RAILROAD WEEK IN REVIEW

June 10, 2016

"The Industrial Products sector is the linchpin of the Union Pacific franchise" — Rob Knight, Chief Financial Officer, Union Pacific

Railway Age held its annual Rail-Insights conference in Chicago this week to rave reviews. Unlike the usual conference where speakers do power-points peddling their points of view, *Insights* is more like sitting in on a story interview with an editor. So it was entirely fitting for Railway Age Editor-in-Chief Bill Vantuono to open the proceedings garnering insights and outlooks from Rob Knight.

The interview was wide-ranging, from coal (UP thinks there's still some life there) to the new business pipeline (cheap nat-gas feedstocks open new doors in plastics production on the Gulf Coast) and agriculture (large amounts of grain in storage and a boomer crop coming). Next up was AAR President Ed Hamberger, who chided government agencies for, on the one hand, insisting on two-man freight train crews *plus PTC* on the one hand, and promoting driver-less automated trucks on the other. Which segued nicely into RSI President Tom Simpson's observation that until the 11th hour the FRA had relented on the ECP requirement for crude-oil trains, then stuck it back in when it was too late to react.

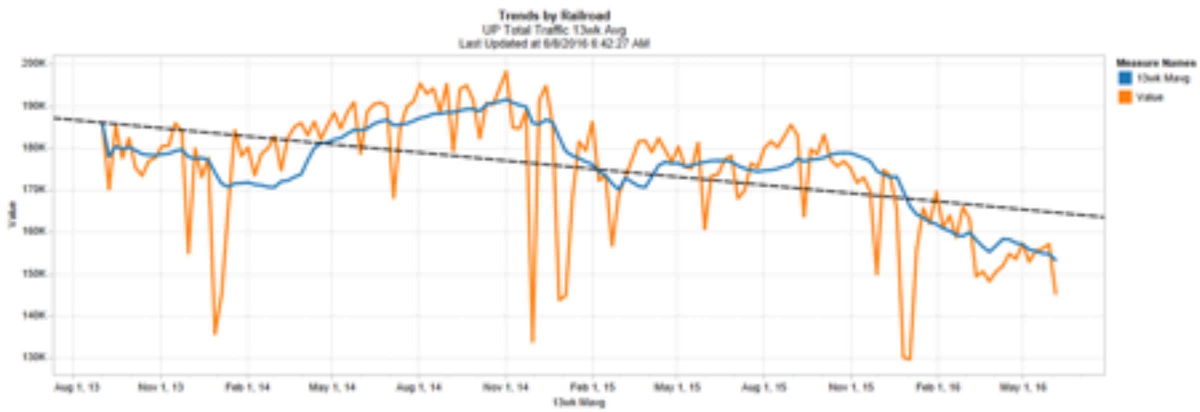
Cowan & Co. lead rail analyst Jason Seidl interviewed Gil Lamphere — formerly IC chair and CN director, now a private rail investor — about railroad earnings and financial engineering. Gil gave a scathing commentary on the over-emphasis of the operating ratio, the holy grail of measuring capex as a percent of revenue, borrowing money to buy back shares that never should have been issued in the first place, and the disconnect between depreciation and replacement spending.

Railway Finance Corp's David Nahass drilled down on the railcar and locomotive leasing environment with Residco's Greg Schmid and Fifth Third Bank's Rob Hart. Nahass wanted to know about how lease-rate factor affects customers. Simply stated, it's the monthly lease payment as a percent of the total cost of the leased equipment. Thus, a $100,000 covered hopper leasing for $1000 a month has a lease-rate factor of one; a used covered hopper valued at $50,000 and leasing for $300 a month has a lease-rate factor of zero-point-six. It was an important point to make for the present soft lease market, and who better to bring it out but Nahass and his panel?

(Speaking of Nahass, once again he is offering a discount for railroad attendees at the 2017 Railway Equipment Finance conference near Palm Springs the first week of March.)

