RAILROAD WEEK IN REVIEW

July 7, 2017

“Precision railroading cost control and balance sheet performance at CSX haven't yet translated to merchandise carload growth. Will top-line volume market share growth be addressed in the July 19 quarterly analyst call?” — Jim Blaze, former Class I strategic planner

“CSX volumes came in somewhat lower than expected, but the pace of operational change surprised to the upside.” — Cherilyn Radbourne, TD Securities

AAR revenue units were up 6% year-over-year in the 2017 second quarter. Merchandise carloads have shrunk to a third of the total while intermodal is pushing half and coal has recovered (for the nonce) to 13% of the total. Within the merchandise commodity groups, only the metallic ores and metals (mostly metal products and ferrous scrap) and non-metallic minerals (chiefly aggregates including frac sand) commodity groups posted double-digit percentage gains.

AAR Class Is	**NA Rails**			
Commodity	**YTD 2017**	**YTD 2016**	**Delta**	**Pct Tot**
Total Units	18,003,299	16,977,111	5.70%	100.00%
Intermodal	8,834,603	8,498,888	3.80%	49.07%
Auto	706,276	733,821	(3.90%)	3.92%
Coal	2,336,798	1,946,553	16.70%	12.98%
Merch Carloads	6,125,622	5,797,849	5.65%	34.02%
Source: AAR Weekly Rail Traffic July 1				

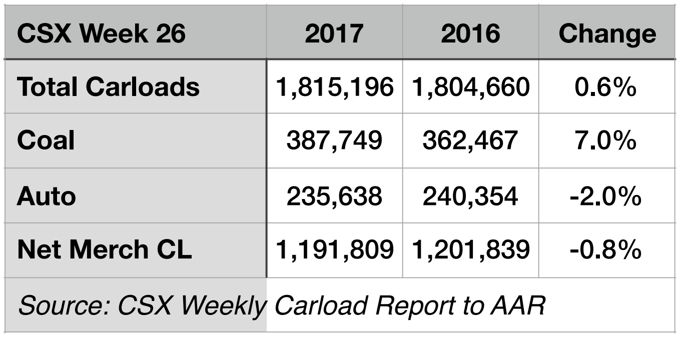
I’m reading these results as yet another sign the carload sector is increasingly consigned to the bulk commodities, where one lump of potash or bundle of fir two-by-fours is no different than any other, whereas things like appliances and specialty steel shapes are distinguishable products of higher unit value and must move without delay to keep receiver inventory costs under control.

The analyst community has its own gives and takes. Cherilyn Radbourne, of Toronto’s TD Securities, writes that the 6% total growth number represents “a sequential acceleration from the 4% growth in Q1/17.” However, she sees Q2/17 growth rate as “somewhat misleading because Q2/16 marked the recent lows for a number of commodities, thus easy prior-year comps. We expect the cost-cutting undertaken in 2015/2016 to yield healthy ex-fuel surcharge incremental margins and forecast very strong y/y earnings growth in Q2/17.”

Over at RW Baird in Milwaukee, Benjamin Hartford notes that investor sentiment among rails “has remained highest among our covered stocks YTD. Rails have outperformed the S&P 500 by +8% since January, supported by accelerating carload volume growth during 1H17, the easiest quarterly volume growth comparison against 2016.” He sees “incremental headwinds to industrial rail carload volume growth during 2H17.”

Rome wasn’t built in a day Department. AAR Performance reports show CSX making marked strides in taking out yard dwell time and running the core trains faster between their terminals. The cynic in me sees fewer cars making for a faster railroad simply because there’s less freight cluttering up the place. After all, the value of Precision Railroading lies in providing a more reliable product that will create more customers… and more cars. So far, I don’t see it.

Here’s what happens to merch carloads when you back-out coal and auto. Hardly an encouraging word for the feeder line network. Let’s be generous and simply say it’s a Work in Progress.



CSX Week 26	2017	2016	Change
Total Carloads	1,815,196	1,804,660	0.6%
Coal	387,749	362,467	7.0%
Auto	235,638	240,354	-2.0%
Net Merch CL	1,191,809	1,201,839	-0.8%

Source: CSX Weekly Carload Report to AAR

That said, there’s been quite an email thread on the EHH “Story thus Far” that’s being written. A participant who’s been though railroad mergers, acquisitions, and right-sizings over the past 30+ years writes, “I’m hearing lots of instant expectations about CSX, but it doesn’t work that way.

“Skepticism is fine, but it’s only July, and the hump yard rails are still warm. I wouldn’t infer much from a second quarter report. For years, I enjoyed hearing John Snow and the gang gush about the glories of SeaLand, the barges, the railroad etc., and all those trucks to be diverted from I-95. It was almost out of Steinbeck — Lennie and George: Tell me again how it's going to be.

“Recently rival NS has registered a new view in favor of looking to box cars for more business. Yet I recall that a CSX official once opined that the company could never make money with its boxcar fleet. EHH now opines otherwise; that could be interesting. My view on EHH is that he is sort of like the Wallendas: if you keep doing it, it ain’t luck. If you fall, all will notice the splat.”

Fellow pundit Fred Frailey adds, “Michael Ward knew goddamn well operations were a mess. He went hat in hand to David Goode at NS and asked permission to recruit Tony Ingram, a top-notch operating guy who had gotten passed over for the top operations job and was twiddling his thumbs. Goode said okay.

“Tony came to CSX just as the One Plan [patterned after the NS Thoroughbred Operating Plan] was in development. He tweaked it and it went into place and was generally ignored. Ward begged Tony to give people a year to fall into place and obey orders. The week the year was up a slew of top CSX people were fired, and the operating plan suddenly worked pretty well.

"I believe the same people who did the NS plan did the CSX one, and if not, they both had the same characteristic by employing algorithms, so that if you cut off or added a train or changed a schedule, it told you the best way to optimize everything."

I second Fred on this one, having watched the NS TOP at work before, during, and after Hurricane Katrina in new Orleans. They said, "Hey, TOP, how would freight move on NS if New Orleans didn't exist?" Within hours a solution was at hand. Without TOP, the process would have taken days.

At CSX the challenge has always been getting six railroads that didn't get along to play nice in the sandbox. There have been apocryphal tales of bridge operators on the L&N seniority list not taking trains with crews on the B&O seniority list. Or an operator at a former NYC yard saying, "My dad worked here for 30 years and if their process was good enough for him, it's good enough for me." And so on. Here's hoping EHH gets TOP priority.

Last week I mentioned depressed used car prices and their impact on new car sales. Auto industry analyst Daniel Ruiz (*blindersofflc.com*), in a *RealVision* conversation with Grant ("*Things That Make You Go Hmmm*") Williams says, "Used car values are the foundation of the entire automotive industry. They've been falling significantly, and, because of that decline, we've had a lot of attention on used car values."

His argument is that it's about trade cycles — the length of time between a customer's new car purchase date and when he trades it in. The optimal trade cycle happens when the principal balance owed on a car meets the current market value of that vehicle, so what the dealer gives for the trade-in equals what he can get for it on the used car lot, while not dinging his net on the new.

But people are keeping cars longer. The lower the trade-in value, the higher the monthly payment for a new car. With household budgets squeezed by escalating heath costs and stagnant wages, there's not enough left for a larger car payment, ergo no trade-in, and new car sales suffer as the trade cycle lengthens. And that's why new-car sales estimates are falling — as we saw in the UP chart last week. So if your customers include auto-parts makers or new-car distribution sites, some serious channel checks are in order.

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