RAILROAD WEEK IN REVIEW

August 17, 2018

"*GWR North America carloads were up five percent in Q2, which was the fastest growth Genesee has seen since 2011. The growth was broad-based and their industrial development pipeline is a positive leading indicator" — Allison Landry, Credit-Suisse*

"When a company gets financialized, the owner is replaced with a management team, and the management team's job is to get this thing prepped for float on the stock exchange, which is how they're going to make money. — Simon Mikhailovich, on RealVision.com,

Genesee & Wyoming North American revenue units for July were up 12 percent year-over-year, with about the same mix dominating. Once again, bulk commodities from ag products and aggregates to coal and lumber comprise 80 percent of GWR total units. Year-to-date revenue units are up seven percent and July loads are four percent ahead of June's.

The metals group jumped by nearly 50 percent system wide, thanks to more finished steel goods and scrap steel. Utilities, exports, and overhead moves pushed coal tonnage up nine percent. The non-metallic minerals group was up ten percent, ag products increased 11 percent, and "Other" carloads increased 60 percent, mainly on empty overhead moves in all regions. Few of the top commodities by volume, paper excepted, are boxcar moves.

By comparison, AAR June revenue units (July isn't out yet) were up four percent with intermodal the big gainer. Carloads including coal and auto increased just one percent. Among the carload volume leaders, grain, STCC 28 chemicals, metal products, and aggregates were the leaders — not particularly strong boxcar users. The key take-away here is the shortline group is adding cars faster than the Class Is, and, were it not for non-Class I carriers, the larger roads would be down in merch carloads.

By way of review, GWR's North American regions serve 41 U.S. states and four Canadian provinces with 115 short line and regional freight railroads operating over more than 13,000 route-miles. A large measure of its success comes from what I call its "contiguous railroad" model, meaning it operates clusters of roads in geographic regions where every regional railroad connects physically with every other railroad in that region, with a few exceptions.

That means they can concentrate on an owned fleet of EMD units; they can work several railroads with one set of track and mechanical resources; and they don't have to rely on the kindness of strangers to get power and equipment from one property to the next. They have the resources and skills to do ISS settlement where it fits, and where it doesn't, can rely on a handful of individuals to make the handling line or switch carrier arrangements. It's a model worth replicating wherever possible in the shortline business.

The USDA has upped its forecasts for the 2018-19 crop year, saying that total corn, wheat, and bean production could increase two percent following two years of declines. The USDA also raised its export estimates by almost four percent and now forecasts flattish overall grain exports — any larger increase in wheat being offset by lower forecasts for corn and beans. Wolfe's Scott Group says UP and KCS have the most grain/ag exposure among the U.S. rails at some 17 percent of revenue (CSX and NS are closer to ten percent).

More grain being grown requires more fertilizer. With the supply environment for phosphate fertilizers tightening, we must also look at how the demand will likely play out. According to a chart in the recent Mosaic investors' conference handouts, demand could reach 70 million tons in 2019, up eight percent from the 65 million tons shipped in 2015.

In like manner, potash demand expected to rise to as much a 68 million metric tons in 2019, up 10 percent from 62 million tons in 2015. The supply and demand are expected to remain balanced, which might mean that the market oversupply has been worked out. Given these factors, potash prices might see upward momentum.

For nitrogen fertilizer investors, energy cost is one of the most important considerations because it can account for 60–70 percent of the raw materials expense. Companies located in the United States have an advantage compared to companies outside the United States. During the second-quarter earnings call, CF Industries said, "Increased energy costs, particularly for producers in Europe and China, have raised and flattened the upper half of the global cost curve, necessitating higher nitrogen prices."

The question now becomes whether North American railroads can make hay while this sun shines. QCS data for STCC 281 fertilizer carloads show no particular trend up or down over the past four years. The tariffs are taking a bite out of export grain moves, and farms are cutting back on purchases from tractors to storage bins to NPK.

Moreover, other countries are looking to increase their share of the global market (WIR August 3) for both grains and ferts, so the bottom-line impact on railroad volumes is yet to be determined. What a great time to go have a chat with your farm-supply customers.

I quote Mikailovich above because I worry when railroads stop being owned and run by railroaders. By "financialized," he means there is a shift of focus from running the core business to generating maximum financial returns for the institutional shareholders. The Cult of the Operating Ratio, which I wrote about here August 3, is one manifestation..

Once the newly-acquired company is floated (his term) on the markets, management's main objective is to juice up the stock price, because that's how they get compensated. How different that is from the operating owner whose main objective is to survive and prosper by being there. (Like Woody Allen said, 80 percent of success in life is showing up.) So an entrepreneur's job — a business owner's job — is not to be separated from his company.

On the other hand, the financial manager's incentive is completely different. He doesn't have three generations invested into this factory. He needs to make his stock options work over the next three to five years. The ownership of business becomes financialized and you end up with a company that's run by people who are interested in the next 24 months. The former operating-owner who used to have something that was robust and potentially multi-generational becomes a speculator.

The cult of the operating ratio can turn every Class I railroad but one, BNSF, into a "financialized" company. Head-counts are drastically reduced, locos are parked, low-yield commodities are shunned, and share buy-backs get precedence over capex. Market managers are managed more by their markets than the other way around, losing their original role of creating customers. This is not a promising trend and it leads straight to more business on the highway.

Gary Marino is back in business. His new holding company, International Rail Partners, has acquired the old IC Memphis-Canton Line, operating until recently under Ed Ellis' Iowa Pacific brand as the Grenada Railroad, under a lease-purchase agreement with the North Central Mississippi Regional Railroad Authority.

The Marino group turned the first wheel two weeks ago. This is Marino's first acquisition under the IRP banner, and it's his third iteration as a shortline holding company, having started, run, and sold RailAmerica and after that Patriot Rail. The railroad is 212 miles long and does about 10,000 cars a year, though the southernmost 81 miles has been closed since 2012. IRP and the regional railroad authority plan to reopen that segment.

Grenada got its start in 2015 when the Authority bought the line for $43 million from scrapper A&K Materials. The Authority put in $30 million from a State of Mississippi bond issue and Iowa Pacific provided $13 million with an agreement to make lease payments that cover the state bond payments. The franchise moves commodities such as forest products, plastics, petroleum products, flour and grain. The only Class I interchange is with CN at Southaven, just south of Memphis.

The 10,000 car traffic base, mostly low-rated commodities, on 131 active miles of railroad is pretty thin gruel — 76 cars a miles a mile where the Rule of 100 suggests 13,100 cars on this mileage. But then, Marino over the years has demonstrated a knack for turning around weak properties. Let's see how he does in Ole Miss.