RAILROAD WEEK IN REVIEW

February 17, 2023

"In a precedent-setting move for the railroad industry, CSX on Feb. 7 reached agreements with the Brotherhood of Maintenance of Way Employees Division (BMWED) and the Brotherhood of Railway Carmen (BRC) for paid sick leave, and on Feb. 10 added the International Association of Machinists and Aerospace Workers (IAM) and National Conference of Firemen and Oilers (NCFO). The eight remaining unions, it is believed, will eventually accept the agreement." — Railway Age Newswire, February 12

"CN President JJ Ruest said on the 3Q2021 call, 'We intend to use a balanced approach, achieving operational excellence rationalizing our cost structure, adjusting capex, and capitalizing on our technology investments.' Could this mean an end to the Cult of the Operating Ratio? Regardless of how it all sorts out, JJ and his predecessors have made Canadian National a prime example of How to Run a Railroad and build a sticky customer base." — Railroad Week in Review, October 22, 2021

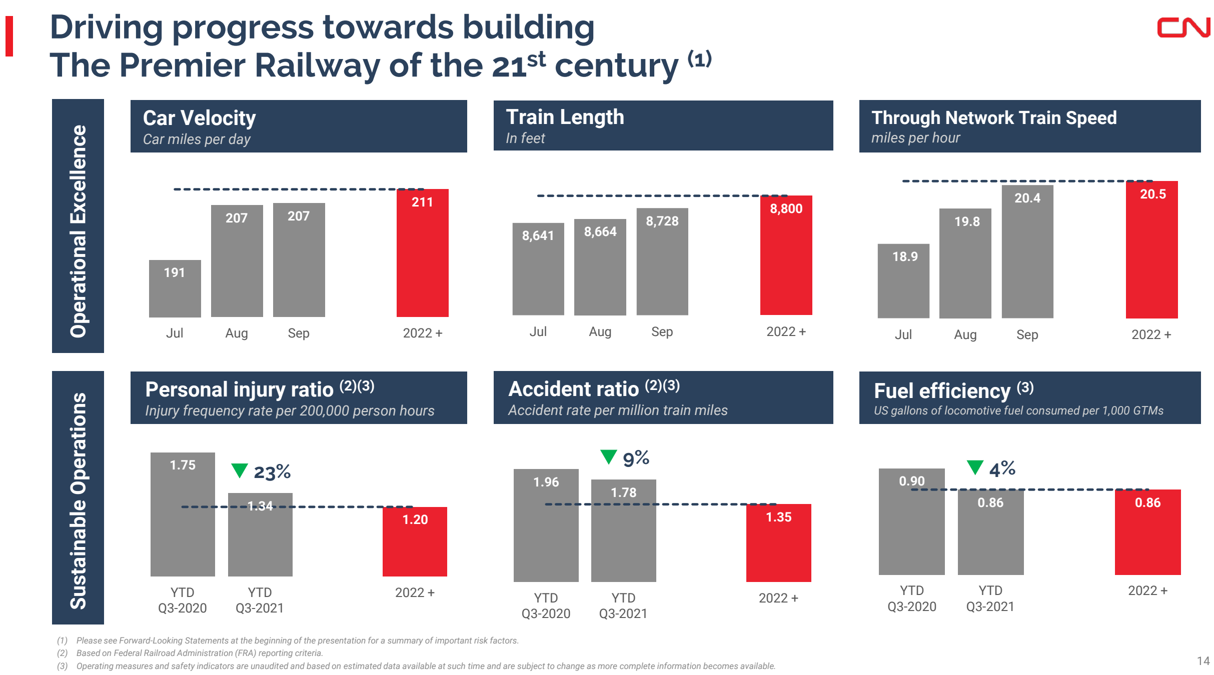
"During 2022, CSX generated $3.49 billion of free cash flow before dividends. However, the company spent $4.73 billion on buybacks, coupled with another $852 million returned as dividends. No way I am going to like such a move, where shareholder returns are higher than the free cash flow generated by the company." — Lucca Socci, Seeking Alpha, February 13

Continuing the dwell and velocity thread, I did a little digging to get some clarity. Recalling my conversations and yard visits with CN early in the move to Precision Scheduled Railroading, that seemed a good place to start. On one particularly memorable trip, I saw why local freights ran irrespective of the number of outbound loads — power and crews were needed at the other end for the next day's loads and empties coming off the branch.

