RAILROAD WEEK IN REVIEW

July 21, 2023

“We expect stable homebuilding demand brought on by higher new-home mortgage rate expectations, given that most current home owners’ rates sit below 4 percent. The Mortgage Bankers Association (MBA) projects rates of 5.8 percent by the end of 2023. We note that housing start projections by the MBA have risen, underscoring consumer interest in homeownership.” —Charles Schwab Equity Report, July 19

“Despite headwinds across many of our markets, the team was able to capitalize on strong year-over-year improvement in service. Importantly, as service has improved, there are opening up opportunities to discuss new business with our customers where we are seeing in our year-to-date pipeline up 30 percent.” — Kevin Boone, CSX Chief Commercial Officer

“I don't think the Fed's done raising rates. I think the Fed has a real problem on their hands because you’ve had inflation go down yet in the next couple of months, with gasoline prices being lowered by the Biden administration with the SPR release, among other things, inflation remains sticky” — Tom Thornton on Real Vision July 18

There may yet be some life in the frac sand business. A recent note from Stifel Financial tells us they are “trimming near-term estimates on U.S. pressure pumpers but believe the rig count will stabilize around current levels in a $70+ oil price.” A combination of fewer drilling companies and “limited net new capacity” will keep frac supply/demand fairly balanced.

Drilled and completed wells (DUCs) are generally down with gas basins seeing the sharpest declines. But fewer DUCS doesn’t necessarily equate to less gas coming out of the ground. Wells are getting deeper and “completion activity is likely to stabilize around current levels.” For the Appalachian basin, Stifel expects activity to moderate around current levels.

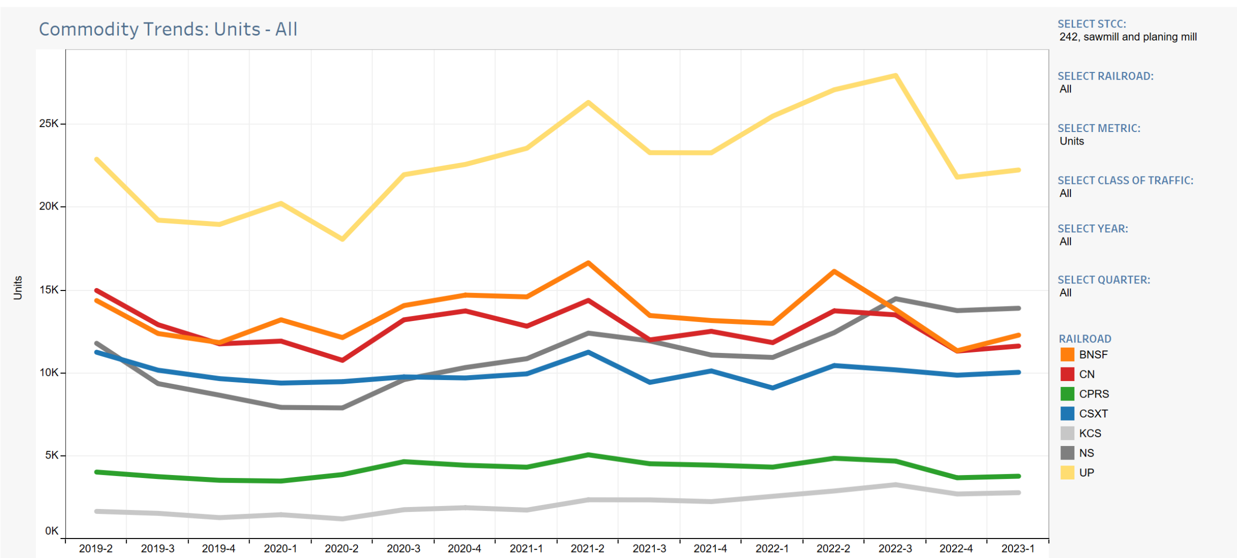
More specifically, total active frac fleets in the Haynesville and Marcellus decreased four percent in 4Q22. But it still takes frac sand to drill deeper and farther, so the absolute tonnage to many locations is shifting to the same tonnage to fewer locations. Once again, knowing your customer is key.

CSX opened the 2Q2023 earnings call season Thursday. Revenue units for the quarter decreased three percent from last year, dragged down by intermodal (down ten percent). Merch carloads including auto (up 21 percent) gained three percent with nice gains in aggregates and the metals group. Coal was up four percent thanks mainly to the 17 percent export coal increase (export coal is 47 percent of total coal tonnage.)

