RAILROAD WEEK IN REVIEW

August 4, 2023

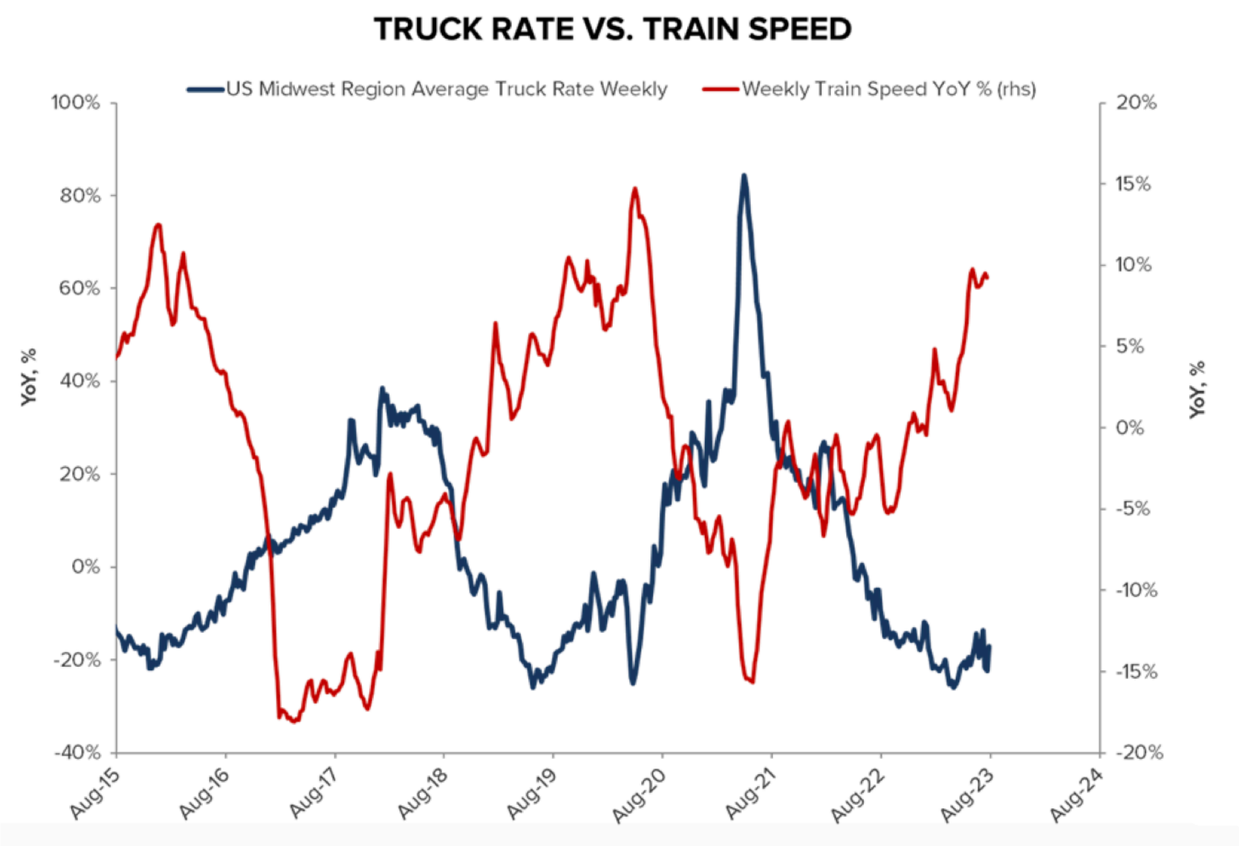
The CEO quotes leading off last weeks letter are there to provide those seeking to do business with the railroads in question with ammunition to use on their calls. Whereas all the CEOs talk about building a business and creating customers, reports from short lines seeking to create new business customers or improve service are meeting with resistance at the mid-management level. In short, is the railroad in question walking the talk?

NS, for example, reported some positive numbers for its merchandise sector but that could be in spite of themselves. My channel checks among NS short lines reveal that market managers in certain commodity lines have actually been resistant to creating customers where the origins and/or destinations are on short lines. On CSX, there are indications that train crews serving short lines are skipping shortline interchanges and then filing an AAR Rule 15 report, saying the interchange was full and they couldn't make delivery. See WIR July 14, page 1.

