases were 84%, matched by net borrowings. Thus, very little of the gross operating cash flow was actually distributed to shareholders.

How have companies in this sector performed for shareholders? From 2006 through 2010, the industry delivered median total shareholder return (TSR) in the form of dividends and share-price appreciation of 2.6% more per year than the S&P 500 index. The strongest TSRs were delivered by railroad and pipeline (excluding natural gas) companies, and the weakest TSR was in water transportation.

Do transportation companies that invest in the future deliver more value creation? Comparing TSR with the overall "reinvestment rate" -- which quantifies the percentage of cash flow that is reinvested in the business -- can be a good way to gauge the relationship.

To calculate the reinvestment rate, add capital expenditures, acquisitions, research and development, and other investments. Next, divide that sum by the total of earnings before interest, taxes, depreciation, and amortization (EBITDA), research and development (R&D), and rent, less taxes.

Across the market as a whole and in most industries, our research shows that companies with higher reinvestment rates tend to deliver higher TSR. Yet from 2006 through 2010, this did not hold in transportation. We separated companies into three groups: those with reinvestment rates over 100%; those with rates of between 50% and 100%; and those with rates of below 50%. The first two groups both had median TSRs of 2% per year, while the lower reinvestment group delivered median TSR of 6.5% per year. Over the five-year period, the lower group's extra TSR compounded to 27%.

That five-year period started with a strong economy in 2006 and part of 2007. Then the financial and economic crisis set in, however, and by the end of 2010 we were only part of the way back to a normal midcycle economy. Perhaps this was not the best period to be heavily investing in transportation. Or, it may turn out that the companies that invested heavily during the downturn, a period when assets tend to be cheaper, will deliver better TSR as we approach the next economic peak. We will need to wait a few years to see how that will turn out.

What about companies that distributed more via dividends and share repurchases? We compared TSR with a similar "Distribution Rate" and found that those distributing more performed substantially better for shareholders. The 32 companies that distributed over one-third of their cash flow generated TSR of 9.2% per year, a stark contrast to the virtually zero percent generated by the remaining companies.

It stands to reason that if reinvestment didn't pay off for transportation companies during this period, distribution would prove to be a better use of cash flow. It will be interesting to see if these companies continue to outperform or if they would have been better off investing during the downturn.

Why is reinvestment so ineffective in delivering value creation in transportation? It seems to tie back to the high capital intensity and the substantial degree to which corporate investment merely maintains, updates, and replaces existing assets, rather than serving as fuel for future growth.

If instead of the reinvestment rate we examine revenue-growth rates, a different story emerges. The median TSR for the one-third of companies with the lowest revenue growth rates was zero. The two -thirds with higher growth delivered median TSR nearly 7% higher, which compounded to 40% extra TSR over 5 years. Thus, reinvestment that actually results in growth seems to create value. While reinvestment that serves to sustain existing operations may be necessary to protect value, it doesn't seem to create new value.

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