RAILROAD WEEK IN REVIEW

July 22, 2022

"The long-term prospects of precision agriculture remain decidedly positive. As global population growth outpaces that of arable land, precision ag can improve yield in addition to the widely anticipated input cost reductions… As economies generate wealth, dietary preferences shift from vegetable based to animal based." — Scott Shearer, PhD, PE Professor and Chair, The Ohio State University

"There is more demand for rail service than what we are able to satisfy. The efforts we are making now to grow our workforce and add capacity to our network are because we see plentiful long-term opportunities for rail, driven by customer demand for more fuel-efficient, environmentally friendly transportation options, and growth in domestic manufacturing." — Jim Foote, CEO & President, CSX

"Second quarter volume was down one percent compared to a year ago. Growth in our industrial group was more than offset by a decline in our Premium and Bulk business segments. To improve network fluidity, we made reductions to our active freight car inventory and those efforts had a negative impact on all three of our business groups." — Kenny Rocker, UP EVP Marketing and Sales

Precision agriculture is coming into its own. As supply chains have gotten more complex, the downstream damage from their interruption grows exponentially. Precision agriculture in the US and Canada can increase yield per arable acre, meaning more tonnage per loading point.

Precision ag is a game-changing secular story, starting with fertilizing machines that can can deliver specific nutrients based on each individual plant's needs. And that's relatively new technology. According to a note from Cowen & Co. last month, "A robust replacement cycle is underway, driven by 1. Aging equipment, 2. New technology, 3. Low inventories, and 4. Solid farmer P&Ls." But even a healthy income statement is not conducive to expensive equipment laying idle during the off season.

Yet the fact remains that agriculture is a seasonal business. The big drag here is farmers having to pay 100 percent of the cost of the equipment needed for precision agriculture yet actually using the equipment less than 50 percent of the time. That's why Deere and others are exploring the "subscription model" of farming equipment usage. For Deere alone, Cowen estimates revenues from new precision technologies used in US corn approach $3 billion a year. Beans could easily add another $billion.

Think leasing with a twist. You lease a car and pay a monthly fee whether it's driving around town or sitting in your garage. The subscription arrangement helps. There are firms that help farmers reduce costs by connecting equipment not in use with farms in need of machines. This way, a harvester that costs hundreds of thousands of dollars, but sits idle for most months, can be rented out to farms in different states and put to work all year round.

And so it is that I think The Canadian railroads' investments in per-car capacity and more effective train scheduling are steps in the right direction. At CP, CEO Keith Creel says not only will there be more grain per acre to move, there's fertilizer – CP customer Canpotex is the number one potash producer in the world. CN Chief Marketing Officer Doug Macdonald tells me, "Our velocity is the best it's been for about five years. We are doing a lot of things right and really sticking to the schedules. " The grain crop starts to move in Sep and "we are focused on delivering what we have on the railway."

CSX led off the Q2 Earnings Call Season Wednesday afternoon. The spread in year-over-year volume changes between carload and intermodal is tiny. Could mean one of two things. Either intermodal growth was lackluster or carload got hammered. Pricing may have played a part — total revenue units increased a mere 19 basis points, yet system RPU leapt 18 percent.

Merchandise carloads barely budged — up 15 basis points — with every commodity group ex-auto in the red. Coal dropped three percent and intermodal units increased less than one percent. But RPU? Every merchandise carload commodity group took high single- or low double-digit gains. Intermodal got 18 percent more per box and coal RPU jumped 58 percent even as total tonnage dropped two points.

Operating expense jumped 63 percent with double-digit gains in payroll, purchased services and a doubling of fuel expense. That's after taking proceeds from asset sales as credits to operating expense. Operating income was up less than one percent to $4.7 billion and the OR was a respectable 55.4, up 12 points with the lower number largely a function of the nearly $400 million asset sale credit a year ago. Net income barely budged — up less than one percent to $1.2 billion.

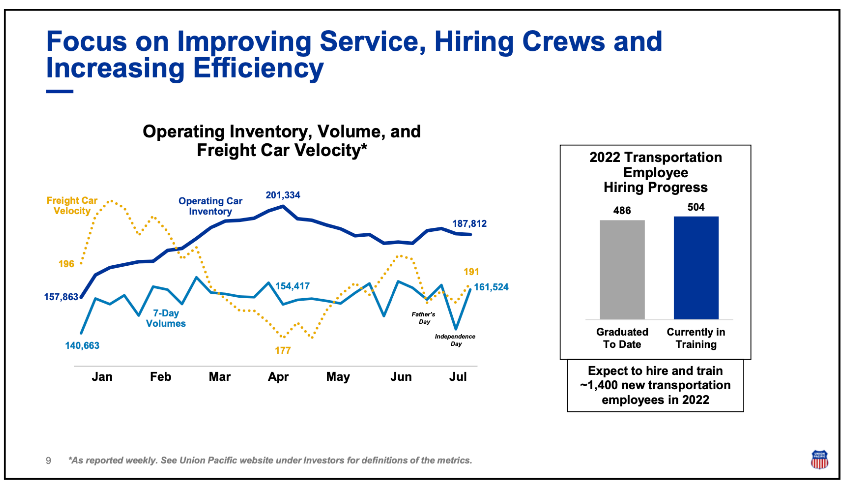
Drilling down into the merchandise carload commodity groups, CSX reported a small gain in industrial chemicals offset by fewer units of crude oil and related products, ag/food rose on grain and ethanol, aggregates and salt goosed the minerals line, and STCC 24 losses took the edge off forest products. Steel was down but scrap was up, and a drop in phosphates hurt fertilizer results.

The outlook for the second half is unclear. Kevin Boone, EVP for Sales & Marketing, concluded his portion of the presentation by saying, "Currently, we are still seeing demand in many markets, however limited by the global shortage of labor. We believe this will continue to benefit rail's value proposition and the opportunity to increase market share over time." Not much to hang your hat on.

Union Pacific revenue ($5.8 billion) was up smartly (14 percent) on no real change in revenue units (2.1 mm, down a point). RPU rose double digits (15 percent). By way of review, UP has reclassified their commodity groups into Bulk, Industrial, and Premium. Coal & Renewables is coal, coke, frac sand and nat gas; Energy & Specialized is non-met minerals, ethanol, petroleum products; Premium is auto and intermodal.

To compare apples-to-apples among railroads, I keep everything but coal and intermodal in the *merchandise carload* category. The weekly AAR carload report is a handy way to sort things out. Aggregates -- including frac sand, grain mill products (ethanol here), and metals -- were up double-digits. Grain took the big hit — down 12 percent.

Operating income increased one percent to $2.5 billion as ops expense rose 25 percent largely on fuel, equipment rents, and purchased services/materials. The OR gained five points to 60.2. Net income was $41.8 billion, up two percent. GTMs rose a point; RTMs were down a point. Here's how the railroad has done YTD:



Rocker says the second half will see gains in ethanol, industrials, chemicals; grain will continue to lag.

No doubt it's been a tough first half, but I think the elements are in place for UP to have a much more robust second half.

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