RAILROAD WEEK IN REVIEW

July 8, 2022

"Regionalization is the transition from a world of stable prices and consistent growth to one of rising costs of living where the threat of global famine is real. The breakdown of an economic order framed by just-in-time supply chains requires a rethink of trade networks and relationships." Peter Zeihan, ***The End of the World is Just the Beginning***

"Mars, Inc., gives credit for its success to the austere business practices known internally as the Five Principles: quality, responsibility, mutuality, efficiency and freedom. They may sound like managerial guff. But they strike the right balance between making money and doing good. Many more showy corporations aim for that under the trendy slogan of 'stakeholder capitalism. '" — "Mars Unwrapped," The Economist, July 2

The message from Mars is that you do well by doing good. The *Economist* business columnist known as Schumpeter writes, "Mars Inc. gets the purpose v profit balance right. Corporations should learn from the low-key, family-owned 'mammal-feeder' … Many more showy corporations aim for that under the trendy slogan of 'stakeholder capitalism.' Few carry it off as convincingly as Mars."

Mars is a privately held company yet, as Schumpeter notes, "Stakeholderism, or what Mars calls mutuality, puts the interests of customers, workers, suppliers, communities and the environment alongside those of the family shareholders." Sounds very much like Berkshire Hathaway, which often refers to its shareholders as "family."

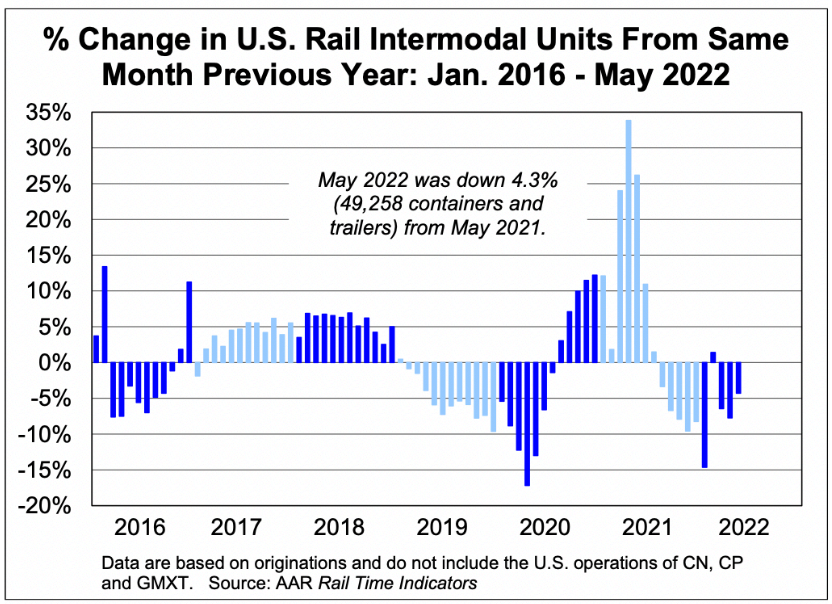
Buffett, to my mind, is one of the world's great capital allocators. According to his February, 2022, Shareholder letter, "Our goal is to have meaningful investments in businesses with both durable economic advantages and a first-class CEO" and pretty much leaves them alone to run their respective businesses.

As for BNSF, much is made of the fact that BNSF doesn't play the OR, head-count, or PSR games. And yet, as Buffett writes in his Letter, "Your railroad had record earnings of $6 billion in 2021. Here, it should be noted, we are talking about the old-fashioned sort of earnings that we favor: a figure calculated after interest, taxes, depreciation, amortization and all forms of compensation." Buffett is vehemently opposed to EBITDA — deceptive "adjustments" to earnings. So what you see is what you get.

I'm about half way through Ziehan's book and oil-based transportation is a major theme. It has made "globalization" work, making it possible for anybody to get anything from just about anywhere. However, as we're seeing from the COVID lockdowns in China and the results of Russia's Ukrainian adventure, the global market can be fragile.

The book goes into great detail about what's causing the decline of globalization as we know it. And if the ability to get anything from anywhere diminishes, so will the market for containerized goods to be moved from the port where they hit the US to their consuming markets. We may just be getting a taste of that now.

AAR Intermodal volume for the US in 2022 through May was 5.56 million units, down 6.6 percent from the record-setting first five months of 2021. Year-to-date container volume was down 5.7 percent; year-to-date trailer volume was down 16.5 percent.



The rate of change month to month shows how the trend for the last five years has not been exactly robust. Yes, the drop in 1H2020 can be blamed on COVID and the 2H2022 jump a sign of pent-up demand from the first half. But please note what 2H2022 comps against. Hardly boom times.

