RAILROAD WEEK IN REVIEW

December 17, 2021

"As natural gas prices go higher, we pivot toward the food sector, because now ammonia prices are going much higher, fertilizer prices are going higher, which means grain prices are going higher. And I think that we get toward that higher food costs as the point where the rubber meets the road politically — 30 percent of food and grain costs are energy-related." — Tony Greer, TG Macro, December 10

"The purpose of financialization is to reduce the number of shares and thus juice up the price. The incentive comes from the fact that management compensation is based on stock options. The incentives are lined up not to produce the most sustainable, innovative, long term competitive, strong balance sheet companies, but rather short-term profitability at any cost, by any means possible." — Simon Mikhailovich, The Bullion Reserve, December 3

"Carloads excluding coal were 0.4 percent lower in November 2021 than in November 2020 — their first decline in nine months — and 1.3 percent lower than in November 2019. In the first 11 months of 2021, they were up 5.4 percent over 2020 and down 3.7 percent from 2019." — AAR Rail Time indicators, December 3

As we approach the end of 2021 and peer into what 2022 is likely to bring us, I thought it a good time to remind WIR readership of what we are what we are not. Over the past 25 years WIR has evolved from a financial paper concerned with share prices and buy-sell considerations into a mirror on what's happening in the railroad business. And why.

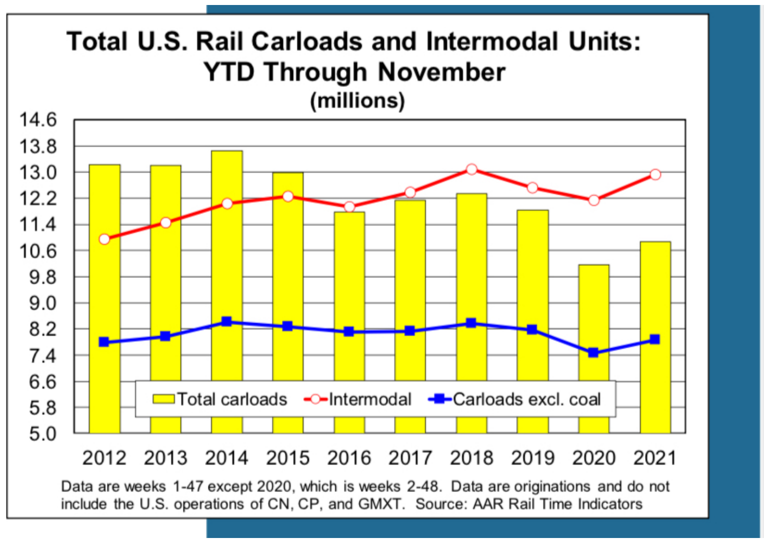
A primary goal is to help non-Class I railroad operators deal with what's happening now and how to use that input to run a better railroad in terms of customer value and financial stability. In other words, WIR observes and writes about commodity markets and their impact on railroad carloads. I don't trade railroad industry shares; WIR does not pretend to give investment advice. But WIR comes at the railroad industry in terms of how to make the best use of what you have.

When I do quote share prices, it is only to show how a company is faring in the eyes of investors. Lumber and aggregates up, go see your customers in those commodities. Cost of fertilizer up? How does that affect the ADMs of the world and thus your grain customers? Steel on a roll? What are your steel scrap customers seeing as they look out six months?

Given the rate of inflation increases, raw materials your customers buy today will cost less than they will tomorrow. And the higher price of the newest inventory is going to have a bigger impact on working capital, so it's the first to go — LIFO at its finest. Moreover, customers are seeking shorter transit times for inbound material because of the spread between their cost and the value of the finished goods. Just-in-time is losing out to just-in-case.

It follows that non-Class I railroads are only as good as their connecting Class Is in creating end-to-end supply chain value for their customers. So if the Class I management incentives are to cut costs to lower the OR and juice share prices, they start reducing the asset base from conductors to locomotives to classification yards. As we have seen, that leads to poor local service and market share lost to trucks. WIR will help you understand the trends you're seeing and give you some watch points for what's ahead. And forewarned is forearmed.

The trend of U.S. railroad revenue units[1] is down. Revenue units are in decline, never mind the intermodal uptick. The shrinking yellow bars are driven by classic carloads, the very lifeblood of the non-Class I railroad community.



There appears to be a relationship between carload volumes and share-buybacks. Buybacks 2014-2016 for the three US Class Is reporting such things averaged 50-80 percent of capex.

Between 2017 and 2020 buybacks as a share of capex averaged from 69 percent to 175 percent. UP exceeded 100 percent in all four years; CSX ran more than 200 percent in 2018 and 2019. The high for NS was 143 percent in 2018.

