RAILROAD WEEK IN REVIEW

September 2, 2016

"The rails had best stick to what they do best, and that's the carload sector, generating more than half of total North American Class I railroad revenue." Week in Review, August 16

Last week I wrote about how share prices for commodity producers from crude oil to frack sand to steel and corn signal potential railroad merch carload traffic trends. Which in turn signals there is additional carload business to be had if only the service product had a competitive advantage.

My sense is that rails are losing share to trucks *and* there is less stuff to move as the global economy contracts. Moreover, the loss of coal will hit the BNSF, UP, CSX and NS particularly hard. Yes, predecessor roads ATSF, SOU, MOP, Q et al had minimal coal, however it seems to me the merged plants have been rearranged to make coal flow better, possibly at the expense of carload OD pair options and flexibility.

Nothing can replace coal as a "here to there and back again" conveyor belt model. However, intermodal corridors can work — especially if you can swap out blocks like the passenger rails used to swap out sleepers between a train's end points. Competitive advantage comes from putting intermodal terminals close enough to end markets so there's never more than a 100-mile one-way dray.

Unlike the dark days of the mid-1960s, track and power are in pretty good shape — thanks in no small way to to robust coal and intermodal volumes. And we have to be ready to pick up the good track where it's no longer needed and put it down where it is, like the ladder train in the Pogo comic strip. Otherwise let it degrade to the FRA Class level appropriate to the service.

As NS has shown with their dedicated shortline sales force, boots on the ground can uncover new carload opportunities. Remember the old sales saw: You can't ask for the order if you don't go see the people. It certainly seems to me Class I moves are being missed because the Class I sales force isn't out there seeing the people the way short lines are.

NS-direct seems like a good move for getting to the smaller intermodal accounts. Let's duplicate that for tracking down the smaller carload accounts. Smaller margins, however, mean tighter expense and asset allocation control. That includes office workers and sales staff.

We don't need new tools, only to use the tools at hand better. For example, we hear about a need for boxcars but 12-turns a year doesn't justify the expense; we must speed up the customers' load/unload routines and take out delay between OD pairs.

One way to take out delay is to tell yard managers they *will* block for the distant node or be out looking for another line of work. It can't be local option, where one guy says he'll do it to speed up and un-clutter the yard and another refuses because it messes up his routine.

Fact is, to sell well means "You gotta know the territory," just as the salesman says in the opening *Music Man* number. The short lines can be a tremendous asset here. And, Mr. Class I market manager, don't be running off carloads because they don't hit a 1.6 RVC. They may just be spreading out fixed cost, making RVCs more than 1.6 possible for the rest of the customers.

A reader who's made a career of cutting carload transit times takes exception to my "block for the distant node" solution, observing that the vast majority of carload delay en route happens at interchanges and intermediate serving yards.

> One class 1 recently introduced a simple graphic support whereby cars in each track were color-coded by days of dwell. This included any yard location on the system where car inventories are tracked. This simple tool took two months to get to production and is easily understood by all. Green = good, Red = bad.
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> While the reduction in car dwell has been apparent, the fact that this tool cut across all departments (Operations, Customer Service, Car Control, Central Yard Office, Mechanical, Interline, etc.) really shows the power of KISS. It also shows that the hurdle to get started is not that high for the areas where the cars dwell the most.

To which I say, short lines have set the bar pretty low where they run special trains from the interchange to a cluster of on-line industries, have the Class I drop pre-blocked cuts in their shortline serving yards, or do a headlight meet with the serving Class I at the interchange where track space is limited. (I watched all three last week.)

A second reader who runs a growing carload operation along with a significant intermodal franchise notes that over the past 40 years we've seen a shift to private ownership from railroad ownership of freight cars, with less demurrage and storage fees (absent today's glut of crude-oil cars), and longer lags between place and release at too many customer locations. His outfit maintains "a portfolio of factual data on freight car velocity by customer" that captures "an array of positive and negative results … even though *every* profiled industry is served not less than five days per week based on cars available."

R**ail volumes continued their weekly slippage**, down nearly eight percent for Week 33 (August 20). The page 3 table summarizes the AAR numbers year-over-year and adds a direction of change: coal is down as a percent of the whole by 3.2 points; autos up six-tenths of a point, etc.

And, if you drill down into the merchandise numbers, you'll see that straight STCC 28 chemicals are down just point; petroleum products — mostly crude — are down 20 percent, skewing the category to a negative eight percent. Do keep in mind that petroleum car-counts are half the

YTD Wk 33 8/20	2016	2015	Change	2016 %tot	2015 %tot	2015-2016 Chg
Total	25,376,511	27,432,321	-7.5%	100.0%	100.0%	0.0%
Coal	3,112,732	4,230,618	-26.4%	12.3%	15.4%	-3.2%
Auto	1,301,927	1,247,810	4.3%	5.1%	4.5%	0.6%
IM	11,855,405	12,274,285	-3.4%	46.7%	44.7%	2.0%
Merchandise	9,106,447	9,679,608	-5.9%	35.9%	35.3%	0.6%
Source: AAR						

straight chems carloads, and, in 2015 at least, constituted only three percent of total carloads including coal and auto, excluding intermodal, per the AAR's July 2016 Chemicals book.

Intermodal looks like the clear leader in picking up share of total 2015-2016. However, recall that intermodal numbers represent individual boxes, not individual carloads. I use 1.7 boxes per platform or carload-equivalent: one surface between trucks to carry the load. Thus intermodal in carload equivalents becomes 34 percent of the total, up two points year-over-year.

Intermodal share of total up 2.0 percent plus merch carload share up 0.6 percent plus auto share up 0.6 percent says we've covered coal's 3.2 percent decline in share. Merch carloads' 36 percent of total carload-equivalents now edges out intermodal.

The big take-away is that merchandise carloads are holding their own, picking up a fifth of what coal has lost. If we can do that with the less than stellar performance in transit times and pricing, imagine what we could do with true market-based pricing and superior performance in the eyes of the customer.

Low oil prices and well supplies. Schwab's recent paper, "Is it time to consider bank loan funds?" looks at sub-investment grade bank loans. Under caveats, author Colin Martin writes, "The key risk that we see for high-yield bonds today is low oil prices." Energy bonds make up more than more than 15 percent of the Barclays U.S. Corporate High-Yield Bond Index, and, though that may not have been a problem when the price of oil was north of $100 per barrel, it poses a risk at $50 per barrel. Martin concludes, "Lower prices mean less revenue and cash flow to pay creditors, heightening the risk that some companies could default on their debt." In other words, know your driller customers.