RAILROAD WEEK IN REVIEW

December 6, 2019

"The USDA Crop Progress Report shows that Illinois and Iowa, the two-largest corn producing states, have 12% and 14% respectively of their corn still on the field. North Dakota has finished harvesting only 30% of its crop. South Dakota has 68% of its corn off the field, compared with a 96% five-year average. Michigan and Wisconsin farmers are only halfway done with corn picking, almost all the crop is coming out of the field wet to very wet. The point is that there is a lot of grain drying left to go and supplies are tight." — PFL Railcar Report, December 2

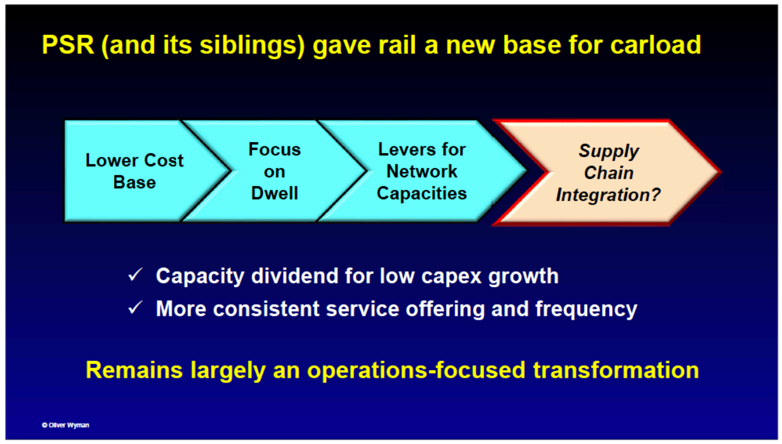
"Carload commodities sustain the broader railroad network capillaries needed to capture new traffic. Carload has the largest opportunity for new growth in coordination with supply chain partners. The railroads are entering a period of softening demand for commodities by the carload." — Rod Case, Partner, Oliver Wyman Group, RailTrends 2019

The PFL report above must be very worrying for non-Class I railroads in these states, many with a granger-road heritage. They could be hit harder than the Class Is, where shortages here are offset by surpluses there. To begin, AAR industry-wide grain is down two percent. The Dakotas and Wisconsin are BNSF and CP strongholds and BNSF grain is down five percent quarter-to-date. CP is up two percent in Q4 to date -- largely, I suspect, because more normal flows in the Canadian grain belt offset losses in the US. CSX dominates Michigan, and its grain is up a point.

That said, I would suggest shortlines in these states stay close to their grain merchant customers and start lining up car commitments for dryer weather in the fields and shortages in the destination markets. I have no doubt that when the grain is ready to move to market, covered hoppers will be in great demand.

I seem to recall BNSF some years ago had a program whereby customers could buy options to have a fixed number of empty grain cars available over a certain period of time. Like options on the stock exchange, these options could be bought and sold as options holders refined their needs. So if Dealer X has an option for 1,000 cars and now sees a need for 800, he could sell the former and buy an option for the latter. The car owner benefits because his fleet is fully engaged; the car user benefits by knowing he'll have the cars when he needs them.

Rod Case argues that the carload commodity business is the canary in the railroads' coal mine. He says the precision scheduled railroad model ought to give new life to the carload sector for three reasons: PSR creates a lower unit cost base; adds capacity to the network by, among other things, reducing yard dwell hours; and offers more consistent frequency and reliability.



These are highly marketable features, yet the transformation to PSR remains obsessively operations-focused. Pity. I don't see the railroads out touting the supply chain benefits to the very customers who could fill the newly-created capacity.

Fact is, the lack of a supply-chain focus has contributed to the three point drop in non-coal carloads thus far in 2019 and a five point drop in the last few months. In other words, the rate of decline is accelerating.

Case says the need to innovate is critical because the assets already are in place, and that these assets are rarely used enough to make replacement economical. On the other hand, railroads could become true customer supply chain collaborators without adding to the asset base.

The need is there. DOT studies predict the net ton-mile demand for merchandise truck transportation services will increase over the next 25 years at a three percent CAGR — a doubling of volume — and barely move the needle for railroad merchandise carload volumes. And it's not just metals, aggregates and forest products, either. Even grain, with its ten percent share of total railroad ton-miles (2017) and 280,000 cars in grain service, will not be immune to the diversion from railroad to truck.

Case shows how the railroad share of grain tonnage can decline to 56 percent of ton-miles from the present 68 percent — a one percent per year negative CAGR. [*Add to that the weather variables cited in the PFL report and the outlook is seven scarier. — rhb*] It need not go negative IF railroads can get more than ten turns a year out of a car, manage the system to make ten-car blocks feasible, and match supply to demand at the destination — more supply chain friendly.

Now that the railroads understand the principles of precision railroading better, it's time for the commercial side of the house to make railroads easier to work with. Customers need to see the move end-to-end, not just to the end of the originating carrier for interline moves. Sales reps must know shipper *and receiver* inventory carrying costs and how they affect what a customer will pay for the transportation product. And ops has to be able to create the product that meets customer process needs in the batch process that is the railroad.

Case concludes, "Growth will come from more competitive supply chain offerings." And I couldn't agree more.

Union Pacific Chief Commercial Officer Kenny Rocker told the RailTrends 2019 crowd that trip plan compliance was running at 70 percent (WIR Nov 22). He also remarked that making the carload product less complex and more consistent will improve "the customer experience" and facilitate opening new merch carload markets.

Now comes UP President and CEO Lance Fritz to the Credit Suisse 7th Annual Industrial Conference to enlarge on Kenny's key points. Trip plan compliance in November hit 76 percent — a six-point improvement — with dwell, car-miles per day and system core train speed all improved. With respect to the last, I recall a factoid from some years ago that a one mph gain in UP system train speed meant using 250 fewer locomotive units to do the same work.

Another benefit of higher train speeds is locomotive productivity as measured in GTMs per available horsepower day. UP's 2019 third quarter marked an 18 percent improvement year-over-year and November was a 13 percent improvement on October. This particular shoe fits short lines very well: they know how many locomotives are in service and how many GTMs they move in a day. Increasing mean time between failures increases available horsepower days and helps right-size the fleet. Moreover, increasing GTMs per available horsepower day improves car-miles per day and improves what Rocker calls "the customer experience."

I worry about the way share prices keep growing at a faster rate than earnings per share, even after repos. Schwab's Liz Ann Sonders, talking on Schwab Live Daily last Tuesday, said she's seeing "PE creep" as result of share prices going up faster than earnings. She confirms my old rule of thumb that long-term PEs have been in the 15x range and notes that even as earnings have slowed, the S&P 500 keeps making new highs, boosting PEs in the process.

Take CSX. The company reported $2.00 a share for the full 2015 year and a share cost $25.95 for a PE of 13.0. The full year 2019 estimate is for $4.20 with a year end closing price of $72 for a 16.8 PE ratio. At this rate, earnings increase110 percent and share prices increase 171 percent. The PE will jump to 16.8, up nearly four points.

I'm at a loss to explain why. Revenue units are going up at two percent a year, if that. So financial engineering — share buy-backs, earnings ißncreases against little change operating expense, all amidst a generally moribund economic outlook — is my only explanation for the bracket creep.