More meaningful than the quarterly results are the YTD trends. Stuff happens in one quarter that corrects itself or get worse in subsequent quarters so the more quarters one can see in one bite the more significant the trends. That said, YTD thru Week 26, July 1, decreased a mere two percent, practically a rounding error. Of 16 carload commodities ex-coal and auto reported to the AAR, half posted significant gains.

The metals group — primary metal goods, metallic ores, iron & steel scrap — increased eight percent. The ag group barely increased though grain was likewise up eight percent. Other notable gains were in lumber and aggregates. The former is important given what's happening in the single-family homebuilding business.

The whole STCC 24 lumber and panel category represents about 140,000 carloads a year to CSX or roughly $250 million in revenue. Not surprising since two of the three hottest homebuilding markets are in North Carolina and Florida, right in the middle of the prime CSX service area. This chart from RSI shows CSX wood products volumes holding steady April 2018 through April 2023, pandemic notwithstanding.

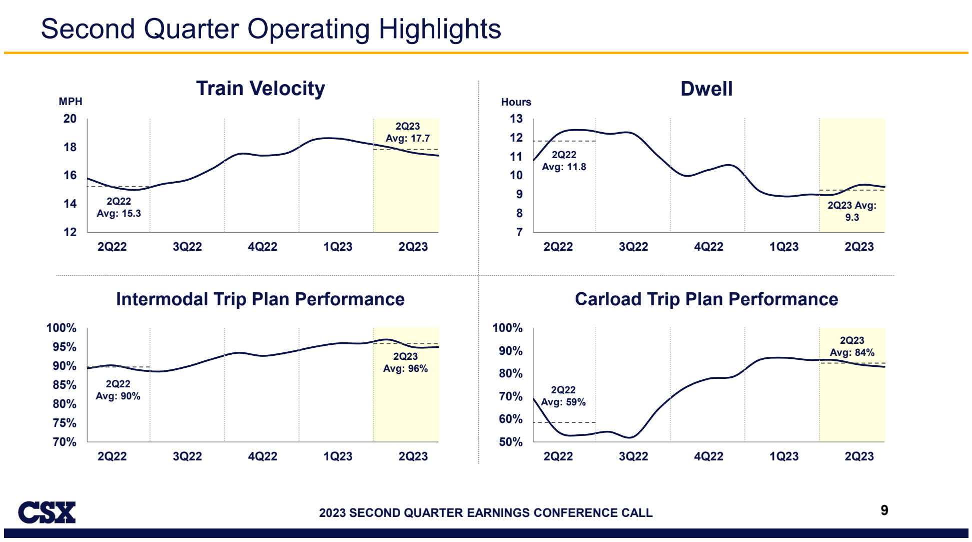


Moving to CSX revenues, I'm keeping to the YTD numbers because I think we've seen some real changes in operating attitudes in Q2 that weren't evident in Q1. Railroad freight revenue increased five percent to $6.6 billion even though intermodal dropped 12 percent. Merch carload revenue including auto was $4.4 billion, plus eight percent, helped by auto's 21 bump. System RPU was $2,442, up five percent.

Total revenue including trucking and ancillary charges was $7.4 billion, up two percent; operating expense gained five percent, driving a one point drop in operating income. The OR was 60.2, up 151 bips. Net income was $1.9 billion, off three percent.

The earnings call was generally upbeat. CEO Joe Hinrichs highlighted the "strong results of our merchandise business" in his very first sentence, which I found particularly refreshing given top billing intermodal gets on every earnings call. Chief Commercial Officer Kevin Boone talked up the kind of marketing calls they've been having with customers and increased shortline collaboration in new business efforts.

COO Jamie Boychuk highlighted year-over-year improvements in average system train speed, terminal dwell, and trip plan compliance in both intermodal and manifest services. On-time departures and arrivals both improved by double digits. The improved service product let Chief Commercial Officer Kevin Boone cite volume gains in most commodity lanes.



In sum, I sense a greater focus upon creating customers and less on cutting costs regardless. The "Guiding Principles of Scheduled Railroading" — straight from Hunter's book — are front and center on the csx.com home page. And I think the leadership is now in place to make them stick.

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