RAILROAD WEEK IN REVIEW

February 26, 2016

“While the main risks of NIRP have not yet been realized, the negative reaction in the stock market poses a threat to the global economy.” — Jeffrey Kleintop, Schwab Chief Global Investment Strategist

Negative Interest Rate Policy “is gaining popularity with 30 percent of the value of stocks in the MSCI World Index now represented by companies domiciled in NIRP countries. The increasing number of central banks adopting NIRP is weighing on the profit outlook for financial companies that now must pay to hold some of their reserves at the central bank and hurting the performance of the global financial sector,” writes Kleintop.

Class II and III rails in the bulk commodity business need to pay attention. The signs are everywhere. Just in the last few weeks on their 4Q earnings calls, CN said global oversupply and the strong US dollar hurt grain exports, CSX cited the “weak export market for phosphates and fertilizers” plus lower export coal vols, and UP says it too is seeing grain exports suffer as a result of a relative global grain glut.

Monday’s *Wall Street Journal* led off with a story on the “deteriorating backdrop for the global mining industry.” BHP, Rio Tinto PLC , Glencore PLC and ConocoPhillips are among the household names taking hits in commodities such as iron ore as China’s appetite for raw materials declines. And the February *International Railway Journal* says 2015 carloads for China Railway Corp dropped 11 percent year-over-year, with 2014 four percent down from 2013.

Salient Partners’ Chief Risk Officer Ben Hunt touches on global export volumes in his Feb 19 “Silver Age of the Central Banker” commentary. Says he, “Global trade volumes – not just values, but volumes, not just in one geography, but everywhere – peaked late in 2014 and have been in decline since… I’m thinking that the US and Europe are now off three percent from peak volumes, Japan is off five percent, and China + Hong Kong is off seven percent.”

He continues, “Both China’s export volumes and its export values are declining, and no matter how much domestic credit and currency they pump in (and god knows they’ve tried), there is no possible way to stimulate the domestic economy enough to pick up the slack from a declining export sector.” And as China goes, so goes the export market for bulk commodities out of North America and so go carload volumes on short lines heavy in ag, minerals, and ores.

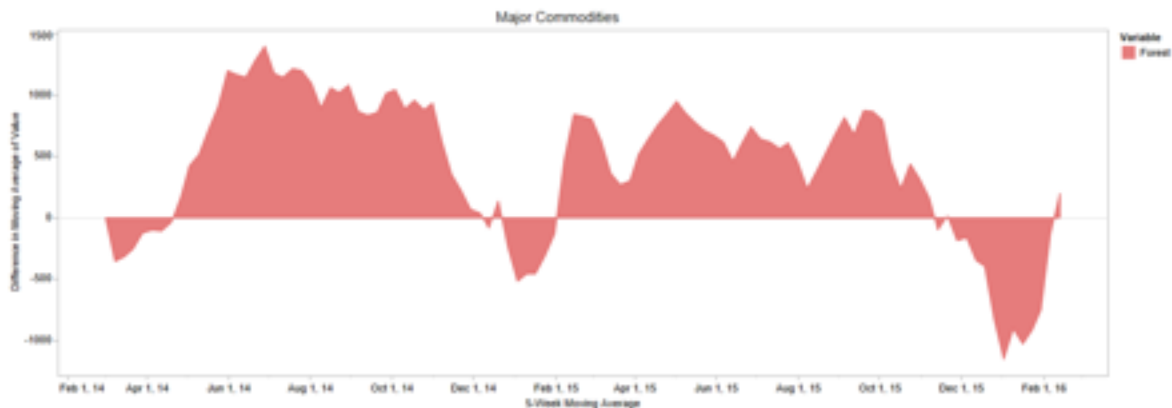
Schwab’s Kleintop concludes, “QE asset-buying programs helped lift stock market valuations, but they have shown little success at boosting economic activity. While the main risks of NIRP have not yet been realized, the negative reaction in the stock market poses a threat to the global economy. The effectiveness of slightly negative interest rates is far from assured and increasingly negative interest rates may not just weigh more heavily on the stock market, but on drivers of

economic growth as well. While we believe that the global economy will avoid a recession in 2016, central bank moves toward more deeply negative interest rates would elevate the risk of prolonging and deepening the slide in the stock market."

And in railroad shares in particular. As I write this Thursday morning, only CN among all Listed Class I rails is anywhere near its 200-day moving average. Every rail said on its Q4 call they expect 2016 vols to lag 2015's. GE Transportation's RailConnect Index of 400+ short lines shows 2015 full-year declines in most bulk commodities and the tea leaves are pointing to more of the same in 2016. So when Janet Yellen starts talking about NIRP in the US, I start to worry about the shortline railroad outlook.

