RAILROAD WEEK IN REVIEW

March 3, 2023

“BNSF Railway efficiently serves many smaller markets by working closely with approximately 200 shortline railroads…. For the year ending December 31, 2022, 38% of freight revenues were derived from consumer products [auto, intermodal], 23% from industrial products, 23% from agricultural products and 16% from coal.” — Berkshire Hathaway 2022 10-K

“UNP has repeatedly and significantly failed to reach its potential under Mr. Fritz’s leadership. UNP has ranked the worst in safety, volume growth, revenue growth, cost management, EBIT growth, and total shareholder return. These are highly underwhelming results despite UNP having the premier railroad franchise in North America. We assume you share our disappointment, given that Mr. Fritz has consistently failed to meet the annual incentive compensation targets set by the Board.” — Soroban Capital Partners letter to UP Board, February 26

“We’re grateful to the Air District for making the purchase of these two Knoxville Locomotive low-emission, state-of-the-art units feasible, as they provide benefits to the communities served by the railroad that would not be possible for us to do on a stand-alone basis. It’s a true win-win, public-private partnership.” — California Northern President Brad Ovit

BNSF finished the year with total revenue up 12 percent to $425.9 billion on a six percent revenue unit decrease to 9.5 million units. buoyed by the 19 percent RPU gain. The big revenue jump came from the 162 percent increase in fuel surcharge revenue to $3.5 million. Absent the FSC boost adjusted freight revenues increased just two percent.

Merchandise carloads including industrial and agricultural products decreased four percent and represented just 28 percent of total units. Coal carloads were unchanged, representing 16 percent of total revenue units; “consumer” — auto and intermodal — revenue units fell by eight percent, representing 55 percent of total units.

BNSF documentation accompanying the results tells us FY intermodal boxes dropped 10 percent primarily due to lower intermodal shipments resulting from supply chain challenges and lower west coast imports during the second half of the year. Only three of the industrial and ag products groups in the AAR groupings gained.

Crude oil, both forest products STCCs, and metals took the biggest hits. Grain slipped due to lower grain exports and fertilizer shipments, partially offset by higher volumes of domestic grains, renewable diesel, and feedstocks.

Operating income for the year slipped two percent to $8.6 billion, largely on the 66 percent jump in fuel expense and a 31 percent hike in materials/supplies/other. The operating ratio dipped by nearly five points to 66.8, though without the added FSC revenue the OR would have been a sorry 77. Net income was $5.9 billion, down a point.

Soroban pulls no punches in its letter to the UP Board expressing its displeasure with the railroad's performance under the leadership of CEO Lance Fritz. This cannot be taken lightly as Soroban owns a $1.6 billion stake in UNP, making the firm a top 10 economic owner of the Company. Specifically, the letter identifies its concerns thus;

> UNP has repeatedly and significantly failed to reach its potential under Mr. Fritz's leadership. UNP has ranked the worst in safety, volume growth, revenue growth, cost management, EBIT growth, and total shareholder return. These are highly underwhelming results despite UNP having the premier railroad franchise in North America. We assume you share our disappointment, given that Mr. Fritz has consistently failed to meet the annual incentive compensation targets set by the Board.

This is indeed unfortunate. IMHO Chief Commercial Officer Kenny Rocker has worked hard to keep customers' supply chains fluid, even as operating obstacles were challenging at times. Unfortunately, it got to the point where disgruntled customers engaged the STB to Do Something. See, for example, Foster Poultry Farms ex-party petition for Emergency Service Order, FD 36609, February 20, 2023.

The UP Board responded promptly, saying it had begun discussions with Fritz a year ago, engaging "a leading outside consultant" and in November formed a task force of directors to identify "highly-qualified candidates both within the industry and adjacent industries." The Board expects to name a successor who will assume the position in 2023.

I'm afraid the Soroban overture smacks of what Tony Hatch accurately tags as "the cult of the Operating Ratio." By my calculations UP has, in CAGR terms over the past five years, increased net income by five percent on flat volumes, increased free cash flow as a percent of operating income by 16 percent, and did it it all on little change in revenue units. As I see it, this Soroban adventure could very well wind up mirroring the ill-fated TCI run at CSX back in 2009.

Looks like the US is down to one vendor of new mainline locomotives. Caterpillar is taking a $925 million non-cash goodwill impairment charge related to their Progress Rail division. The company said on the Q4 earnings call that "the impairment was primarily driven by a revision in our long-term outlook for the company's locomotive offerings." It's Wabtec that remains standing, having purchased GE's locomotive business in 2018.

In 2010 CAT had acquired the assets of EMD for $825 million, renaming the business Progress Rail, and "bringing the full range of EMD products and services" to the international railroad community. The best known is probably the EMD SD70ACe. The rationale for the purchase was ostensibly to allow EMD "to leverage global expertise and partnerships with Caterpillar."

Details on the rationale for the write-down are slim. Five years ago EMD unveiled a new freight locomotive that met EPA tier-4 emission regulations, but who bought how many is unknown. I did a google search for tier-4 locomotive ownership found only GWR's California Northern, using two Knoxville Locomotive Works products which went into service in July, 2019.

From the GWR presser, "The two new 2,400-horsepower diesel locomotives use selective catalytic reduction technology to meet the most stringent emissions requirements set by the EPA. Their high-efficiency, 12-cylinder MTU engines are expected to provide fuel savings of 25% and reduce diesel emissions – carbon dioxide (CO2) and oxides of nitrogen (NOx) – by 80% compared to the two circa-1976 locomotives being replaced."

Once again, share price trends can tell its a lot about industry trends. The four leading publicly traded railroad equipment suppliers are Trinity Rail, Greenbrier, GATX, and Wabtec. The first three build and lease freight cars of all types whereas the Wabtec specialty is locomotives (bought out GE) and its extension of the Westinghouse Air Brake franchise (the WAB of Wabtec).

Of the four, WAB has the best following on the street. Share prices have grown by 17 percent whereas others have posted slight declines, which tells me WAB still sees life in the locomotive market, even though the Class Is have thousands stored. And they have kicked their offerings up a notch to offer heavy-haul, alternative fuel, and lighter weight equipment. Could be Knoxville Locomotive Works, the new kid on the block, will be the staunch competitor, particularly in the world of non-Class I railroads.

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