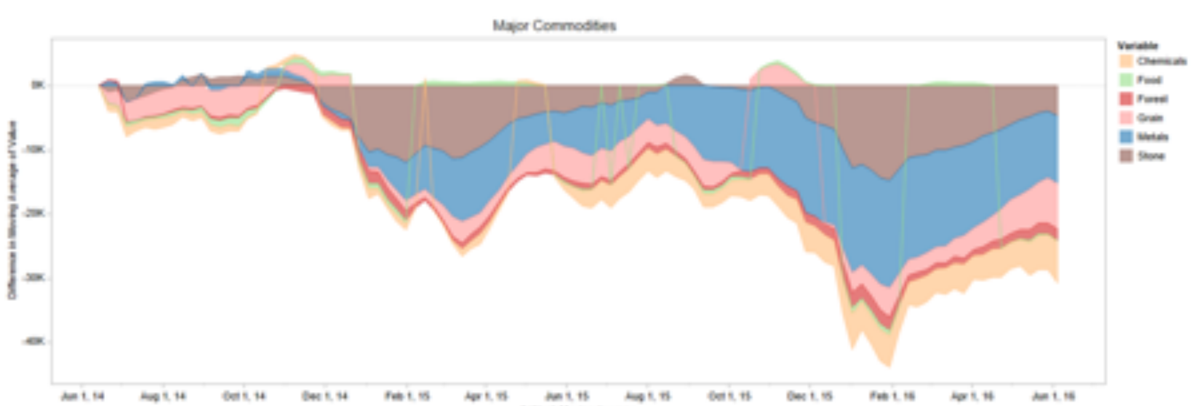
We wrapped the program with my interviewing FEC's Jim Hertwig, Pan Am Rail's David Fink, and Watco's Rick Webb. I wanted to know about their current strengths, how their properties differ from what they were five years ago, and how in five years their properties will differ from what they are now. We were able to shape the conversation to bring out the fact that these leaders not only are friends, but also that they are looking for ways to collaborate on setting new product-service levels by using the Class Is as overhead carriers.

Since Rob Knight highlighted the UP franchise strength, I thought it might be instructive to see how his railroad is faring against the broader railroad universe. As you can see, weekly cars-on-line is in a downward trend (in this illustration, each intermodal box or trailer is a car).



A similar chart for total North American rail traffic (below) shows a trend line of some 1.5 million units a week, plus or minus 200,000 units. To be sure, coal is a drag. Look what happens when you take out coal, intermodal and auto to get a look at the merchandise sector (ag, industrial chems including crude) for North America. We're still looking at a downward trend with metals and stone the biggest hits.

The chart tells us two things: the long-haul carload business is down across all commodities, and it confirms trends toward smaller inventories and tighter supply chains. Moreover, it suggests that carload pricing is not competitive, no matter what the rails tell us about maintaining "inflation-plus" pricing.



I see two ways to win more carload business. One, change the branch-line pricing model so not all branch-line costs are laid against the existing traffic. Used to be that chickens grown in the Carolinas ate mainly Carolina corn. But when midwest corn became competitive, sources shifted and the branch lines serving growers shifted their costs to the remaining shippers — short-haul wood pulp for the paper mills, mainly — pushing up their costs so their rates became uncompetitive. Better to use network pricing and spread branch-line costs to the network, keeping short-haul pricing competitive.

Two, the receiver shift to smaller inventories runs counter to the Class I big train model. The Reading Bee-Line model (WIR June 3) is an apt solution, and one way to get there is to block for the distant node at origin. For example, all the Atlanta cars coming into Selkirk on the head end of the train from Portland, Maine can go straight to the receiving yard, bypassing the hump, for the next outbound heading that way. Lather, rinse, repeat at Rocky Mount and so on.

We've got to stop thinking the only way to get trucks off the highway is with intermodal containers. The carload model works as long as transit times are competitive, equipment turn times support reasonable rates that deliver the right car-contribution per day, and trailing-tons per available horsepower hour are up to scratch.