Time is Money, Part II. Two weeks ago, in the context of commodity carloads for the first three weeks of 2016, I wrote, "The longer a car spends getting from origin to destination, the more it costs both in out-of-pocket ops expense and in opportunity cost from lost track space and other assets — crews, locos, etc. — consumed getting those cars over the road."

The trigger for this particular comment was a note from a lumber customer objecting to the long transit times, particularly when the load originates on a different Class I than the one at his gate. He writes, "We suspect there are other vendors closer in and more truck-competitive but our Class I sales rep never mentions them. We buy a lot of Canadian spruce for home-builder customers but — priced competitively — southern yellow pine would do."



As you can see from the chart, paper and lumber carload volumes are still less than robust. Part of the reason has got to be the uncompetitive transit times, as well as pricing. However, I'm willing to bet if transit times came down, rates would too, if only because it costs less to move a car faster. Perhaps, if transit times were better the rails might even eke out some premium pricing, increasing margins with lower incremental operating ratios. But you've got to sell it.

Norfolk Southern has an answer. They've published a PDF listing more than 60 NS-served sources of lumber, panel and engineered wood sources. The accompanying map is keyed by location and type of forest products supplied and is indexed to suppliers by name. Best of all, a

number of origins are on NS short lines, and they include such household names as Gilman, Weyerhaeuser, Louisiana Pacific, Jordan, and Georgia Pacific. For more information, call Daniel Juhasz in Norfolk: (757) 823-5448. And tell him Week in Review sent you.

Rod Case at Oliver Wyman has collected a highly instructive set of data on why railroads can't seem to run to plan. This chart is from 2013; however, it's a safe bet that today looks the same.

Everybody knows the NA rails are very focused on safety and have excellent results to show for it. The record with respect to unplanned interruptions to train operations is not so salutary. As you can see from the chart, in 2013 the rails experienced *more than half a million above-the rail* delay events from these eight event categories (UDEs are undesired emergencies like brake hose separations or other component failures).

Rod ran the numbers and concludes roughly one out of every four train-starts will be delayed by an unexpected event. Worse, more than half the delays (crew time-outs, unplanned work events) would have been avoided had the leadership been paying proper attention. Moreover, it appears rail management too readily accepts *ad hoc* cancellations in scheduled trains and daily local plan interventions, creating a fault-tolerant environment that interferes with operating to plan. Figure an average $200 per train-delay hour and you can just hear points ticking up the OR.

Rod concludes,

While I agree many front line managers are inexperienced, the clarity of purpose must be hard to divine when you are facing a new railroad operation every day. Unfortunately, this current fault-tolerant view of our industry's economic model risks driving us to bottom-feeder status in US surface transportation and is slowing killing off carload at a time that coal is in retreat. This feels like the onset of a vicious cycle that will impact our economics.

MidRail Corporation is a new addition to the North American community of shortline holding companies. The leadership team members include Gil Lamphere, whom I first met when he and Hunter Harrison were running the IC; Dave Dealy, who opened many BNSF doors for me during his tenure there as SVP-Transportation; Henry Chidgey, whom most of us know from his RailTex days with Brice Flohr, and John McPherson, who ran the FEC 1999-2007.

Joining this distinguished crowd are investment bankers Raj Gupta and Jeff Valenty, transportation attorney Ron Lane, and railroad equity investor Shane Duggan. Together they will invest in and develop smaller, "below the radar" rail projects in what the company calls "the undiscovered, undercapitalized niche that is the next frontier of railroad investment."

MidRail seeks, amount other things, Class II and III railroads with revenues in the $500 million range, a reasonable EBITDA multiple, and where additional equity or debt investments up to $80 million would be appropriate. MidRail investments are to be made through wholly or partially owned subsidiaries and/or corporate portfolio investments. The aim is to go public in five years.

The target list is impressive, including heavy-duty upgrades or even new construction to tap under-served markets; growth and buy-out capital for controlling minority/majority ownership existing Class II and III roads; and long-term lease or cash purchase of non-strategic Class I branch lines. The list goes on, but you get the idea. From what Dealy tells me, I conclude these guys are serious and they have the horses to do the job.

The timing couldn't be better. We know NS and CSX are downsizing their networks, especially in the coal regions, to reflect the volumes available and likely to grow in the future. You've read here about my sense that the Class I merchandise carload network continues to run very badly, and how the shortline community needs to be more aggressive in convincing their connecting Class Is to make the carload product more accommodative. Perhaps this group of known Class I players can add some clout to the argument. (I have contact info if interested or curious.)

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