THE RAILROAD WEEK IN REVIEW

August 21, 2015

"The Dow Jones Railroad Index is down more than one fifth this year, on track for its biggest annual decline since its inception in 2000 and its first loss in seven years." — Reuters

Railroad and railroad supplier shares are all in "bear market territory," i.e, sporting declines of 20 percent or more off their highs. That's past the "correction" stage — any decline short of the 20-percent mark. Reuters continues, "Relentless declines in commodities — particularly oil and coal — have taken their toll" in share prices.

Looking at the 52-week highs, CP and NS have taken the biggest hits, down 34 and 32 percent respectively; least scathed is CN, off a mere 24 percent. KCS escapes with a 25 percent hit; CSX is off 25 percent; UP slips 28 percent; GWR is dinged for 30 percent. (BNSF escapes these share-price comps by being privately held, though parent BRK/B is down 10 percent.)

Tony Hatch, in his Annual Letter for the National Railroad Construction & Maintenance Association (NRC), correctly notes that the railroad sector has outperformed not only the broader markets but also the related transport markets *this century*, yet 2015 thus far "has brought more uncertainty than any year in recent rail history. Ambiguity begets insecurity and that word is an anathema to the financial community, one of the larger stakeholders in the railroad renaissance." And insecurity brings share prices down.

Tony cites an unprecedented level of change, overseen by a large cadre of senior managers who are relatively new to the C-Level slots. Here's his bucket list of concerns for the major freight rails, and, by extension, their regional networks of non-Class I feeder lines:

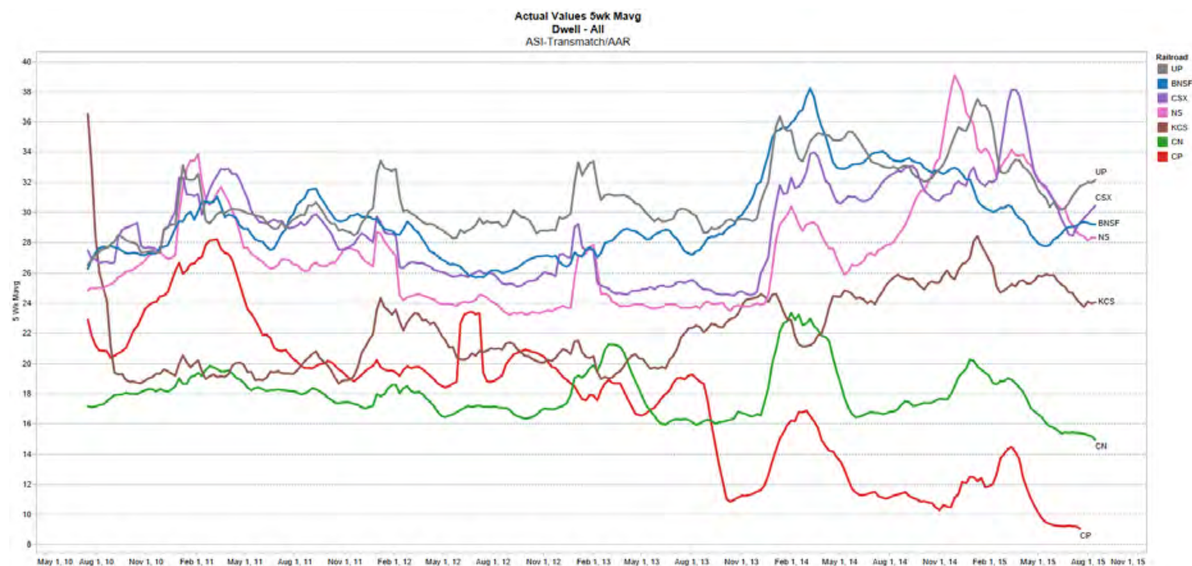
- Service recovery is critical (for share, productivity, retaining regulatory freedom, etc);
- Coal has yet to stabilize, even if it is showing signs it is still likely to be 30 percent of the utility fuel source in 2030; this was its second big surprise downward "adjustment" this decade. The brave new world will be of lighter tonnage and comes with long-term change potential, some perceived as good for railroad finances (reduced MOW capex, e.g.) but others seen to be bad, "stranded assets," for example;
- Crude-by-rail and frac sand haven't turned out to be the volume replacement for coal. The rails will retain an important role but the global pricing story highlights the unpredictable nature of the oil business;
- Grain remains unpredictable, joining crude in creating nightmares for demand planners, even if global populations and income growth fuel the need for protein at the same time as arable land amounts shrink;
- The commodity super-cycle and the China gold rush come to an end;
- The nature of the current cyclical status is unclear - where are we in the auto cycle? Housing? Steel?

