RAILROAD WEEK IN REVIEW

October 20, 2023

"The rails will underperform the market even though expectations for the S&P 500 call for a very slight increase. The five public rails are followed by 25-30 official analysts, depending on the carrier (I follow the private side as well and as best I can, of course), and on all five there have been 25 or more downward Q3/23 estimate revisions for the group." — Tony Hatch, October 16

"To this day, the 1980 Staggers Rail Act is one of the best examples of bipartisan legislation on deregulation, establishing an effective economic framework that created the nation's safe and efficient freight rail network." — AAR Signals, October, 2023

"With energy prices still elevated, the question is whether the economy is due for a grinding halt in growth. When we look at actual congestion — traffic on roads, traffic in ports, traffic in airlines et cetera — we still see significant activity, hence strong demand for petroleum-based fuel." — Andreas Steno Larson, Real Vision, October 17

The third quarter earnings call season started this week. Much of the material presented is necessarily backward-looking, but I think that for our purposes we need to focus on what the carriers see coming next. The common thread between both the UP and CSX calls is that each has a new CEO who is trying to build the carload customer base but who is faced with an entrenched bureaucracy that has been accustomed to doing things its own way for a very long time. That said…

Union Pacific led off the earning seasons with CEO Jim Vena noting the railroad faced a "challenging volume environment driven by continued soft consumer-facing markets." Very true — revenue units dropped nearly three percent to a shade over two million and freight revenue was down nine percent, reflecting the seven percent decline in fuel surcharge. Net income was $1.5 billion, down 19 percent.

Bulk commodities – grain, fertilizer, food and refrigerated, coal and renewables – dropped ten percent in revenue on a four percent volume decline. Industrial products saw a six percent decline in revenue on flat carloads — weak housing and lower packaging demand were offset by strong rock and petroleum products moves plus new business development wins.

Intermodal revenues declined 18 percent on a six percent decline in boxes largely on weak west coast imports. Automotive actually posted a one percent revenue increase as

revenue units increased six percent on strong OEM production and business development wins. Non-freight revenue slid 13 percent on lower accessorial charges.

Operating income decreased 17 percent to $2.2 billion. CFO Jennifer Hamann laid the expense increase on a 2022 one-time labor charge, inflationary pressures, increased workforce levels, and casualty cost. Part of this came from the six percent decrease in workforce productivity measured in car miles per day.

What we have here is UP keeping employees on the payroll even as volumes decrease, having learned their lessons from cutting head counts too quickly in the last go-round. Below the line net income fell 19 percent, largely the result of the steep ops income drop.

Operational Key Performance Measures showed a five percent gain in freight car velocity to 200 miles per day, 75 percent intermodal trip plan compliance, and 64 percent manifest/automotive trip plan compliance. Locomotive productivity increased four percent to 129 GTM per horsepower day, and a one percent increase in train length to more than 9,000 feet. Still, UP moved six percent more GTMs on four percent fewer gallons of fuel.

In spite of all the negatives, one has to com away from the call with the feeling that Vena can make a difference. Thanks to the "challenging volume environment," Chief Commercial Officer Kenny Rocker sees no particular strength anywhere. Running a smarter railroad will be key.

CSX posted a four percent freight revenue decrease to $3.2 billion on 1.6 million revenue units, down 2.3 percent. Fuel surcharges really retrenched, bringing system RPU down two points to $2,079. Merch carloads including automotive were unchanged at 649,000, merch revenue was off a point to $2.1 billion, RPU down 1.6 percent to $3,254.

Operating expense was down two percent largely on fuel (average $3.02 per gallon, down 24 percent) but the lower revenue figure pushed operating income down 18 percent. Net income was $846 million, down 24 percent. Capex was $1.6 billion, up ten percent; free cash flow after dividends but before share repurchases increased 24 percent to $2.7 billion.

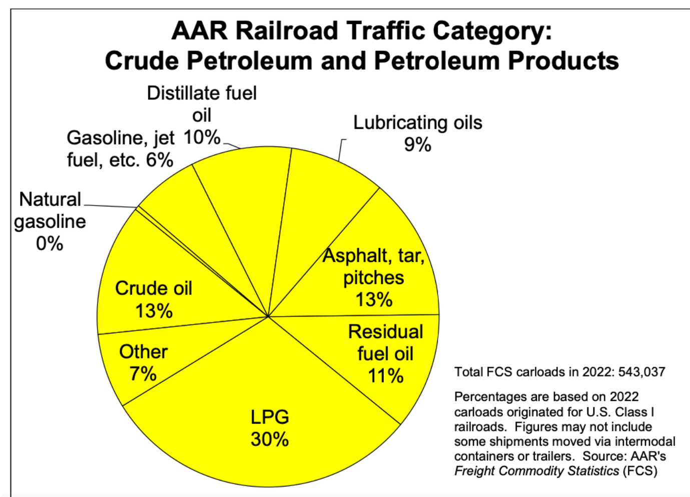
Merchandise carloads saw a strong midwestern harvest to benefit the ag sector. Even though grain was down ten percent in the quarter, it had increased eight percent year-to-date. Automotive (finished vehicles and parts), the metals group, and aggregates/cement posted gains. A plastics slowdown took the edge off chemicals volume, down five percent

YTD, and both forest products STCCs posted losses, though lumber is up six percent YTD.

Over the past year, I think we've begun to see where CEO Joe Hinrichs is making a difference thanks to his intense customer focus. Says he, service is the only thing CSX has to sell, and it's up to the marketing and operating teams to sell it. As I noted above, the entrenched bureaucracy is Hinrichs' biggest hurdle but I'm sure he will prevail.

The October 6 AAR Rail Time Indicators tells us U.S. carloads of petroleum and petroleum products were up 16 percent (5,547 carloads) in September; their weekly average of 10,051 was the most in three and a half years. Year-to-date carloads were up 11 percent, paced by gains in crude oil, fuel oil, and LPG.

To build on the italicized Larson quote above, the fact remains that oil drives everything from your car to plastics to fertilizer. Tracy Schuchart, a leading energy market trader and strategist, puts it this way: "You can't do anything without energy. You can't grow food, you can't live, you can't move anything.



"So I think that we're going to be again in a period where we're going to have higher inflation, and the Fed is either going to raise rates to ridiculous heights and break something in the economy, or they're going to have to, again, look at accepting higher inflation rates."

Which plays to the railroads' strength in LPG and the crude oil drilling process, to say nothing of the petroleum group's role in plastics production.

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