In Montreal a westbound departure for Winnipeg was filled to the maximum passing siding length regardless of car type or commodity — covered hoppers of grain, auto racks, tank cars of chemicals, a few open-top hoppers of met coal for an industrial customer, and so on. Just get it out of town.

This was truly Precision Railroading. You always knew the location of every load and empty, no train was longer than any passing siding between OD pairs, and you had enough power and crews to run to plan. And that meant measuring everything, including transit times between stations and dwell time at every yard along the route for every car.

And that's how you get metrics like, for example, these from the 3Q2021 slide set:



At CN car velocity includes time on main lines, branch lines, and yards. Through network train speed counts time from when a car is released at origin to placed at destination, but time placed into hold, BO, offered at interchange, or constructively placed is not included. And intermodal moves are included, counting platforms as "cars," capturing everything from single-unit well cars to five-platform articulated cars.

Bottom line — you can't fix it if you can't measure it. Branch line dwells too long? Crews running out of time on their jobs? Car cycle times hammering customer leased-car numbers? Measure velocity and dwell and amend the operating plan to get the numbers you need. Keep customers smiling because smiling customers are sticky customers.

A 150-car Norfolk Southern train suffered a derailment in East Palestine, Ohio, about 50 miles west of Pittsburgh, last Friday. About 50 cars went on the ground, some of them carrying vinyl chloride, a colorless but hazardous gas used in the manufacture of plastic products. Crews released and burned the contents, generating a huge smoke plume that held over the town for hours. Hundreds of residents had to be evacuated for several days. There were no immediate deaths or injuries from the accident.

The incident occurred about 9 PM and the train was eastbound to Conway from Madison, Illinois (across the river from St Louis). The NTSB has confirmed that a faulty axle was the cause and that the train crew had received a detector alert "shortly before the derailment." NS says there were 20 hazmat cars in the manifest train.

Subsequently the EPA sent a letter to NS listing several chemicals that were released but had "not been discussed publicly before." The letter, posted on the EPA website, is called a "general notice of potential liability," and its purpose is to notify the company that it "may be responsible" under federal "Superfund" law for cleanup of the site or the costs the EPA has incurred in cleaning up the site.

Cleanup is going to be an expensive proposition and lawsuits have been mentioned. Cowen railroad analyst Jason Seidl writes, "We would expect NSC to take a noteworthy one-time charge in Q1 given that the railroad incurred a $35 million [accident] expense in the 2005 first quarter that hurt OR by 170 bps and led to some additional costs for the full year. Shares traded at a discount to the group for a very short time in early 2005 and rebounded by year-end. We see any material sell-off in NSC stock following negative derailment headlines as a unique opportunity for investors to step into the name."

Shares have in fact shed about $20 each since the event, selling in the $230s after closing at $253 the day before the derailment.

A little less than a year ago I compared all the Class I 5-year CAGRs in revenue units, operating income, net income, and long-term debt. The biggest average increase was in long-term debt; the smallest was in revenue units. The average increase in shareholder equity was only 110 basis points. This time around I wanted to see how debt, equity, and share buybacks compared.

In every case the full-year amount spent on share repos was greater than free cash flow. And long-term debt went up almost enough to cover the stock buybacks. (CP was the only exception — there were no buybacks.) The three US Class Is all have more debt than equity; CP and CN are the exceptions: D/E ratios of 49.4 at CP and 70.6 at CN.

Meanwhile share prices have been muddling along at the 200-day moving average, though CP is again the exception and CN is a close second. Both are operating as true Precision Scheduled Railroads, working all five points of Hunter's original recipe. As in cooking, if you don't follow the recipe you get unpredictable results.