- Intermodal remains the growth hope of the industry - but questions remain on the rails and their…
    - Service capability as length of haul (LOH) shrinks in the domestic segment
    - Changing and unpredictable international trade flows (the Panama canal, for example, dockside labor, big ships/irregular schedules, near-sourcing, etc., etc....)
- Doubts remain about intermodal pricing, margins, OR impact and ROI

Tony's not alone in his views. An informal e-mail thread with a number of my contacts who are former Class I officers, current and former short line owners, and the Usual Suspects of pundits and observers, also notes the newness of many field managers and the loss of institutional knowledge of How Things Work. One discussion has to do with running to plan to make sure the assets are where they need to be for the next day.

Another has to do with whether operating ratio declines are a function of higher rates or running a better railroad. Sample: "This creates an interesting conundrum: Rails raise rates faster than expenses go up, because they can. Ops expense cuts cut into ops performance. Poor service delivery hurts the time-value proposition. Biz goes away, ops expense drops but not as fast as revs, and ORs start creeping up gain." WIR comments invited.

And while we're on the subject of service, Fred Frailey writes in *Trains*, "My definition of customer service is simple: Doing what you say you will do when you say you will do it. Shortline and regional railroads are good at this, and the big railroads ought to be good because they have the money and the tools."



But the Class Is aren't doing it, irrespective of money and tools. Doing what you say you're going to do does not mean holding cars in yards for days. Drew Robertson's latest chart (above and enlarged on Page 4) from ASI/Transmatch shows a 5-week moving average of dwell times for all the Class I roads. The Canadians are doing very well, but seeing the Big Four US Class Is mired in the 28-32 hour range is disconcerting, to say the least.

On every earnings call, we hear the same mantra: get more car-miles per day; increase rates to cover car replacement cost; move more trains out of class yards according to plan. Yet every week Drew's charts show cars spending on average a day or more in class yards. Merchandise carloads not in unit trains typically hit two-five class yards between release and place, which means a trucker can deliver the goods in fewer days than the cars are in yards. Not a good way to gain competitive advantage.

Needed are senior management teams setting clear performance goals for their field managers and then making sure the latter have the tools to meet those goals. Take a ride on an office car and have the roadmaster or trainmaster along to tell you what you're seeing and why you're seeing it. Ask questions: Why is this symbol freight being held out? When was the last time that bridge was painted? What are crews' instructions for roll-by inspections? You may find the man in the hot seat has a boss who's not up to the task. It's up to you to take corrective action.

The ASLRRA wants to showcase shortline initiatives to stem the decline in carload commodity moves. This week's *Views & News*, the ASLRRA newsletter, asks member railroads to highlight steps they are taking to reverse these trends. Consider: GE Transportation's *RailConnect Index of Short Line Traffic* shows 2015 carloads through August 9 down five percent or a quarter of a million loads from the same 2014 period. There are double-digit percentage losses in coal, ores, waste materials, and metals. Lesser losses occur in grain, aggregates, lumber and petroleum products. And most of it is in single-carload lots.

Says the ASLRRA, "The information we provide will help our industry confront a challenge that has the potential to be a real game-changer for short lines and Class Is alike. We welcome your ideas for best practices and strategies for reversing this decline."