My take-away is that as long as share buybacks are running at more than 100 percent of capex service quality will suffer, particularly in the merchandise carload sector. The key metrics to watch are changes in average train speeds and dwell times, measuring each railroad against itself and not against the others as the reporting methods differ among Class Is. I'd also watch train length, RPMs, and changes in T&E headcount. All can affect interchange frequency and car-count and all the stats are in the public domain.

Alan Shaw, as one of his first official acts as NS President, has responded to the November 23 letter from STB Chair Martin Oberman regarding STB concerns about NS service quality. Shaw acknowledges crew shortages particularly along the Cincy-Chattanooga corridor and on New York's Southern Tier. He cites yard congestion in Chattanooga and Birmingham causing "slower train flows," which have in turn slowed down other parts of the NS network.

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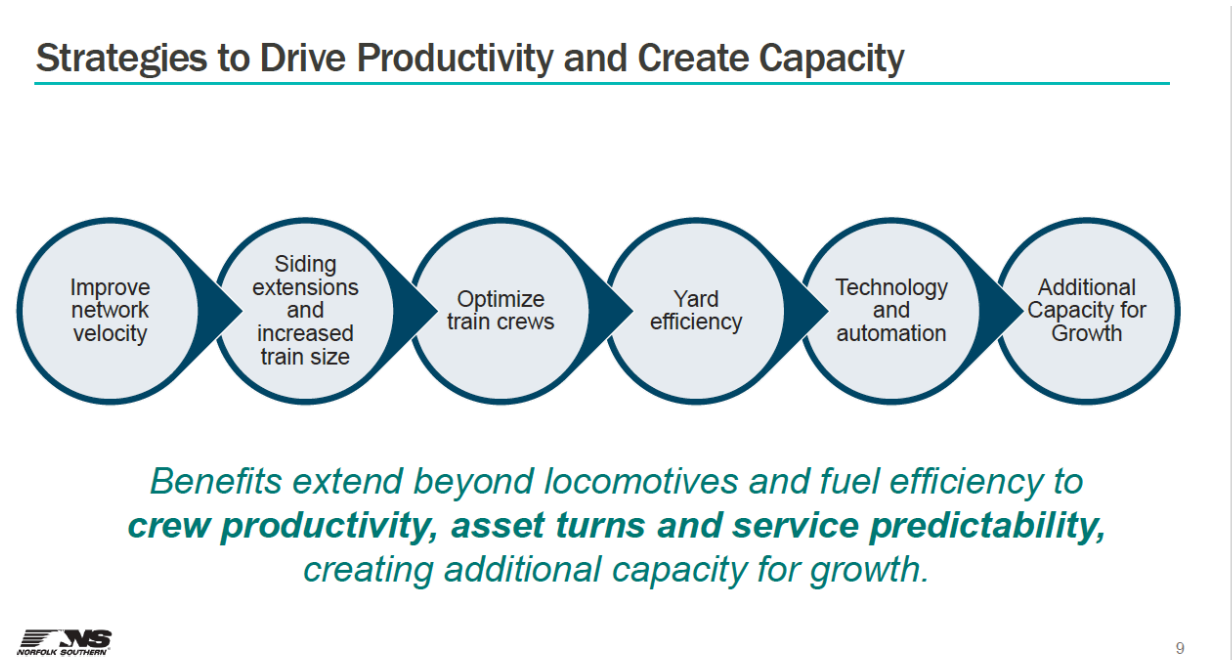
[1] To the AAR an intermodal box or trailer is a "carload;" I use "revenue units" for both. I reserve the term "carload" for classic freight cars with trucks and couplers at both ends. A flat car for intermodal containers and trailers is a "platform." To create "carload equivalents" divide reported intermodal "carloads" by 1.7, a number that assumes most platforms carry more than one container and some small portion of platforms don't.

Shaw says in his December 10 letter, “We have made substantial progress” in the yards cited and improved flows on the CNO&TP, but the Southern Tier remains a work in progress. They’ve ramped up a program of new hires and recalled furloughed employees, offering location transfers where desired. As of December 6 there were 285 employees in conductor training, “the highest level year-to-date,” with more to come.

All of which is very welcome news. NS has laid out an aggressive plan for service and competitive advantage improvements for 2022. This slide is from the December 1 Stephens Annual Investment conference presentation by Shaw and CFO Mark George.



Looking at it strictly from a merchandise carload viewpoint, there is much to cheer. As I have written repeatedly in the past, the regional railroad service offering is only as good as that of its connecting Class I. Channel checks from various regional railroad and customer sources over the last six months show the very service degradations driving Oberman to write in the first place.

Missed interchanges and demurrage charges stemming from trains holding for tonnage were two of the most often cited. The slide above addresses these and others. I think network velocity will improve from better crew utilization and yard efficiency, though bigger trains implies fewer departures and potentially longer transit times between O-D pairs. But as long as they can put more trains over the same track segments, speed and services will be more competitive.

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