RAILROAD WEEK IN REVIEW

January 6, 2017

"The one sure thing is that we're going to be accompanied by significantly more uncertainty over the next several months than we were over the last." — Legg Mason, 2017 Outlook."

China is a significant force to be reckoned with, railroad-wise. Mostly missed by western media, China in February 2016 ran a 32-container freight train over a 6,500 mile route from a point 200 miles north of Shanghai to Tehran. Thus has China created a new *Silk Road*. A December report from London's Cross Border Capital tells us this inaugural journey — part of China's $4 trillion One Belt, One Road (OBOR) initiative — "brings closer the day when a high-speed rail network will join China to new markets in the West." The note continues,

> Tehran and Beijing agreed to expand bilateral trade by $600 million over the next decade. China is already Iran's largest trade partner, a history built on oil. While sanctions cut Europe and the United States off from buying Iranian oil, waivers from the U.S. State Department allowed China (as well as India and South Korea) to continue its purchases. [Bloomberg notes that trade between China and Iran stood at $52 billion in 2014, "before the plunge in oil prices."]
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> The journey, which crossed through Kazakhstan and Turkmenistan before arriving in Iran, included two breaks of gauge, adding additional cost. Central Asia uses a different track gauge (inherited from the Soviet Union) than China and Iran which both use standard gauge. Whether the saved time – a full month – is worth the cost difference between shipping by sea or by rail is unclear.

I can see a time when the Silk Road rail network extends into Europe, opening western markets to China — and the countries along the route to direct trade with China — reviving this most ancient of trade routes. Direct rail service across half the world will significantly harm volumes on the present-day sea lanes, biting into commodities from outbound US grain to inbound Chinese furniture. Moreover, George Friedman writes in his Jan 4 Geopolitical Futures letter,

> China has a key geopolitical imperative. It depends on exports to sustain its economy. Most of those exports are shipped by sea, and therefore access to the world market begins at its eastern coastal ports. Geography poses a problem for the Chinese. Shipments from the country's east coast ports, both south and north of the Taiwan Straits, must transit through a string of islands. Some are large islands, while others are extremely small. But they form a string of choke points through which Chinese maritime trade must pass.

But suppose, Friedman continues, there is some sort of military incident that makes these choke points block free access to the Pacific and to the west via the Indian Ocean and the Suez Canal.

Being entirely dependent on sea lanes is not in China's best interests, ergo the railroad Silk Road — the OBOR initiative. Like Friedman says, Rails West becomes a key geopolitical imperative.

Elsewhere, China clearly has a leg up in global rail infrastructure and equipment markets. Every issue of IRJ (*International Railway Journal*) is chock-full of news items about China building railroads, providing equipment and supplies, and even funding. From the December issue (all values in US dollars):

— Zambia: China Railway Construction Corp (CRRC) to build 389 km line worth $2.3 billion;
— Inland China: Testing intermodal platform to spot-load tractor and trailer without uncoupling the cars or using circus ramp;
— Argentina: CRRC to supply 107 diesel locos and 3,509 wagons, China loans Buenos Aires $14.2 billion to modernize suburban network, $4.4 billion to upgrade freight lines;
— Hungary: Exim Bank of China lending $1.6 billion to finance 85% of cost to upgrade Belgrade-Budapest, joint-venture with China Railway International Corporation;
— Vietnam: CRRC supplies eight meter-gauge, twin-cab shunting diesels for steel mill at Ha Tinh, about half way between Hanoi and Da Nang;
— South Africa: CRRC supplying locomotives for Transient Freight Rail.

It's time to be upbeat on drilling again. Credit-Suisse has released a 53-page treatise that contains more than you'll ever need to know to manage your railroad's exposure to the energy exploration and production business, but the trends are unmistakable and positive for rail names active in this sector.

Oil prices are creeping up and making what were marginal producers more attractive. Rig counts *per se* are less meaningful because they "under-estimate the implied demand of longer laterals, more intensive frac jobs, and other services tied more to wells than rigs." Revenues are expected to triple in two years as ebitda margins expand. And to get more out of the down-hole you have to put more in: pipe, sand, cement, etc. Color me upbeat on the outlook for the AAR metals and construction commodity sectors.

Meanwhile, RBC Capital Markets offers up its list of "Global Energy Best Ideas," complete with the oil/gas fields where short lines are active. We get, for example, Anadarko in the Permian and Wattenberg; Noble in the Niobrara, Eagleford, Permian, and the Marcellus; Sunoco Logistics in the Permian; and Synergy Resources in the Wattenberg.

Union Pacific has bought out Railex, the owner and operator of the dedicated perishables train service with origins in California and Washington and a purpose-built receiving facility near Schenectady NY. (I rode the first and last segments of this train a few years ago and wrote it up in *Trains* magazine. UP and CSX couldn't have been better hosts.) According to the press release, "UP has acquired the Railex refrigerated and cold storage distribution assets in Delano, California; Wallula, Washington; and Rotterdam, New York," but not Railex Wine Services, handling principally bottles in 55-degree cars from the Columbia Crest winery in Washington.

UP's been counting the huge volume of reefer trucks on I-80 paralleling its main across Nebraska, and more than once has expressed a desire to pay a larger role. Railex served the purpose of getting growers and grocers interested and involved. The present transaction is proof that the concept works. Now to add trains to markets like Charlotte and Jacksonville.

Every January we get a maelstrom of prognostications for the upcoming year from a gamut of observers, from market analysts to bookies. Happily, some seem to get pretty close to the mark. I think Legg Mason gets it about right. Herewith my comments on some of the shoes that best fit those of us in the short line business.

** "A virtuous cycle of moderate economic improvement in the U.S., combined with measured Fed rate hikes that don't choke off recovery, is well within the realm of the possible — think continued earnings improvement as well as resurgent demand." All of which implies moving more stuff, from raw materials to finished goods, and moving stuff is what we're all about.

** "A focus on domestic economic health could provide renewed interest in investment of a very local type: refurbishment of bridges, roads, water systems and transportation." Here again, more stuff, and shortline flexibility and creativity has a key role. I recall a short line that brought water main pipe to replace a buried supply line adjacent to the railroad. Load at pipe supplier, offload where needed.

** My own favorite complaint, share repos, comes in for some harsh words: "The demand created by a renewal of fiscal spending could very well drive cash into the quest for improved productivity." In other words, let's get back to growing eps by growing earnings that stem from selling transportation services, not from manipulating the share-count.

** And finally, "The one sure thing is that we're going to be accompanied by ***significantly more uncertainty*** over the next several months than we were over the last." Italics are mine, and one of the best ways for short lines to make the uncertain less so is to align resources to support customers who truly want them as a long-term supply chain enablers. Happy New Year.

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