YTD 2022 intermodal volumes through June are down six percent from what they were a year ago. Yet carload business including coal and auto was off a mere ten basis points year-over-year.

This suggests we're seeing less of what's sourced overseas and more of what's produced chiefly on the lower 48. Which follows from Zeihan's writing. And so stuff not sourced a boat ride away is sourced closer to home, and that requires raw material flows. By the carload.

We know there is a strong market even today and shipper channel checks tell us it could be even stronger. A common thread among the shipper complaints at the STB "Urgent Issues" hearings in April was the fact that poor service prevented customers from moving even more material by the carload. Let’s hope the Class Is start providing the proof of improvement that the STB seeks in its mandated weekly progress reports.

As we close the books on the 2022 second quarter, volumes lag year-over-year even where there is a continuing demand for transportation services demand. Intermodal continues to be the big drag, down six percent; bulk (coal and grain) is down a point and merchandise is flat.

Not surprising given the continued negative rate of change in dwell and velocity. Year-over-year comps show terminal dwell increasing 17 percent and system velocity has dropped 24 percent. The STB keeps asking what can be done NOW. To me, better allocation of resources. There is too much railroad for the asset base and they’re not spending enough time in front of customers. (If they were, the Foster Farms debacle couldn’t have happened.) Maybe they need to spin off more miles to the more nimble short lines and regionals.

This asset-turns quilt chart by Loop Capital rail analyst Rick Paterson is quite revealing. Yellow is relatively unchanged, green is better, and orange is worse. None of the Big Six Class Is are showing *any* green of late. Tom Peters in *Thriving on Chaos* has written that customers pay up for quality and look elsewhere when it’s lacking.

Service Matrix: **Equally-weighted Velocity + Terminal Dwell versus each Railroad's Post-recession Average**

	1Q15	2Q15	3Q15	4Q15	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18
UP	-16%	-8%	-5%	-2%	3%	5%	0%	-2%	-11%	-4%	-10%	-21%	-24%	-11%	-13%
BNSF	-3%	2%	1%	13%	16%	24%	13%	10%	-6%	2%	8%	9.9%	4%	1%	-6%
CSX	-28%	-16%	-16%	-12%	-17%	-13%	-17%	-22%	-21%	-7%	PSR -30%	-11%	-4%	7%	19%
NS	-29%	-10%	-5%	4%	4%	10%	6%	3%	1%	-8%	-6%	-16%	-36%	-37%	-24%
KCS	-10%	-16%	-16%	-3%	1%	0%	-13%	-15%	-10%	-7%	-3%	-13%	-9%	-13%	-33%
CN	-5%	14%	20%	21%	21%	26%	26%	17%	6%	14%	4%	-18%	-44%	-16%	-14%
CP	-24%	16%	20%	22%	22%	30%	24%	26%	13%	36%	24%	14%	-6%	14%	13%

	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	1Q22	L3M
UP	PSR -2%	-6%	-3%	7%	13%	8%	21%	11%	15%	8%	9%	3%	1%	3%	-2%
BNSF	-6%	-16%	-15%	-9%	-1%	2%	17%	-9%	-3%	-13%	-11%	-10%	-11%	-22%	-19%
CSX	25%	33%	31%	32%	45%	45%	42%	25%	20%	17%	17%	14%	8%	1%	-6%
NS	-21%	5%	23%	PSR 27%	28%	30%	35%	22%	6%	-9%	-3%	2%	-29%	-28%	-33%
KCS	-27%	-5%	PSR 0%	8.9%	14%	19%	20%	-1%	-13%	-23%	-22%	10%	19%	17%	1%
CN	-13%	-27%	0%	-8%	-11%	-19%	-14%	-34%	-13%	-19%	-5%	-4%	-8%	-35%	0%
CP	23%	-3%	23%	33%	31%	22%	20%	20%	16%	1%	14%	9.6%	6%	-13%	4%

Railroad is turning assets *within* 10% of its post-recession average
Railroad is turning assets >10% *faster* than its post-recession average
Railroad is turning assets >10% *slower* than its post-recession average

Hurricane Harvey CSX Adopts PSR (3Q17); CN Capacity Crunch (4Q17); UP Adopts PSR (4Q18); *Midwest Flooding* (1Q19–2Q19); KCS Adopts PSR (2Q19); NS Adopts PSR (3Q19); *COVID* (2Q20–L3M); Record industry service, aided by COVID-driven lockdowns/freight drought (2Q20); Polar Vortex (1Q21); NS Crew Crunch. BC Flooding (4Q21); Omicron Spike, Jan. (1Q22)

Source: Company reports and Loop Capital Markets estimates.
Post-recession defined as Q1 2010 through the present.

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