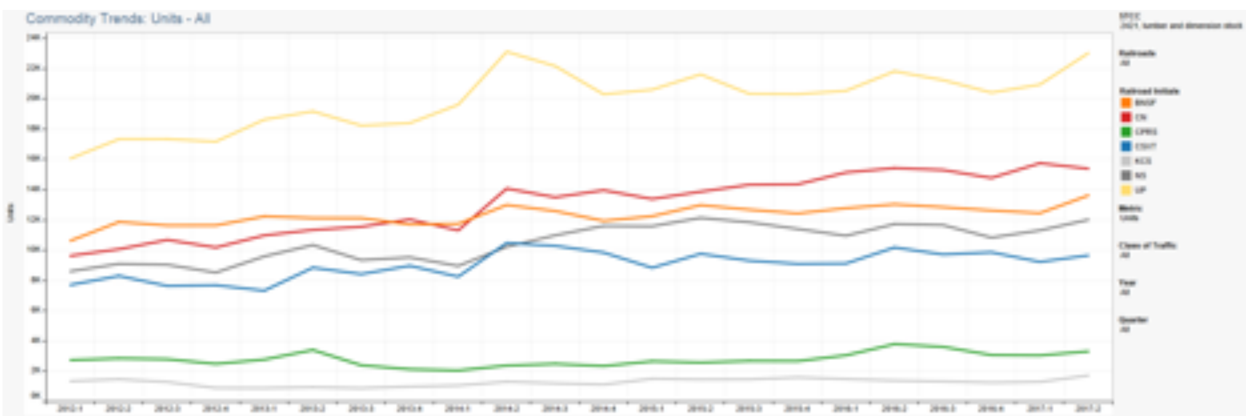
RAILROAD WEEK IN REVIEW

November 17, 2017

"Business fixed investment is showing no sign of sustained pickup, though share prices are up, driven by stock buybacks using borrowed money and encouraged by earnings reports increasingly generated by manipulative non-GAAP accounting." — Harald Malmgren

A recent UBS note on "Homebuilding — Implications for the For-Sale Market from the Single-Family Rental Market" makes it clear that for-rental builders will go where the opportunities to rent are favorable as well as where there exists a market for houses they want to sell out of the rental market. The note speaks to affordability, the value in new homes, and the difficult mortgage environment. Strong and weak markets are named.

As for the impact on railroads, Dan Keen's AAR *Rail Time Indicators* for Nov 3 tells us that "Combined U.S. and Canadian carloads of lumber and wood products rose 2.7% (707 carloads) in October 2017 over October 2016 [and] there's been very little change in year-over-year lumber carloads for several years. Year-to-date carloads of lumber and wood products in 2017 through October were down 0.3%, or 876 carloads year-over-year."



In the U.S. alone, the commodity trends for STCC 24 211, dimensional lumber, show UP in the lead by far in both sheer volumes and steepness of growth curve (CN and CP charts are for U.S. operations only — Wisconsin Central, Grand Trunk, D&H etc.) with KCS and CP lagging. BNSF, NS, and CSX follow CN.

My initial speculation was that UP does so well because UP has both PNW lumber origins and has good coverage in Pacific and southwest lumber destinations. NS and CSX gains could well be supported by housing trends in the east. The market breakdowns by origin and destination from usrailintelligence.com confirm those observations and more.

The markets in northeast (Boston to Chicago and down to Richmond), the southeast (Charlotte to Miami and west to Memphis), and the West (Seattle to Little Rock including all of Texas and Oklahoma) have the most incoming lumber. The UP has superior coverage of the western destinations; CSX and NS dominate the east.

As for origins, British Columbia and the PNW dominate. That explains why UP and BNSF have the most local and forwarded lumber carloads and why CSX and NS have the most received. You have a choice of break-outs — see header, top left: All, Received, Forwarded. Knowing where your connecting Class I focus falls in your pricing discussions can be useful: inbound PNW lumber carries more weight than southern yellow pine for NS and CSX; UP is big in all three.

