RAILROAD WEEK IN REVIEW

August 11, 2017

"The the question of whether a [share] repurchase action is value-enhancing or value-destroying for continuing shareholders is entirely purchase-price dependent." — Warren Buffett, 2016 Berkshire-Hathaway Chairman's Letter, page 7

BNSF second quarter 2017 revenues increased 15% to $5.1 billion on 9% more revenue units and 5% more RPU. Ops expense increased 12% for ops income of $1.8 billion, up 19% , and an OR of 65.2, down 1.3 points. Net income was $1.1 billion, up 20%. BNSF also gets the brass ring for sheer dollars in free cash flow after capex: $1.9 billion.

My editorial comment: Happily, there are no share buy-backs to distort earnings. Says Warren Buffett in his 2016 Annual Letter,

> Repurchases only make sense if the shares are bought at a price below intrinsic value. [Most railroad share prices exceed discounted cash flow intrinsic value by a factor of 2 more or less -- rhb]... Corporate repurchase announcements almost never refer to a price above which repurchases will be eschewed...
>
> There are two occasions in which repurchases should not take place, even if the company's shares are underpriced. One is when a business both needs all its available money to protect or expand its own operations and is also uncomfortable adding further debt. Here, the internal need for funds should take priority."

These results bespeak BNSF excellence among the Big Four US Class Is for percentage gains in revenue, total revenue units, and system RPU, yet show the lowest percentage of freight revenue in the merch carload column, 46% (remember that BNSF auto is in consumer, and it's up 5% year-over-year thru week 26).

Second quarter merchandise carloads increased 8% due mainly to higher grain exports in ag, up 14%, more than 3 times the industrial products gain -- minerals, sand, steel used in drilling offset by crude oil (off 14% by the end of the half). Consumer products revenue units (auto and intermodal) increased 6%; coal jumped 15% on weather and nat gas prices vs coal generating facilities being retired.

My August 4 Week in Review comments about CSX under Hunter drew more mail than I've seen on any one piece in a while. One in particular is from a dear friend of many years and owner of a highly successful regional railroad operation who writes,

> So, CSX core value #1 starts with the customer? I am astonished at this flippant comment after the very serious service disruptions across the CSX system. I've talked with two short

> line owners this week who are concerned whether their customers will return to rail after this meltdown. Rather than wait perhaps weeks for cars to show up, customers shift to truck. More expensive, yes – but far more reliable.

I can see his point, and offer a few observations. I gave Hunter credit for customer care because of this line in his letter of apology quoted in its entirety in *Railway Age*: "Our job is to create a railroad that offers customers the best value of any provider in the industry…" Whether that's press fluff or not, one now has leave to ask Hunter in public, "When you wrote in your recent letter about offering 'customers the best value,' what did you mean? Please elaborate."

I've been trying to keep an open mind about Hunter's efforts to bring "Precision Railroading" to CSX. However, the rampant stories about CSX service failures -- the Penna train wreck, the missed interchanges, tales of customer desertion — are giving me second thoughts. It all smacks of a serious lack of local leadership. Precision Railroading is about having the right assets in the right place at the right time to meet customer supply chain requirements and doing it without compromising safety. But it takes on-the-ground leadership to make sure people are doing what they're supposed to.

Case in point: A railroad has a rule never to run an empty car less than five cars back in any consist over 20 cars. Here comes a 65-car train with 3 units and an empty bulkhead flat up against the power. Turns out the crew was trying to get back to the barn in time to make an early quit. The conductor cut off the power at the head end and went for the car, not taking the time to walk five cars back to make the cut for a safe move. Leadership on the ground caught it and the perp got a few weeks off to think about how his behavior put others at risk.

I know where CSX is combining trains to save crews and how those bigger-than-plan trains impact the system. Local management may be making their lower crew-start targets, but put others at risk. Looks to me like upper management is measuring the wrong things.

Short lines and their customers have not been bashful about what makes them unhappy. Over a month's worth of meetings, phone calls and e-mail exchanges, I've begun to get a handle on the depths of their despair, complete with dates, times, events and real dollar exposure. A sampling:

- A regional railroad incurs increased car hire and fuel expense due to changes in blocking and interchange points;
- A shortage of cars for loading due to CSX clamping down on car hire expense and not allowing foreign or pool cars to load leads to more loads for the truckers;
- A private car fleet operator isn't increasing cars in his fleet because of excessive turn times on the existing fleet. Tonnage that would normally go by train now goes by truck;
- Shippers are seeking outbound product destinations that are local to anybody but CSX or a CSX-only short line;

- Lease fleet cars stuck empty at destination are waiting for a return train home, driving up fleet lease cost per ton moved;
- CSX may be closing humps too fast to phase in that process. (Flat-switching is a learned skill and pre-blocking to furthest destination must be handled properly in each yard. It isn't.)
- CSX deciding to pull out of the car pool for paper eliminates an essential tool for effective equipment management. This decision will mean loss of share to CSX and gains of share to others.

CSX has not been a star performer, financially. Full-year revenue units in 2016 were about the same as full-year 2012: 6.4 million. Revenues for the same period went from $11.8 billion in 2012 to $11.1 billion for 2016. Share prices Jan 2013-Jan 2017 increased 60% — helped in large measure by the Hunter-inspired gap-up this past Jan — to the S&P's 75%.

Moreover, retained earnings12/31/2016 to 6/30/2017 decreased to $11.1 billion from $11.2 billion, showing that CSX actually consumed retained earnings while market cap was increasing. From this I conclude market cap jumped on the Hunter share-price gap up without any material benefit to the shareholders other than capital gains. (As of 4/23/2017 Hunter held 300,000 shares of CSX worth $15 million, so he has considerable skin in the game.)

And yet, in spite of all this, there seems to be an encouraging word or two out there in customer land and among local carriers. Like many of those with whom I've spoken with and e-mailed, I'm hopeful CSX will get better. But will it get better before shippers who've migrated to truck stay there or leased-fleets managers shrink fleets still further due to the increased lease-cost per ton moved, making rail operations economical? Time will tell.

End note: There will be no Week in Review August 18. I'm on the road Sun-Wed with clients and then taking a couple of days away from all this.

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