RAILROAD WEEK IN REVIEW

May 26, 2023

"U.S. agricultural exports in fiscal year (FY) 2023 are projected at $184.5 billion, down $5.5 billion from the November forecast. The export forecasts for all major commodity groups are down, with the largest decreases projected for corn, sorghum, and soybeans." — USDA Outlook for Agricultural Trade

"With Memorial Day approaching, we examine the old Wall Street seasonality adage 'Sell in May and Go Away' and its historical results when applied to rails… Narrowing our analysis by month, June, August, and December have experienced the worst returns relative to the S&P 500." —Bascome Majors, Susquehanna Financial Group, May 24

AAR North American carloads and intermodal boxes moving in the week ending year to date through May 20 (Week 20) declined another eight percent, taking the full-year score to a minus six percent. Intermodal boxes are the major drag; merchandise carloads including automotive were unchanged.

The individual Class Is aren't exactly breaking down the doors. For 2023 thus far CP is the only property with total units in the black, and that by a mere three percent. The most glaring spread is between UP and BNSF: the former down three percent and the latter down 11 percent.

The UP-BNSF spreads get worse as you drill down into the sectors. BNSF intermodal is down 19 percent to UP's minus four. In grain, BNSF lagged UP minus 11 to minus four. Only in Bascome Majors' broader "merchandise" sector were they even: unchanged for both. BNSF was able to post a slight lead in auto — plus 15 to plus 12 — and a forest products "win," down seven to UP down 16. But UP beat out BNSF in aggregates, plus 11 to plus four.

Interestingly, BNSF had a couple hundred more revenue units than UP in Q1 but was down ten percent for the quarter to UP's down a point. Merch carloads were 57 percent of UP revenue vs BNSF's 47 percent. BNSF operating income was down nine percent vs UP's down four percent.

My take-aways: UP's greater reliance on merch carload than intermodal results in more consistent revenues and service levels at better margins. Intermodal box averages of 1.7 per platform support lower carload-equivalent RPUs than carload. BNSF intermodal trains get 12 hp per trailing ton vs three or less for merch trains, ergo operating margins have to be smaller. Could be part of the five-point ops income spread between the two.

At this point half way through Q2 it looks like BNSF could be in recovery mode. I'd like to see less emphasis on intermodal and more on carload commodities where BNSF has a competitive advantage over truck. Might help bring down the OR and create a quality carload product that can earn quality revenue numbers.

A few days ago it looked like NS had turned the corner with institutional investors. Share prices saw a nice gap up (that red spike way to the right) and MarketEdge even upgraded it to a Buy.

But it was not to last. The three down days (volume chart below) undid it. The big red price bar shows an open well above the previous positive close only to fall back below the high of the day before and then heading further south.

Now I realize a few days' trading does not a trend make, but it reflects the buy-side opinion of the property's potential, even in spite of all the good work Alan Shaw is doing to get the message out.

Correction. Last week I wrote, "Looking ahead, the expected increase in U.S. grain production and exports should benefit the U.S. rails and UP in particular starting later in 3Q." Concerning exports, I may have misled you. The USDA "Outlook for US Agricultural Trade" forecasts lower 2023 exports "for all major commodity groups with the largest decreases projected for corn, sorghum, and soybeans."

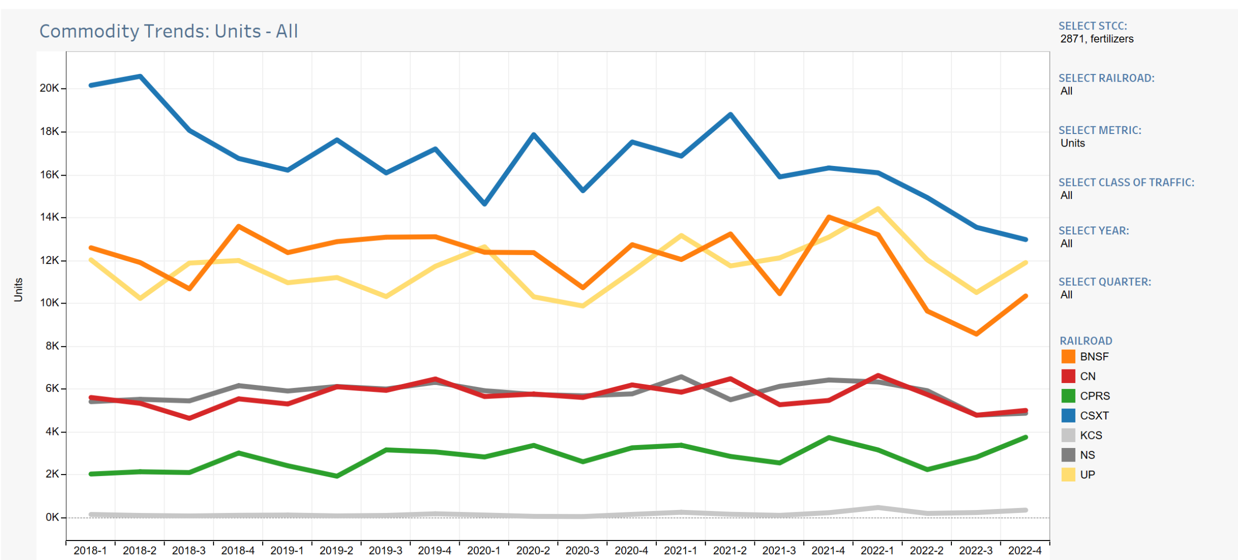
Moreover, "Corn exports are forecast $1.9 billion lower to $16.6 billion on lower volumes. Sorghum export projection is halved to $800 million on sharply lower U.S. production. Overall grain and feed exports are projected at $43.8 billion, down $2.4 billion from November. Soybean exports are forecast down $800 million to $32.0 billion due to lower U.S. supplies and higher competition from Brazil."

Country-wise, "China is forecast to remain the largest market for US agricultural exports at $34.0 billion, unchanged from the previous forecast. Exports to Mexico are forecast to remain unchanged at $28.0 billion, while exports to Canada are forecast down $500 million to $27.8 billion on lower corn demand.” CPKC and the UP-CN-Ferromex link-up ought to benefit along with their connecting non-Class Is.

To round out the ag outlook picture, fertilizer producers Mosaic, CF Industries, and Corteva all sport a Schwab Equity Rating of B or C. Usage of late has been increasing slowly, yet provider revenue streams are taking a hit from a weaker pricing environment, although still strong by historical standards.

Schwab concludes, “Moving forward, we expect the Ukraine/Russia war and difficult weather conditions globally to continue weighing on agricultural production, keeping stock-to-use ratios low and helping to support pricing power.” Still, shares have been drifting lower since January, indicating some Street skepticism of any return to a robust revenue stream.

Nevertheless, railroad carloads of STCC 2871 fertilizers have held about even through the end of 2022 and I see no reason for any sudden changes to these use patterns. CSX has been the dominant player (grain is CSX’s second largest carload commodity YTD, trailing only aggregates) and I expect that to continue.



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