RAILROAD WEEK IN REVIEW

November 11, 2022

"The average revenue per car/unit increased 23 percent for the third quarter and increased 20 percent for the first nine months of 2022 when compared to the corresponding periods in 2021 resulting from higher fuel surcharge revenue driven by higher fuel prices, along with increased rates per car." — BNSF 3Q2022 Financial Performance Review

"Union Pacific is running a small pilot program in Kansas that aims to bring more predictability to engineer schedules. UP is working with the Brotherhood of Locomotive Engineers and Trainmen on the pilot program that lets engineers know when they'll work every 15 days. Under the "11 and four" schedule, engineers know which 11 days they'll work and which four days they'll be off during every 15-day period. The goal will be to see how UP could expand the work-rest scheduling system." — Eric Gehringer, Chief Operating Officer, Union Pacific

*"**The Magic Formula:** Long-term GDP growth = population growth + productivity growth. This simple formula explains everything we need to know about how the world works. US population growth has been falling for decades and productivity growth has collapsed since the 1960s. As a result, the long-term growth rate trend of GDP falls." — Raoul Pal, Global Macro Investor*

BNSF third quarter freight revenue increased 16 percent to $6.7 billion on 2.4 million revenue units, down five percent. RPU gained 23 percent to $2,623. Industrial products carloads were off seven percent yet posted an eight percent revenue gain. Ag products carloads gained four percent with a nine percent revenue increase. Coal carloads slipped one percent while revenue increased 30 percent. Consumer products (intermodal and auto) revenue units slid seven percent and revenue increased 18 percent.

Parsing these results, only five of the 17 commodity groups reporting posted volume increases. STCC 20 foods and aggregates were up the most; loss leaders were Petroleum and Other. Intermodal was down eight percent on fewer international boxes whereas automotive was actually up a point. Operating expense jumped 30 percent, creating a seven percent operating income decline to $2.1 billion — fuel and materials/supplies were the major culprits. Net income fell six percent to $1.4 billion.

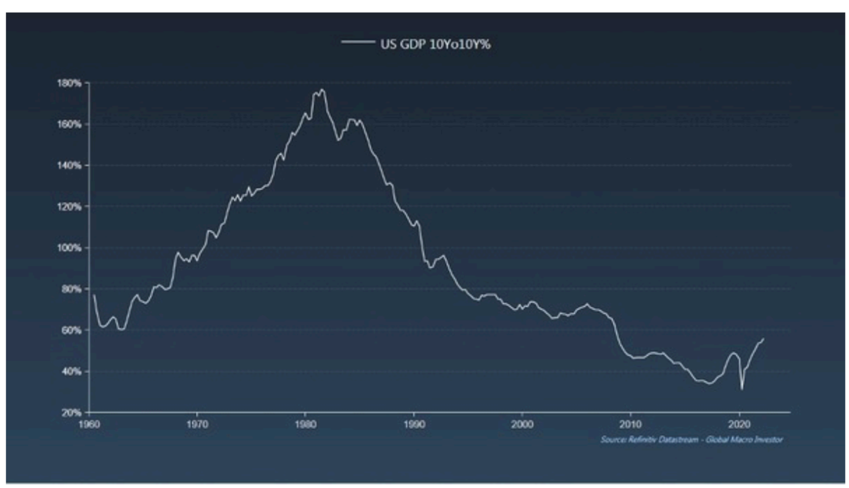
Quarterly results may give one a snapshot of how the railroad did in the past three months vs. a like period a year ago, but — given the long-term planning that goes with running a major property —I think year-to-date results provide the more accurate picture of organizational health. And what really jumps out is the spread in changes between revenue units and freight revenue. Blame fuel surcharges.

Like the other US Class Is, BNSF fuel surcharges made the huge RPU difference year-over-year. At BNSF, FSC more than doubled to $2.5 billion from $904 million a year ago. Back that out and year-to-date adjusted freight revenue is up just four percent against the five percent volume decline. Back out FSC and the adjusted RPU becomes $2,310, up just nine percent vs. the reported $2,514, up 20 percent.

The main reason I want to look more closely at longer-term railroad volume trends has to do with the rate of growth of the marketplace the railroads serve. I've written before about the Dow Theory and why railroad share prices are a leading indicator of the economy's future direction. And that in turn is measured by the rate of change in the Gross Domestic Product.

Trouble is GDP is a lagging indicator — it tells you what *has been* produced, not what *will be* produced. Moreover, GDP was originally designed to measure physical product output from factories to coal mines to oil wells. But more and more of the economic output is in services —from computer programming to retail sales to running railroads.

That said, the more money being spent on goods and services, the greater the GDP, and, as a result, the rate of GDP change leading up to today is still a pretty good indicator of what's likely to come. Unfortunately, it's not a pretty picture.



This is the GDP trend since 1960. And the odds of reversing this trend any time in the near future are slim. That's why longer-term looks at rail traffic volumes will help plan everything from hiring to capex.

So if the rate of GDP growth flattens out or slows, then there will be less stuff to move from maker to market. The charts in the AAR's *Rail Time Indicators* bear out the general downward trend in rail traffic over the last ten or so years. So how can it be railroad share prices seem to keep going up even where the number of carloads of freight is diminishing?

Two reasons. Generating more revenue on fewer carloads (see FSC, above) and cost cutting that increases operating income and decreases the operating ratio. Asset sales and other below-the-line items boost net income. Share buy-backs increase earnings per share and higher multiples based on higher per-share earnings boost share prices even more. Ergo market caps increase while units produced decrease. More money, less work.

And speaking of multiples, Tuesdays's *Almost Daily Grants* notes, "We may be seeing that slow motion margin contraction in action: The nearly completed third quarter earnings season, in which 85 percent of S&P 500 components have reported, has exceeded analyst EPS expectation by an average 1.9 percent. That's well below the average 8.7 percent upside surprise over the past five years and would mark the second lowest 'beat rate' since 2013."

The rails are not immune. I'm still seeing PEs in the 20 plus-or-minus range where the mid-teens have been more the norm in the past. Moreover, carrier shares remained priced at or slightly above Morningstar fair value which would seem to say further multiple contraction may be in order.

None of the Q3 earnings calls touted particularly robust merchandise carload outlooks. Putting it all together, it appears we're heading into a hunker-down mode where customers are putting sharp pencils to inventory levels and supply chain trends. The railroads that serve them would be well-advised to do the same for operating margins.