THE RAILROAD WEEK IN REVIEW
October 23, 2015

"The best way to determine the future is to invent it, but then innovate and, most importantly, implement it." -- Jack Rivkin, Altegris Investments

The Northeast Association of Rail Shippers (NEARS) held its annual fall conference in Philadelphia recently and attracted nearly 300 souls representing railroads of all sizes, railroad suppliers from leasing companies to car-makers, and shippers from steel to cement. Speakers from all these disciplines wowed this record audience with the latest on What's Happening Now, how to cope with the inevitable changes, and where to go from here.

CSX President Clarence Gooden was the Keynote Speaker and set the stage beautifully. He charged his listeners three ways. First, let your Congress-critters know what's at stake if there is no PTC extension: all Class I roads will stop taking hazmats after December 1 to be sure the system is clear by January 1, and there will be no passenger trains allowed after that date. Second, to understand the role of coal in changing the railroad landscape and what the rail industry choices are with seriously diminished coal shipments. And third, how to capitalize on the changes CSX is making to cope with all of the above.

From there we heard from Nucor Steel (the import threat, the role of the railroad in the supply chain), a logistics panel (communication and consistency are critical), a shortline panel (how they provide consistent results by communicating constantly), and two financial speakers. The first, Tony Hatch, did his usual excellent economic overview, and Jason Seidl went the audience participation route. He concludes from his on-stage survey,

> More than half the shippers in the group forecast carloading growth for next year between two and three percent, while a third believed it would reach three percent or more; seven percent felt traffic expectations would be in the one-to-two percent, and no shippers felt growth would fall below those levels. (There were few or no coal shippers participating).
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> Re the national economic growth outlook, nearly the entire audience felt one to two percent would be a good target for GDP in 2016. A quarter of the shippers in the room expected the pace of rate increases to decline, half the balance thought it would stay flat, and the other half predicted it would accelerate.

Several common threads emerged from conversations during the breaks. The railroaders all saw slowdowns in commodity carload shipments. Shippers and third party logistic providers expressed dismay of continuing rail service failures combined with rate increases. And truckers have adequate capacity, so much so that spot-pricing is in the soft side, even with significant driver churn

We also heard Ron Batory, President of the Conrail Shared Assets Operation speak on "The Evolution of Change" at Conrail and how the organization has evolved over the 40 years since the 1976 formation of the original Conrail from the ashes of the Penn Central wreckage. Just since the 1999-2000 split of "Big Conrail" between NS and CSX, Batory's CSAO has increased train-starts 15 percent, added ten percent more crews, and cut T&E hours by 30 percent. The miles operated hasn't changed, yet they're using 37 percent fewer loco units and have cut yard dwell to 19 from 30 hours.

Finally, as a special bonus, the NEARS meeting organizers persuaded Bernard "Bud" Weinstein, Associate Director, Maguire Energy Institute at SMU's Cox School of Business in Dallas, to share his thoughts on how "The New Realities of Fossil Fuel" impact the railroads. I had chance to chat with him over Manhattans the evening before his talk and came away with several tidbits.

One, crude oil users pick sources based on the lowest landed-cost of the crude oil mix they need. Two, the volume changes of crude on rail from none to lots to less is going to be on the less side for the next few years. Three, the present global "supply overhang" has been building for three years and isn't going away. Four, oil prices can still go lower.

The implications for railroad operators and suppliers are significant. As oil/gas replace coal as an energy source, fewer physical carloads of everything from crude oil to steel pipe to cement to sand will required to supply even more BTUs. The global supply overhang is such that the US market is literally a drop in the bucket, and the pipelines *are* coming.

In sum, NEARS offered attendees a menu of change for "Freight Rail Growth in the Mid-Atlantic," and delivered accordingly, as usual. We'll do it again in Baltimore in April and Portland in September and hope you can be there. See *www.nears.org* for further details.

KCS third quarter results were a disappointment. Freight revenue declined seven percent to $607 million on two percent fewer revenue units and a five percent RPU decline. Operating expense was down eight percent, largely on payroll and fuel, generating $220 million in operating income and a respectable 65.2 OR. Below the line, net income after preferred stock dividends was $132 million, down five percent, and eps came down four percent to $1.20 on one percent fewer shares.

Frac sand volume was down 24 percent while crude oil nearly doubled; metals & scrap slipped 10 percent, and grain grew 11 percent. Automotive was off seven percent and forest products slipped four percent. In short, manifest commodity carloads were actually up two percent, with STCC 28 and 29 chemicals and petroleum products, grain, and crude oil providing the offsets to the volume losses elsewhere.

