RAILROAD WEEK IN REVIEW

September 8, 2017

"General Motors opted to aggressively enhance its discounting to move product: J.D. Power estimates that the company's incentive spending rose to 13.9% of its average transaction price, sharply higher than the 11.5% logged in July." — Grant's Interest Rate Observer, September 1.

Cowen rail analyst Jason Seidl has produced a remarkable piece of work that clearly confirms the fact that RPU means more than revenue units when it comes to keeping railroads profitable. And whereas intermodal has grown at the expense of coal, most everything else (where short lines live) remains flat.

Jason has a chart depicting the growth of intermodal relative to everything else, and it helps explain why ORs are dropping and margins are improving. Intermodal is hook-and-haul with minimal terminal expense, whereas most carload freight needs a first-mile/last-mile local job. Even coal, with all its big terminals, requires more work at the ends of the move than does intermodal.

Moreover, intermodal RPUs are such that they are closing in on carload RPUs, assuming 1.7 boxes per platform or well-car. Diesel fuel prices are back to where they were 10 years ago and rails are getting more tons moved per employee, while ops expense per GTM has come back down to where it was in 2007. More money, less work.

Back in early 2009, chemicals, coal, grain, and aggregates were the top volume carload commodities for the non-Class I rail group. Today, not much has changed. But as RPUs have risen, so have shortline divisions. State grants and 45Gs have taken some of the bite out of track expense, and, with more efficient power and sharper operating practices, ORs are retreating from the 90s (or worse) where they were for so long. Moreover, as more short lines go under the umbrellas of a few multi-railroad operators, more or less fixed expenses like mechanical materials and track maintenance equipment can be spread across more names.

My take from all this is simply that, as intermodal approaches 50% of all Class I revenue units, commodity carloads will continue to grow at roughly the rate of inflation or GDP -- call it 2% per year -- and their numbers will stay at about the same percentage of the total carload pie. So, like the Class Is, the shortline mantra must be one of more money for less work. Adhering to the four bullet points in last week's WIR will help. [Email me if you want a copy of Jason's note.]

In economic news, Schwab's Randy Frederick writes that the August unemployment and underemployment rates reached lows not seen in ten years, and the labor participation rate has held at 7% for four consecutive years. Wholesale inventories for July increased 40 basis points against a 20 BP estimate, August consumer confidence was up 2.6 points to 122.9, and the August ISM manufacturing index was up two points to 58.8.

On the other hand, *Barron's* is less cheery, citing "signs that the consumer might be tapped out, with the savings rate near its lowest level since the financial crisis, implying that spending could slow. The Federal Reserve seems intent on raising interest rates, even as inflation remains below its 2% threshold. And even the housing market shows signs of cooling off; new-home prices plunged 9.4% in July." Lots of "coulds" and "mights," so I'll take this bit of gloom with a grain of salt.

Meanwhile, *Grant's Interest Rate Observer* picked up on the slowing rate of auto sales: "August saw a seasonally adjusted annual pace for the month of 16.03 million vehicles, well short of the 16.6 million consensus and about 6% below 17.1 million SAAR logged in August of 2016. Average per-vehicle concession for the first three weeks of August rose 6% to $3,856 from $3,645 a year ago per J.D. Power." Kinda reaffirms what Stephanie Pomboy has been warning about.

AAR auto volumes (vehicles and parts) through July were down 6%, and shortline auto moves were off 15% in June alone. I suspect auto vols will most likely fall further as dealers try to sell off inventory (see incentives, above). But the hit goes deeper than finished vehicles and parts. Many short lines supply parts-makers with everything from steel to plastic to soda ash (glass), and seat-stuffing material. As finished vehicle demand slows, so does the demand for what goes into those cars.

Still, Morningstar says U.S. auto sales may have peaked in 2016, but even the 16 million SAR is "nowhere near recessionary," and car sales in China and Europe are still up year over year. lumber and construction materials' prospects are brightening because millennials' home-buying is causing surging demand for housing at the lower end of the pricing spectrum." Lower end or not, it's still lumber on center-beams.

The IYT (iShares Transport Index) has had a choppy year, up as much as 7.3%, down as much as 3.1%, and by the end of August posting a 2.5% gain. Railroads, on the other hand, are up 12.4% year-to-date, adding further fuel to Jason's remarks, above. Volume deltas may be unexciting, but share prices are doing nicely, thank you (my Gang of Seven, plus BRK as a proxy for BNSF, are all at or comfortably above their SMA 200s), because of better management techniques and the shift in mix.

Notes from the field suggest that CSX service is improving. Moreover, both the September 5 *report to the STB* and CFO Frank Lonegro's *Cowen Conference presentation* 6 convey the same message. Both documents, in fact, are filled with ideas short lines can use to enhance their relationships with CSX and thus be seen by their customers as true customer advocates.

Let me recommend you start with the STB document to see, among other things, why timely place and pull improve dwell times; how customer behavior can affect car availability; why end-to-end transit time trumps first-mile/last-mile performance. This last includes interchange-on to interchange-off, interchange-on to place, place to release, release to interchange off.

The Lonegro presentation builds on the above. “Strategic blocking” must include shortline pre-blocking for the distant node. Reducing OD pair transit times is a worthy goal — saving a day in each of up to three class yards between OD pairs can make a difference in customer satisfaction and equipment utilization. Too, the shorter the transit time, the smaller the replacement cost element of the final rate.

My sense is Hunter never liked unit trains. He’d rather round up all the cars in a given yard going to the same place, put them all in the same train, and get them out of town rather than holding the grain cars for a train, the coil cars for another train, the sand cars for a third train, and so on. Mixed departures benefit transit times, car utilization, and customer dwell. Fact is, all those boutique unit trains are separate train starts. Eliminating those and blocking mixed commodity carload trains for the distant node speeds cars through yards, leaving less opportunity for hold-outs and crews going on the law.

Lastly, pay particular attention to the revised performance measures in the Appendix to the STB report. Take note and measure your CSX performance between OD pairs accordingly. And keep in mind that even though merchandise carloads are trending down, the trend ought to reverse as transit times and reliability improve. The way I see it, as train lengths go up and train starts go down, fuel burn decreases, lowering that piece of ops expense and contributing to a lower OR.

Kansas City Southern kicks off its annual Strategic Partners conference in Kansas City this coming Tuesday, September 12 with a golf outing, reception and dinner. Wednesday morning features remarks from, among others, KCS President Pat Ottensmeyer, EVP and Chief Marketing Officer Brian Hancock, and KCS-Mexico President Jose Zozaya. In addition, there will be presentations from a number of suppliers and customers. The afternoon features a trade show with commodity reps from KCS, several shortline tables, and a number of vendors.

I’m looking forward to a strong showing. KCS shares (NYSE: KSU) are up 23% this year, and that comes largely from the Mexico story, with strong franchises in automotive, cross-border intermodal, grain, and — coming soon to a KCSM stop near you — refined petroleum products. Allison Landry at Credit-Suisse writes, “We have increased confidence that the secular growth story at KSU has re-emerged… with a larger growth opportunity than we initially thought in the cross-border refined products business.” Consequently, C-S thinks “refined products could generate incremental EPS” of around 4% through 2019.