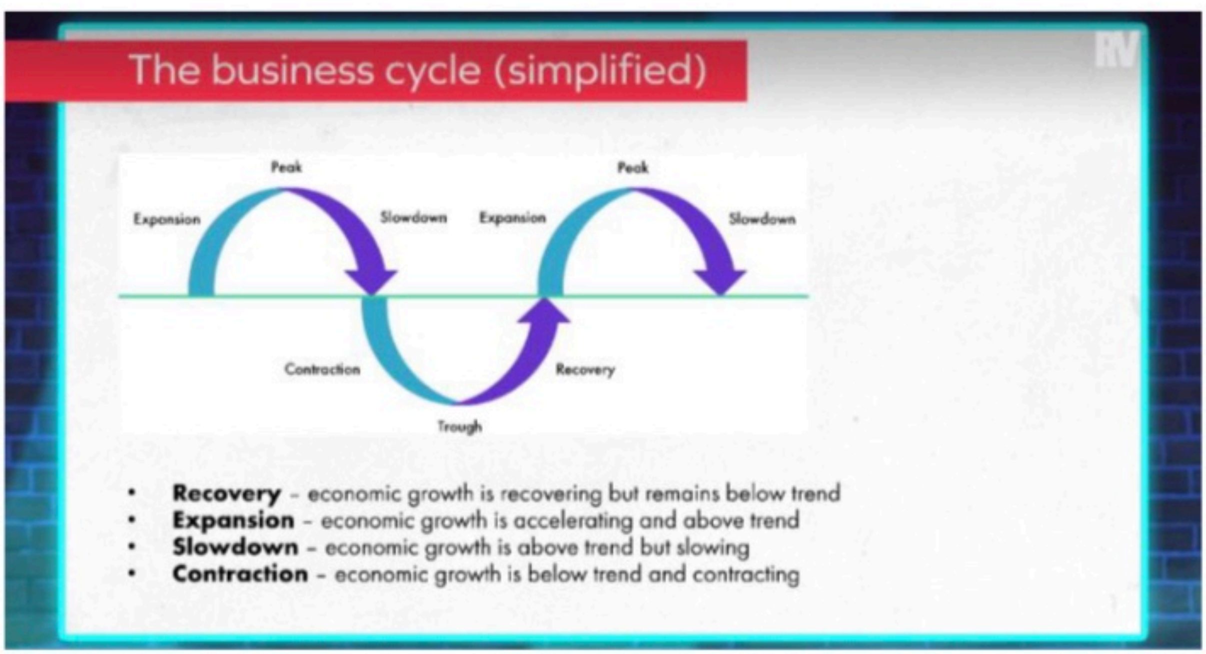
A recurring theme among my shortline channel checks has to do with new business development. A senior executive with a major shortline holding company writes, "They all say they have this goal but it's not apparent in their dealings with us. At CSX, for example, I am hopeful that new leadership will move more actively to toward this goal. The one theme that I would suggest is to try some new plans that either are home-grown or that short lines bring up. There is still too much defense and not enough offense to grow the rail industry's business."

Good friends running two shortline holding companies report recurring car supply problems. On the one hand, cars requested to handle outbound loads show up late or not at all. On the other hand, a customer depending on a steady stream of four cars a day five days a week is ill-equipped to take 20 at once. The serving shortline has to park the cars someplace and meter them to the customer as needed, screwing up car-scheduling times and trip plan compliance. A shortline forest products manager says his road lost some 400 loads to trucks due to Class I service failures of this sort.

There is reason to believe the situation is going to get worse before it gets better. I have been writing regularly about the continued trend in truck freight rates coming down. The reason quite simply has been that as railroad performance has improved there have been fewer loads available for a truck as the business they won from the railroads during the bad service days are being lost back to the railroad as they get their acts together. And since price is the only unique selling point any trucker has, prices come down to attract business. It works.



Railroads can help themselves and their customers with an understanding of how the movement of goods is affected by the business cycle. Right now I think we're coming out of the trough stage and will start to see goods moving. Volumes will continue to be strong during the expansion phase through the peak and will fall off in the slowdown phase and into contraction.



Perhaps the Manufacturing ISM is the best expansion/contraction indicator. A reading below 50.0% indicates the industry is in economic contraction.The index registered 46.4% in July. Companies continued to manage production and headcount in the face of economic headwinds, but at a slightly better rate than June's 46.0%, a 12-month low. New orders remained in contraction at 47.3%, 1.7 percentage points higher than June, while production increased slightly to 48.3%, a 1.6-percentage-point bump.

To me, the big front end of understanding global macro things — understanding a company, understanding its management, understanding the world that company lives in — is really the only way to Know Your Customer. And your customer's performance contributes to the Gross Domestic Product which in turn is the product of productivity, demographics, and debt.

Which gets us back to the ISM Manufacturing Index that is, I think, the best indicator of the country's economic direction. It's stuck in the sub-50 range, signifying a less than robust market for goods. As noted above, GDP is the product of demographics, productivity, and debt.

We have an aging population that produces less and less, even though technology and robots can mask the effect. We're making up for the decline of a producing population and less overall productivity with debt.

Having a declining market for physical goods, half the populace living paycheck to paycheck, and higher debt servicing costs means fewer goods moving and reduced demand for transportation services. We have now come full circle to the relationships between and among the business cycle, your customer's supply chain, and railroad traffic levels.

The goal of the quarterly earnings calls is to convince one that buying shares in the railroad at hand will make the funds at hand today worth more tomorrow. Presenters trot out year-over-year Key Performance Indicators for operations, financial achievements like cash flow and earnings-per-share, and carload/revenue growth by commodity line. They close with expectations for the coming year, but they don't say how those expectation will be met.

That's where your knowledge of the interrelationships between and among the business cycle, your customers' demand for freight transportation services, the ISM Manufacturing Index, GDP, trip plan compliance, etc. relate directly to your own profitability.