RAILROAD WEEK IN REVIEW

August 11, 2023

"While intermodal is currently grappling with retail sector de-stocking, we consider it to be a key long-term growth driver for most Class-I railroads due to its potential cost savings for shippers and secular constraints on truckload capacity." — Morningstar, August 8

"This is a cause for concern, in our view, and we lower our rating on CSX to Neutral from Buy for the first time since Feb 2016. We believe a growing difference within the newly restructured management team led to the change." — Bank of America note on Boychuk departure, August 4

"We believe Canadian National is confronting short-term hurdles while its long-term growth potential remains intact. I reiterate a buy rating for CN due to its enduring advantageous position and unaltered long-term fundamental growth narrative." — Seeking Alpha, August 7

BNSF railroad year-to-date through the end of Q2 the handled 4.3 million revenue units vs 4.9 million a year ago, down 11%. Intermodal was the big downer, off 18%. There were 1.3 million Merch carloads ex-auto, down 5%. Coal/coke was off 3%.

All Merch carload commodity groups but Industrial (no change) were down single digits. Of the 17 AAR carload commodities only five were up: STCC 20 foods in boxcars, aggregates, grain mill products, ferrous scrap. The big losers included grain, down 15%, chemicals including a crude oil gain, off 11%, and lumber/panel/OSB down 11%. By way of comparison, UP total units were down 2%; manifest carloads off a point.

Business Unit	Q2 - 2023	Q2 - 2022	Q/Q % Change	2023 YTD	2022 YTD	Y/Y % Change
Revenues (in millions)						
Consumer Products	$ 1,895	$ 2,450	(23)%	$ 3,762	$ 4,533	(17)%
Agricultural Products	1,292	1,388	(7)%	2,768	2,745	1 %
Industrial Products	1,447	1,458	(1)%	2,827	2,755	3 %
Coal	936	999	(6)%	1,965	1,888	4 %
Total Freight Revenues	**$ 5,570**	**$ 6,295**	**(12)%**	**$ 11,322**	**$ 11,921**	**(5)%**
Other Revenues	258	345	(25)%	525	687	(24)%
Total Operating Revenues	**$ 5,828**	**$ 6,640**	**(12)%**	**$ 11,847**	**$ 12,608**	**(6)%**
Volumes (in thousands)						
Consumer Products	1,157	1,379	(16)%	2,223	2,654	(16)%
Agricultural Products	278	303	(8)%	578	608	(5)%
Industrial Products	407	421	(3)%	796	824	(3)%
Coal	360	373	(3)%	729	759	(4)%
Total Volumes	**2,202**	**2,476**	**(11)%**	**4,326**	**4,845**	**(11)%**
Average Revenue per Car/Unit						
Consumer Products	$ 1,638	$ 1,777	(8)%	$ 1,692	$ 1,708	(1)%
Agricultural Products	4,647	4,581	1 %	4,789	4,515	6 %
Industrial Products	3,555	3,463	3 %	3,552	3,343	6 %
Coal	2,600	2,678	(3)%	2,695	2,487	8 %
Total Freight Revenue per Car/Unit	**$ 2,530**	**$ 2,542**	**— %**	**$ 2,617**	**$ 2,460**	**6 %**

The railroad experienced a 24% decline in second-quarter operating earnings to $1.3 billion after taxes, reflecting lower freight volumes (down 11%), flattish average revenue per car/unit, and higher non-fuel operating expenses (up 9%). Compared to the same period(s) last year, intermodal demand is facing retailer inventory de-stocking and loose capacity in the competing truckload sector.

Industrial end markets have turned sluggish, and coal fell due to rising competition from natural gas. On top of that, the industry saw declining fuel surcharges year over year. BNSF fell short of its closest peer, Union Pacific, even as that firm faced lower freight volumes (down 2%), lower average revenue per car/unit (down 3%), and higher non-fuel operating expenses (up 9%).

BNSF's operating ratio worsened to 69.2% in the June quarter from 64.2% in the year-ago period, compared with Union Pacific's operating ratio of 63.0% for the June quarter (which was off from 60.2% in the year-ago period).

Looking at it from an investor's perspective, Morningstar writes, "Our valuation of Berkshire's railroad operations decreased to $56 per Class B share from $58, with our revised forecast assuming that carload volumes increase at a 1.1% compound annual growth rate in 2023-27 (compared with negative 1.5% previously), with freight revenue expanding 3.5% on average annually and BNSF's operating ratio reaching 63.8% at the end of 2027 (down from 66.8% at the end of 2022).

Jamie Boychuk's sudden departure from CSX last week came as a surprise to many observers. At CN he clearly had been a Hunter Harrison protege, and when Hunter brought him to CSX we always assumed the relationship would last. I have always been a great supporter of the five tenets of "Precision Scheduled Railroad " as laid out in Hunter's classic tome *HowWe Work and Why* (my autographed copy is always close at hand).

By way of review, the Five PSR Principles are: Provide Service — Do what you say you're going to do. Control Costs — Eliminate unnecessary costs. Optimize Assets — Use assets more efficiently and productively. Develop People — Cultivate the best team of railroaders. Operate Safely — Safety is the top priority.

Unfortunately, when US Class Is started their PSR implementation they started with cost control and never went beyond that. Remember Hunter first started is PSR initiative at BN (before the SF) by scheduling cars, not trains. That way you could reliably tell a customer when to expect the car — Provide Service — and control the railroad costs incurred in the process.

He knew that making car scheduling work would require an organization of talented and dedicated railroaders who recognized an unsafe act was an unplanned cost that could denigrate the other four principles. The concept was slow to take root at BN but later when Hunter took control of the IC he could really roll it out.

We first met when the railroads were holding their quarterly meetings in NY. I recall clearly his talking about getting five turns a month on grain trains between the upper midwest and the Gulf export ports. When I asked him how they did it, he said simply, "We schedule everything." And so began my PSR education. And when Hunter went to CN he took PSR with him.

Fast forward to today. In the early 2010s it had long been felt that neither NS nor CSX was operating up to potential while CN under Hunter was running like a Rolex. And we asked ourselves, what would happen if Hunter were to come to either these railroads. Then he did, bringing Jamie Boychuk.

Seven months into his tenure Hunter died. The Board tapped another CN alumnus, Chief commercial Officer Jim Foote, to be CEO. Boychuk rose in the operating rans with increased responsibilities. He had, after all, been Hunter's guy, and knew how PSR really worked. Then the pandemic hit and the best-laid plans became garbage. The CSX version of PSR failed to deliver.

Present CEO Jim Hinrichs, a former senior executive with Ford, came to CSX last September to succeed the retiring Jim Foote. He said right off that he wanted to see CSX improve service and the improved first and second quarter 2023 results showed progress. The tenets of PSR are front-and-center on the csx.com website and it began to look like PSR was really working at CSX.

Now comes word of the Boychuk ouster. The Street is floored (see Bank of America note excerpt above) and CSX shares tank. Clearly Boychuck had gained significant stature with the CSX operational turnaround, so what could have happened? The CSX press release on Boychuk's departure doesn't say much nor does the trade press. But the sudden departure of a senior executive of a major railroad warrants continued close attention. I am not the only one watching and wondering.