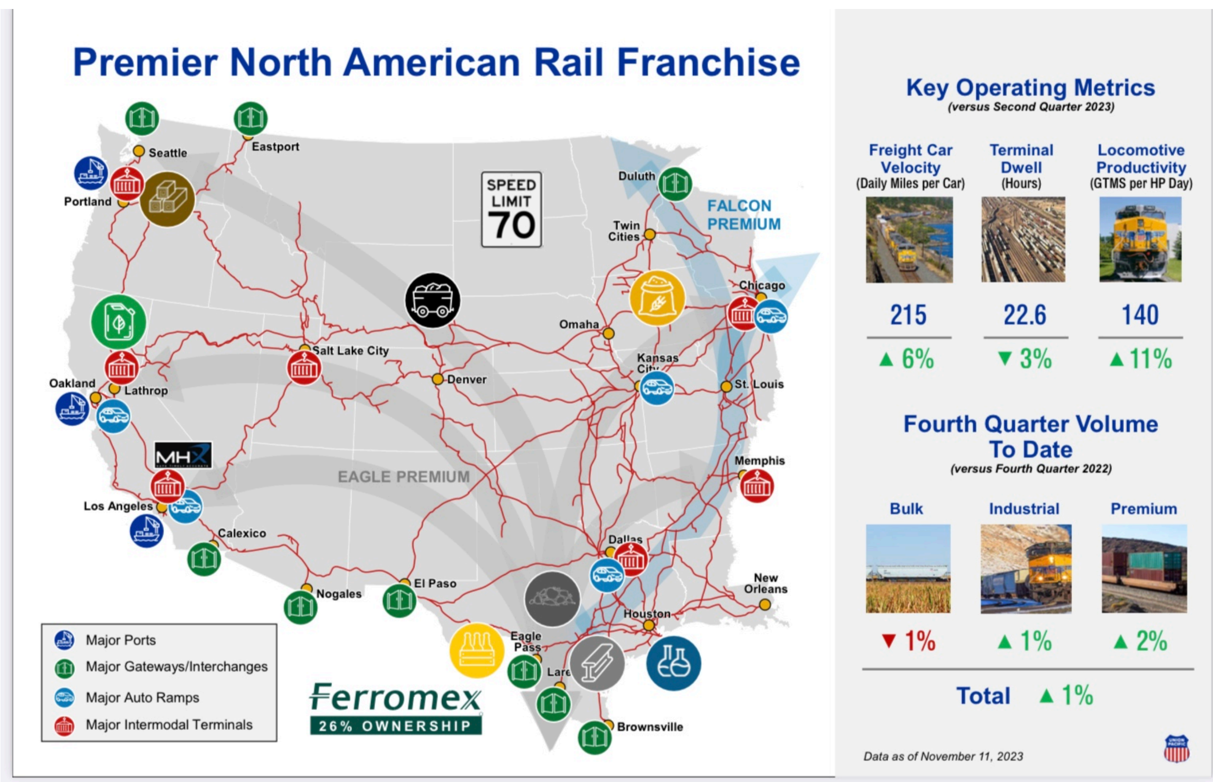
RAILROAD WEEK IN REVIEW

November 17, 2023

“Today is a watershed moment in the S&P because it brought the first of many benign CPI numbers, I think, for months to come. We got CPI that was all soft-ish and then oil took a big tumble down from around 85 to the 75-80 range. And I don't think people understand how bullish that is for the stock market. Lower energy prices take out that potential sting of having an upside surprise in inflation data, which is then going to derail the bond market.” — Tony Greer, Real Vision Daily Briefing, November 14

I don’t know if it’s cause and effect, but markets had a banner day Tuesday even as we heard bullish and encouraging remarks from senior executives of UP, CSX, and CN at today’s Stephens Annual Transport conference (NS and CP were the next day). UP’s Jim Vena framed the day’s proceedings with the bullet points on this graphic:



To start, “We handle products that are safest operated on the railroad, but we need to do a lot of work to get there. And that's my primary goal, and it’s a foundation of who we are and what we need to do. The three pillars are safety, service and operational excellence.”

You’ll note velocity is measured in car-miles per day, not system train speed as reported to the AAR. Trip plan compliance gets close, but the service levels required by UPS and a bulk grain train are entirely different animals. Says Vena, “I think the last number that we have out is around 216 car-miles per day. I have said that we could get to 220 and I don't see any reason for not getting there. And that's a really good number without the noise that you get on train speed.

