RAILROAD WEEK IN REVIEW

October 6, 2017

The proportion of lenders easing credit standards in the prior fiscal quarter has reached its highest level since March 2014… Investors of all stripes – from banks and insurance companies to hedge funds and private equity firms – are plowing into real estate loans as an alternative to lower-yielding bonds." Almost Daily Grants, Grant's Interest Rate Observer, Sep 26

Union Pacific has redesigned its Marketing & Sales organization, consolidating the present six major business units into four: Agricultural Products, Energy, Industrial and Premium. Gone are the automotive, intermodal, coal, and chemicals business units, which, I think, given the railroads' changing product mix and customer supply-chain focus, makes perfect sense.

The new order will not lack for leaders. Beth Whithed continues as EVP and Chief Marketing Officer. Brad Thrasher gets the Agricultural Products team, adding ferts from the chems group. Linda Brandl takes on the Energy group, expanded to cover coal, coke, frac sand, crude oil, STCC 29 LPGs and other energy products, and wind product marketing.

Kenny Rocker wins the revamped Industrial Products group that includes not only commodities that comprised the previous Industrial Products business unit, but also losing frac sand and wind while gaining industrial chemicals, plastics, and soda ash. Intermodal and Automotive are combined to form the new Premium group under Jason Hess. Congratulations and best wishes for success go to all.

I'm hopeful the revised customer and commodity focus will get favorable investor notice. UNP shares, though up 11% year-to-date, lag the Class I group, where CSX is number One at 47%, but that's largely Hunter-driven. Number Two is KCS, up 26%, and which is entirely believable, given what they have done to merge KCSM operations so completely into one KCS railroad. CN at just over 22% is number three — no surprises there. Shares for NS and CP, up just under 22% and up 17% respectively, are still at highly respectable levels, given the slow-to-no-growth economy. By comparison the S&P is up 12% year-to-date.

Fred Frailey, a long-time UP observer, writes in his *Trains* blog, "UP's focus is the profitability of its business—the term used is 'reinvestibility.' In other words, UP asks if the rate it gets on new and even existing business is sufficient to pay for and replace the equipment and other assets used in handling it." Pricing drives revenue and revenue is the OR numerator.

This is a return to former CEO Jack Koraleski's mantra, and something for short lines to consider seriously when examining dwell-time of UP-owned cars on their properties. The longer the dwell, the higher the replacement cost component of the rate, and the higher the rate. Hang onto

the car too long and you lose your competitive advantage. I'm sure Whited and company are paying close attention.

There's an interesting email thread making the rounds on the topic of railroad managers' understanding of customer supply chain requirements and how the railroads' inability to be consistent and reliable works against them. Here's why: Let's say I am the traffic manager at a manufacturing facility that regularly ships to a specific location. My customer calls for a consistent 3.3 cars a day or 83 per month.

But… I can only depend on my serving railroad to get the the cars I need 75% of the time. Right off the bat I have to order 110 cars to get the 83 I need (83/.75). Then I have to contend with the fact that on-time delivery at my customer only averages 84%, so I have a one in six chance of a stock-out, or one day in a six-day work week. As a result, my customer keeps three or four loads on hand as back up inventory. Thus I have to generate 86 loads, not 83, and my car order jumps to 115 cars (86/.75 = 115 cars).

Cars in this lane pass through two intermediate classification yards which between them have a connection failure rate of 1.5 in six cars. This failure rate means I have to order another 5 cars (the 1.5 failure rate times 3.3 cars a day load factor). Transit time is nominally four days so four days of transit times 3.3 cars a day yields 13 cars of inventory in transit routinely. Add it all up and I have 8-9 cars of back up inventory plus 13 cars of in transit inventory, or about 21 to 22 cars of inventory for rail.

That ain't cheap. If my product is dimensional lumber, and I get 100,000 board-feet in a car, my inventory cost at $400 per MBF is $40,000 per car. The nine extra cars I have to add to accommodate railroad operational foibles cost me $360,000 of inventory that nobody can get at.

Worse, out-of-pocket costs for the freight bill on the 8-9 extra loads of back-up inventory *per month,* some 100 cars a year, are a heavy hit. At $2,000 per car, my annual freight bill goes up $200,000 — which, on top of the aggravation of service foibles, makes using the railroad unattractive, to say the least. Better I call my neighborhood trucker.

Does anybody get it? One of our corresponders thinks not. Over his four decades of railroading he says he has met very few market managers who could understand this example. Says he, "To do so requires a knowledge of economics, inventory control, production processes (the railroad is a service industry and not a production environment), and most of all railroading/car movements. Alas, all the turnover in rail marketing departments will only make it worse."

My friend closes with, "The other part of the equation is that the car routings and consistency of operation is the bailiwick of the operating department. Customer logistics is not their concern nor are they reflected in operating metrics."

OmniTRAX continues its supply-chain focus with the appointment of Pierre-Luc Mathieu as president of OmniTRAX Energy Solutions (OES). It's a timely move because OES manages the whole company's offerings to the proppant supply chain, including transload terminals and carload terminals in several basins, and Arrows Up for containerized proppant delivery and storage.

Reporting directly to Mathieu are John Allegretti, CEO of Arrows Up, the frac sand container company; Justin Renfro, Senior Vice President of Business Development for OES; and James Samuelsen, Director of Corporate Development for OES. The company said it expects the full OES team will grow to more than 200 by the end of 2017.

Says Mathieu, "There are significant opportunities in the energy market right now, especially in the supply chain and logistics area where every stakeholder is looking to increase productivity and lower costs. OES will help customers improve performance by providing comprehensive solutions to move proppant and other materials from origin to well head efficiently."

Prior to OmniTRAX, Mathieu spent nine years in various executive roles at Brambles Limited and held several strategy and manufacturing roles with Le Groupe Michelin in Canada and the U.S. He received an MBA from INSEAD, the European Institute of Business Administration, in France and a BS in Engineering from Ecole Polytechnique in Montreal. At OmniTRAX, he previously served as Chief Strategy Officer for OmniTRAX with responsibility for strategy development, service expansion, new market entry and corporate development. He will continue to report to OmniTRAX CEO Kevin Shuba.

RailTrends 2017 will feature a definite trade focus as we're looking at an early-2018 timetable for completion of NAFTA negotiations. Speakers include Michael Bourque, President and Chief Executive Officer, Railway Association of Canada (RAC); Alfredo Casar, the President and CEO of Ferromex, which is not only deeply involved in the NAFTA battle, but 26% owned by Union Pacific; Jim Hertwig, CEO of the Florida East Coast Railway, now owned by Ferromex; and Jeff Songer, COO of KCS, Ferromex' main rival in Mexico.

The Railroad Week in Review, a compendium of railroad industry news, analysis and comment, is sent as a PDF via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 million annual revenues $150. Corporate subscriptions $550 per year. To subscribe, click on the Week in Review tab at www.rblanchard.com. ***© 2017 The Blanchard Company***