Step one ought to be getting the trip plan for every load released to a Class I and watching trip plan performance like a hawk. Two benefits occur: you become an advocate for your customer and you give notice to the Class I that by putting your customers at risk they put your cash flow at risk, and that's hardly what one would call being a "partner." Kudos to the ASLRRA for opening this can of worms.

[Reminder: enlarged ASI-Transmatch chart is on Page 4]

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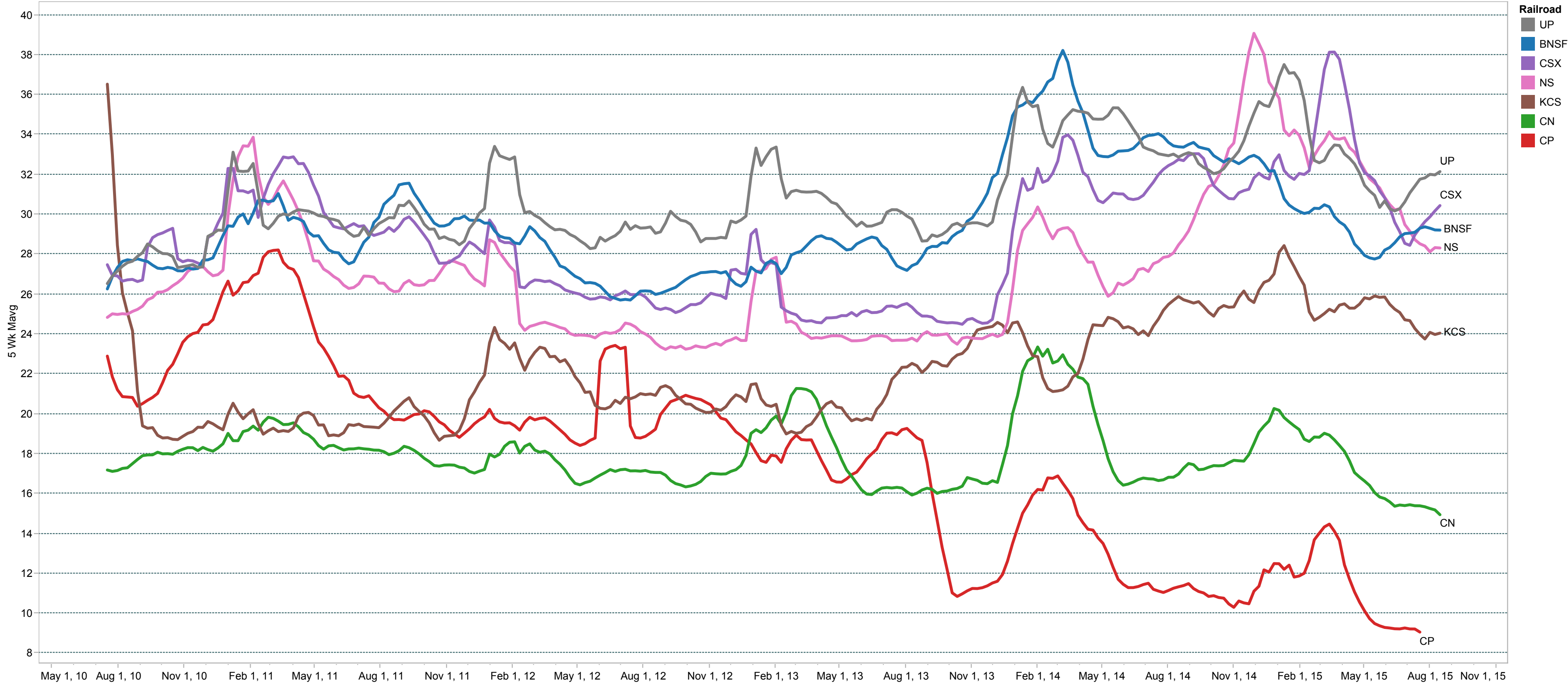
Actual Values 5wk Mavg
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