I didn't get to hear the call, but reports from those that did say that auto production in Mexico missed its mark, with car counts down as noted above, and the 2016 outlook not much better.

Alison Landry of Credit Suisse writes, "On top of high expectations heading into the quarter, the company's indication that automotive carload growth would be flat year-over-year in 2016 clearly rattled investors."

It's possible that KCS could lose some market share of the outbound finished vehicle market to so-called "short-sea" shipping: ocean carriers shuttle finished vehicles from the east coast of Mexico to the US mainland. Though rail will likely remain the dominant mode, *Automotive Logistics* magazine quotes Richard Heintzelman, EVP at Wallenius Wilhelmsen Logistics Americas, who says, "Given the uncertainty of rail capacity to meet vehicle production volumes in Mexico, WWL has enhanced its ocean services from Mexico, as well as US Gulf ports."

Last year, the company expanded its Mexico-US service by adding calls from Veracruz and Altamira to Galveston, Texas; Jacksonville, Florida; Brunswick; and Baltimore. Other sources say about five percent of Mexico's vehicle production currently moves by short-sea to the US, but predicts that this share could increase to as much as ten percent by 2016.

Fellow industry observer Chris Rooney writes, "The idea that short-sea has the potential to capture a significant portion of the Mexico-US auto trade is a real eye-opener. The auto makers are all served by logistics intermediaries who shop and construct these deals and get paid to make them work -- it is a very competitive service business."

In point of fact, Chris continues, short-sea captured two-thirds of the finished vehicles coming out of Honda's new Celaya plant at Guanajuato. The plant is nowhere near water, but can send cars to the eastern US through Veracruz or to the west coast via Lazaro Cardenas. An item on seekingalpha.com sums up the KCS outlook thus:

> Since the beginning of the commodities slump in 2014, KCS overall revenue has declined. This also matches up with the rise of the U.S. dollar, which has weakened export revenue, and as was stated earlier, hurt its revenue from operations in Mexico. While operating margins had previously been at decade highs in 2012, margins trended lower since.
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> The macro environment is having an adverse impact on the company's operations, and as long as uncertainty remains in this space, Kansas City Southern is vulnerable. There is little fundamental reason to own Kansas City Southern at present time, and if the U.S economy begins to slow in coming quarters, the rail company could present an attractive short opportunity.

Canadian Pacific reported its highest-ever revenue for a third quarter, C$1.7 billion, a gain of two percent. Operating income leapt 21 percent to C$753 million on a nine percent cut in ops expense, and the operating ratio improved 6.9 points to 59.9, a record Q3 low. However, CP had a $68 million gain on the D&H sale to NS, taken as a credit to operating expense. Excluding the item, non-GAAP ops income was C$685 million, up a mere 10 percent. The operating ratio remains unchanged. GAAP net income sank 19 percent but a nine percent drop in the diluted share count kept earnings per share to a 12 percent slippage.

Revenue units dipped three percent. Grain, fertilizers and sulfur, STCC 28 chems, crude oil, and the metals/minerals group all showed declines, putting total manifest carloads down six percent. Coal picked up five percent, mainly on shipments to the US; international intermodal ticked up two points while domestic boxes came off five percent as short-haul truckers and the soft Canadian economy took their toll.

On the expense side, the total workforce decreased by nine percent (to date, 5,900 heads fewer than when Hunter took the helm). Equipment rents were up as locos leased to another carrier came home, and fuel expense dropped 35 percent on both lower per-gallon cost and GTMs off five percent. GTMs per gallon increased four percent; CP alone among Class Is achieves the Holy Grail of breaking the one gallon per KGTM threshold.

Asked about where more points might come out of the OR, Hunter replied,

> This operating model does an even better job of controlling costs and producing results during soft traffic conditions than when we have a more robust the top line. To be able to produce the sub-60 OR now with a soft a top line shows there are probably two or three more points to pull out as the economy bounces back a little.

Meanwhile, CP announced that its U.S. BLET Union has ratified a multi-year hourly rate agreement (versus the historical precedent of a mileage-based wage system across the Class Is). The current per-mile pay system makes it very hard for the railroads (not just CP, but every railroad) to plan work schedules, which results in higher costs and a poorer quality of life for the employees.

Under the hourly wage system, the increased control over employees' work schedules will allow for better overtime labor and crew planning, which in turn will provides productivity benefits. Simply put, more crew-starts per T&E employee.

Next week. Notes from the BNSF Short Line conference; Union Pacific third quarter results. I will be at the Lexington Group Annual festivities in and around Newark most of next week, so quarterlies from CN, NS and GWR will have to wait a week.