RAILROAD WEEK IN REVIEW

October 7, 2016

"Knowing which companies profited from jacking up prices isn't enough to separate the winners from losers." — Barron's, October 2, 2016

"Trouble ensues when there is a disconnect between company performance and the willingness of those companies to continue to borrow and spend." — John Mauldin, "A Great Leap Forward?" Page 404, iBooks version

Even though year-to-date rail movements of grain have exhibited positive comps, one must remember these shipments come from this year's crop plus what's in storage. Next year is a question mark, if share price activity for Potash Corp of Saskatchewan (POT) is to believed.

On the plus side, demand for fertilizer, of which potash is the potassium (K) in the NPK nutrient scheme, should continue to grow over the long run as farmers look to increase yields and feed a growing population. China and India are huge markets as they want to raise food production and K applications are lagging. And, since there is no man-made potash substitute, it has to be mined. Supply is thus limited, so Minnesota's Mosaic and international producers like Russia's Urakali are giving POT a run for its money.

The not-so-good news is that supplies may actually lag demand. Low prices led Urakali cut Sep 2016 YTD production nine percent to 7.9 million tonnes from 8.7 million tonnes. BHP Billton's Jansen project in Saskatchewan is on hold. Says BHP, "The crop nutrient began its decline four years ago as weak crop prices and currency declines pinched demand. Prices also suffered from increased competition following the breakup in 2013 of a Russian-Belarusian marketing cartel that previously helped limit supply."

As a result of this turmoil, POT share prices have become range-bound at $16-18 since Jan; at the start of 2015 POT was going for $37 a ticket. Quite a come-down, though perhaps justified: Morningstar pegs POT's fair value closer to $20. To me, multiples expanded partly because some market players didn't understand the Chinese economy and thought there was more demand than in fact there was. And so prices got whacked.

Adding further insult to injury, Canada's Canpotex -- the joint venture that represents potash export sales from POT, Mosaic and Agrium -- decided in June to scrap plans for a new export terminal at Prince Rupert, citing slowing production combined with sufficient capacity at other ports to handle anticipated throughput.

Rail vols as measured by waybill freight sample show annual potash vols in the 137,000 carload range, with UP the leader by far. The broad fertilizer category accounts for some 16 percent of

their STCC 28 chemicals franchise. Potash export vols were off in Q2; ferts as a group are expected to be down for the year.

Now comes the USDA quarterly grain stocks report. As of Sep1, total combined corn, wheat, and soybean inventories are 11 percent higher than they were last year at the same point in time. Total grain inventories are running 18 percent above the 12-year average. Wheat stocks are at their highest September level since 1987 and corn inventories are at a 10-year high.

Scott Group at Wolfe Research says, “High grain inventories should support stronger rail grain volumes the next few quarters. Grain volumes inflected positive year-over-year in 3Q after three straight quarters of declines. UP and KCS have the most U.S. grain/ag exposure at about 16 percent of total revenue, and UP faces much easier grain comps than KCS.”

In a related note, the WSJ reported Tuesday that meat futures are falling on a record glut of meat — hog futures, for example, settled at a seven-year low Monday. At the same time, grain growers are preparing for a fourth consecutive year of bumper harvests this fall. So... more meat on the hoof than markets want, plus too much grain in the feed lots, equals fewer acres planted next season and fewer tons of nutrients to support the growing season. Ergo POT's in a funk and UP may take the biggest hit among rails.

The American Trucking Association (ATA) gathered in Vegas for its annual conference last week. Stifel’s lead transportation analyst John Larkin was there, and he writes that he opted to skip the “wining, dining, gambling, and partaking of all the live shows,” preferring instead to set up his own strong “dance card of wall-to-wall, one-on-one meetings” with trucking industry and industry supplier executives.

Though his note is concerned mainly with the observations and concerns of this attending, he offers some insights helpful to those of us in the railroad business. In a word, it appears truckload volumes are stuck in sideways rut, where recent signs of higher spot pricing are unsustainable. Fleet size reductions will tighten supply of truck capacity more than anything, providing the economy does no worse than the present 1-2 percent GDP annual growth rate.

After reading Larkin, I can’t say precisely how his observations will help the railroad carload biz, though better service at competitive rates would help. As is, we see, for example, lumber and building products rail rates rising even as transit times slow. Reason: slower turns reduce car-contribution per day; raising rates increases that number. However, a non-competitive rate reduces carloads, meaning fewer train starts, meaning longer turn times, meaning still higher rates for even worse service. Somebody, someplace, has to step in and break this vicious cycle.

A favorite rant of mine has to do with boots on the ground facilitating direct conversations with customers and these conversations invariably lead to more freight on the rails. And part of that rant is that the competitive advantage of locally-based short line and regional railroad marketeers must be tapped more fully by the Class Is.

Case in point: Pennsylvania's North Shore Railroad operates a number of non-contiguous properties and is unique in the way it seems to stuff every available square inch of railroad property with customer-pleasing activities. Most recently, their Union County Industrial Railroad (UCIR, formerly part of the Reading main line to Philadelphia) began handling over-sized loads to support the construction of a large, new natural gas-fired power plant in their service area.

Chief Marketing Officer Todd Hunter says, "Many hands are involved, and it requires a team effort to safely handle these massive loads. It starts with our marketing team consulting with the customer, our own operating team for equipment, and our MOW team for clearances. Then it's off to our connecting Class Is for their process and approvals." Not an easy task, but the proof is in the carloads, clearly demonstrating once again that the shortline family is up to the task of moving even the largest, heaviest, and unwieldy items.

And for dessert, North Shore added another high and wide customer in Nu-Weld, a Williamsport-Based metal fabricator on North Shore's Lycoming Valley Railroad, itself comprised of former PRR, Reading and NYC lines. Nu-Weld's competitive advantage is having the only overhead-crane transload for miles around. Given the area's concentration of nat gas drilling operations in the Marcellus Shale basin, Nu-Weld is perfect for steel, pipe, compressors — all the heavy, awkward stuff that needs an overhead crane to move it from freight car to flat-bed.

I mention these two examples because they represent they exemplify the local "boots on the ground" business development talent the Class Is lack. Moreover, the North Shore is but one of several locally owned and operated short line companies in Northern Pennsylvania and upstate New York that have brought rail service phoenix-like back from the ashes left when Conrail was forced to walk away from these properties as part of the Final System Plan for the Northeast.

In addition to the North Shore, we have the New York Susquehanna & Western, the Genesee Valley Transportation Company, the Finger Lakes Railway, the Reading & Northern, the Livonia & Lakeville, and the Western New York & Pennsylvania. The leaders of each of these companies have distinguished themselves by rebuilding their railroads into significant commercial contributors over the past 20 or so years. And CSX, CP, CN and NS are the direct beneficiaries.

Mind you, this is all single-carload freight, but these local marketeers could also add intermodal loads where their customers are within, say 50-100 miles of a Class I intermodal terminal. My model for this scheme is the sales approach taken by both CP and CN: the sales rep empowered to sell *any* rail service. That individual has a better shot at keeping freight under railroad control than the sales rep who can only do carload or intermodal. And controlling the move is key.

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