My comments on the GWR Investor Day (WIR Nov 10) went mostly to Lessons Learned that other short lines may be able to adapt. But I think there's another important aspect, to wit, how what GWR is up to is likely to affect North American results going forward. Tony Hatch writes,

> M&A Strategy appears to have changed, slightly. First of all, annual expected spend looks to be in the $300mm range, down 25% from the recent historical average, excluding the larger international deals, and at ever-increasing multiples that GWR remains correctly conservative in assessing).
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> The latest 5-Year Plan anticipates EPS CAGR of 15-20% which would restore GWR to the top of he railway leaderboard. That would be driven by revenue growth, ex-major M&A, of roughly 5-10%. Free cash flow would be generated around the historical rate of 140% of net.
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> North America should return to growth next year. GWR, being devoid of intermodal, automotive, frac sand and export coal, while heavier on grain and domestic coal, was not a good fit with with the Class I 2017 YTD rail pattern. Class I comparable carloads are up 4% YTD, GWR just above flat. However, even though truck competition is about 20% of the NA base (boxcar paper, etc.), carloads are expected to grow some 2-2.5% over the next five years, roughly in line with Class I merch carload expectations.

To which John Larkin adds,

> With few large-scale US-based families of regional railroads remaining in private hands (Watco and OmniTRAX are exceptions), traditional North American M&A has been difficult. Network rationalization efforts in the Class Is and potential M&A activity could, however, reinvigorate this core market growth opportunity.
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> The historical North American sweet spot has been approximately $100 million to $200 million per year. "Mega deals" are not assumed, but are typically seen every two years. Really only a small portfolio of deals are needed to fit this folio of targets, which is far smaller than the totality of the broader market.

Free cash flow generation averages 140% of book income, with two strong drivers being annual sustaining capex below D&A and favorable tax attributes (cash taxes < book taxes). The short line tax credit benefit is held as upside and not assumed to be guaranteed.

Don Phillips writes (Dec 2017 *Trains*) that non-coal carloads continue to grow in number, thanks especially to chemicals, oil, grain, and frac sand, and intermodal "is now the railroads' cash cow." He also quotes AAR President Ed Hamberger who says, "We have to attract and retain bright, new talent at a time when not everyone appreciates that we are no longer your grandfather's rail system."

Building on a generally positive outlook, Don quotes our mutual friend Tony Hatch, who cites the railroads' "remarkable resiliency and more flexibility than credited by most observers." Rather than focus on the coal-driven bad times, we must shift our view to "the opportunities of the future, how well the rails are actually doing now, and their excellent financial condition."

Don then quotes yours truly on how Class Is are missing new revenue opportunities by not listening to their short lines. "Railroads lose share because the focus is more on ways to speed up old processes through technology than to make the railroads better supply-chain enhancers." At this point I had to give Don some examples of what shapes my view. Without naming any names:

** A steel fabricator can't get cars to send finished goods to his customers. Meanwhile, the very cars he needs are languishing in a shortline storage yard because they have shortline marks, not the marks of the Class I serving my client.

** A short line with tons of scrap rail for a steel mill on another short line a few hundred miles away can't get cars from the intermediate Class I, and that Class I won't move empties owned by the receiving short line unless they can collect "freight cars on own wheels" tariff rates.

** Members of a state lumber association told a short line guy they didn't know the freight railroads were still in business. The connecting Class I refuses to make a call.

** A short line lumber receiver buys his lumber through a national chain. But the national chain has no Class I coverage. When asked why not, the Class I says they're not staffed to call on that commodity group in the customer HQ city. (Betcha he starts making his own calls.)

The list goes on, but Tony is right to say the Class Is are in excellent financial condition. ORs keep coming down, same-store RPUs keep going up, and per-share earnings are up. But, to my point, where is the measure of *new* business to replace what's been lost? Sadly missing, I fear.

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