THE RAILROAD WEEK IN REVIEW

July 3, 2015

"US steel production is down some seven percent year-over-year, implying weak domestic met coal demand." — UBS Morning Meeting, July 2

Railroad industry share prices are in a deep funk. The classic Bear Market definition is down 20 percent from the 52-week high. The chart below shows the rails clearly in a Bear Market (I'm using Berkshire-B as a proxy for BNSF). On the other hand, if you're taking the longer view, and have been in any of these names for five-plus years, you're not too bad off.

Ticker	Price	52-wk hi	Chg	6/30/2010	Chg	Recognia
Railroads				Split-adj		
CP	$ 160.66	$ 220.20	-27.0%	$ 50.13	339.3%	0/3
KSU	$ 91.26	$ 126.49	-27.9%	$ 35.09	260.5%	0/4
CNI	$ 57.87	$ 75.92	-23.8%	$ 26.44	187.1%	0/4
GWR	$ 76.85	$ 105.70	-27.3%	$ 37.31	183.3%	0/6
CSX	$ 32.87	$ 37.99	-13.5%	$ 14.84	156.0%	0/4
NSC	$ 87.67	$ 117.64	-25.5%	$ 46.61	152.4%	0/4
BRK-B	$ 137.54	$ 152.94	-10.1%	$ 79.69	91.9%	0/3
UNP	$ 94.53	$ 124.52	-24.1%	$ 69.51	79.1%	0/3
PWX	$ 17.34	$ 20.20	-14.2%	$ 12.17	66.0%	0/3
Average Chg			-21.5%		168.4%	
Suppliers						
ARII	$ 48.66	$ 82.82	-41.2%	$ 11.22	638.1%	2/1
GBX	$ 46.84	$ 78.32	-40.2%	$ 11.09	606.2%	0/3
TRN	$ 26.30	$ 50.77	-48.2%	$ 8.32	510.2%	0/2
WAB	$ 94.86	$ 105.10	-9.7%	$ 19.75	432.2%	0/1
GMT	$ 53.17	$ 68.45	-22.3%	$ 23.26	194.3%	0/2
KOP	$ 24.53	$ 39.88	-38.5%	$ 19.93	100.1%	0/4
RAIL	$ 20.87	$ 37.48	-44.3%	$ 21.76	72.2%	1/4
FSTR	$ 34.61	$ 39.88	-13.2%	$ 25.56	56.0%	0/3
Average Chg			-32.2%		326.2%	
	CY 2014	**CY 2009**	**Chg**			
US RTMs (bn)	1,851	1,532	20.8%			
Source: Market data, AAR for RTMs						

So do you sell some short-term shares and take the tax loss or hang on for the longer term? I use the Recognia tech service thru Charles Schwab to gauge future performance based on current trading patterns. They break trading patterns (SMA 200 cross, Head-and-Shoulders, etc) into short, medium and long term so you can see the market perception for a given time frame. I tend to use the long term (nine months or more) for rails. The number in the Recognia column represents bullish/bearish technical indicators — 0/3 means no bullish and 3 bearish indicators -- for the longest time frame.

As you can see, the tech tea leaves do not look kindly on railroads or their suppliers. The Wall Street Analyst consensus seems to be that share prices will do better in the second half of 2015 and better still in 2016. Yet the Recognia trends don't support this outlook. On the other hand, they seem to support the theme of continued slow (~2%) growth in vols and middling price increases for the rails.

Speaking of which, there's been some discussion of whether rail share price gains have come from pricing and share buy-backs or on volume growth or a mix. The AAR says RTMs 2009-2014 grew 21 percent over the five years, which implies pricing has had a big impact on ops income and EPS. Why else would share prices be up so much more than volume gains?

Merchandise carload trends are particularly worrisome. Week 25 (ending June 27) Class I carloads ex-intermodal, auto and coal, are down three percent; total units are essentially flat. Intermodal is the only real grower, but it won't cover the losses elsewhere.

AAR Class Is	US Rails			
Commodity	**YTD 2015**	**YTD 2014**	**Delta**	**Pct Tot**
Total Units	17,667,389	17,685,056	(0.10%)	100.00%
Intermodal	8,383,041	8,106,401	3.30%	47.45%
All Carloads	9,284,348	9,578,656	(3.07%)	52.55%
Coal	1,090,196	1,189,404	(9.10%)	6.17%
Auto	672,010	660,586	1.70%	3.80%
Net	7,522,142	7,728,666	(2.67%)	42.58%
Source: AAR				

I'm only saying intermodal can't do it alone and a lot of the core carload biz is at risk. Most STCC 26 is toast. STCC 24 depends on housing starts, with some regions stronger than others. STCC 28 industrial chems and ferts will be OK; STCC 29 NGLs a mixed bag. STCC 13 crude has too many variables to call. STCC 32 metals for autos, drill pipe, rebar also iffy, especially given growing imports (Union Pacific is buying 480-foot welded rail sections from Japan, e.g.). Municipal solid waste will hold but C&D waste depends on construction — no construction, no need to demolish. And STCC 01 grains are too weather-dependent to be predictable.

The whole carload model needs a re-think. Jim McClellan, retired planning SVP for NS, says we need to take the long view. He writes that, as a survivor of Penn Central, he knows how long it can take to fundamentally change a business. The rapid decline of coal, among other things, dictates the need for another era of fundamental change.

In comparison with the seventies, it is a different world. The state of the infrastructure is excellent to superb. Wall Street is pushing management to perform, perhaps too hard. But in the old days the attitude was pretty much "You expect me to run trains and make money as well?" Only Brosnan and Perlman understood that the world was changing. Now all CEOs get the message.

We are going to have a North American market which will challenge the the rest of the world and will win. Long-haul ocean shipping will be replaced with (at least around the edges) either long-haul rail or short-haul truck (parts plants close to assembly plants, not 7,000 miles away, for example).

Moreover, as an (aging) society we seem unwilling to invest in highways. Just get me to my doctor without potholes. And the Millennials are moving away from cars as a necessity. Better to walk to the most recent "hot" bar scene. Not a chance that the highway infrastructure is going to be substantially improved (as it was with the Interstate System, which doomed a lot of the then rail markets).

And so we need to learn to live with it and adjust or die (things do die — think Kodak). My sense is that the current rail management, goaded by Wall Street, will rise to the challenge. There are all sorts of ways to make the system run better but folks have gotten complacent. Maybe the current decline in stock prices will force rail management to think outside the box.

Look, I know how hard it is to change. The NS, at the time of consolidation, got half of its operating profits from coal. A few folks thought that was a bad place to be but it took some strong, visionary leadership (think McKinnon and Goode) to change the culture. Now, over half of the NS units come from intermodal (highest percentage of any railroad).

So change is possible — indeed it is imperative. But unlike the sixties and seventies, the rails are starting with good infrastructure and strong balance sheets. Without those, as I learned at the NYC, even the brightest and most progressive managements (that would be Perlman and Kennifick at the time) could not overcome a deteriorating market place. So stay tuned. Good news will come sooner than you think.