“It would be like saying that we’re going to watch the Formula 1 race and we'll just count the time that they're actually out there operating, but we will take the time that they're in the pits, the time that they're at the start line, how long it took them to do the first lap, and we won’t worry about the last lap. So if somebody wants to use [train speed], go ahead. I like to use the measure that gives us the entire view of the movement for the customer and what the success rate is.”

With the graphic, “You can see the metrics on the right side that are key numbers and that’s what you want to see is in that range, dwell time going down, freight car velocity going up, locomotive productivity getting better. And that's just one of the assets we look at.” And sheer speed helps. “UP is a 70 MPH railroad and that gives us an advantage to move the products at the speed we sold the customer.”

Sean Pelkey, CFO at CSX, avoided all the usual analyst-speak and painted a positive picture of where CSX has been of late and what they see going forward. Generally speaking, the industrial economy is maybe “not as supportive as we'd like it to be, but it's stable.” Metals has has been off a little due to the auto strike. Ag is subject to crop levels and harvests in the various service regions.

Industrial production across the board is flat to down year-to-date but CSX has been able to pick up truck share because of the improved service product supported by “the scrappiness of the sales and marketing team going out and selling that.” As a result, merch carloads are up a couple of points even though “demand levels are down quite a bit this year relative to where they were maybe a year ago.”

Sean concludes, “As we go into next year, I would say we've already got a decent amount of the portfolio locked up. We've got more conversations that are happening in the coming months, and the results that we're seeing coming in are supportive. I'm not going to give you an exact number or tell you exactly where that comes out. But it's been supportive to the narrative around being able to price at or above inflation and grow our business ahead of the economy.” Amen to that.

Canadian National wrapped up the Day One proceedings with CFO Ghislain Houle and Derek Taylor, incoming EVP and Chief Field Operating Officer. To begin, CN wants to put its efforts behind the long-haul markets, where it enjoys a competitive advantage. Whereas they are willing to concede the short haul – 500 miles or so – to the truckers and their competitive advantage here, CN wants to capitalize on its own competitive advantage in the thousand-mile-plus transportation market.

A prime example is the Prince Rupert Gateway, which offers significant strategic advantages to customers—the shortest transpacific sailing route between North America and Asia; the deepest natural harbor in North America; an uncongested rail connection to CN's vast North American network; and the least steep grades through the Rockies.

Rupert takes some pressure off Vancouver and avoids the limitations of LA/Long Beach. CPKC to Lazaro isn't even part of the conversation. But CN-UP-Ferromex is. I found it quite telling when Ghislain talked about collaborating with other Class Is to access new and distant markets like Mexico with UP or KC and Atlanta with NS.

Rather than having each party at loggerheads to maximize length of haul, the railroads ask what makes the most sense *for the customer* in terms of speed and reliability. This is where the split of operating leadership between Patrick Whitehead as Chief Network Operating Officer and Derek Taylor as Chief Field Operating Officer really helps.

Both have played both roles in their careers, so each knows what the other is up against. Whitehead knows how to put the right pieces in place for the individual commodity OD pairs; Taylor knows how to run the railroad to maximize results from his partner's plan. Suffice to say the precision scheduled railroad is alive and well at CN.

Norfolk Southern CEO Alan Shaw sees single car network growth in commodities that tend to run in manifest trains. Coal and grain, for example, run in unit trains that are built to capacity; in merchandise you can always add anther car or another train and size that train to the route between OD pairs.

Shaw says they've lost a lot of business on service alone but is certain customers will come back once confidence in the service product has been restored. In addition to recapturing business once lost, NS sees new manufacturing opportunities in on-shoring and plant expansions which alone could contribute new volumes well into five figures.

They're not buying any new power but are aggressively pursuing their loco rebuild program, converting older DC units to AC. There are currently more than 200 units in the pipeline. Which is a good thing since they'll need that power as old business returns and new business is realized.

The railroad is aggressively pursuing new technologies in mechanical inspection, ROW maintenance, and planning. NS is not alone here, and a common thread among the Stephens presenters is the FRA is behind the technological curve but railroads are pursuing these initiatives anyway, finding faults that traditional eyeballs-only inspections miss.

From the tone of his remarks, I have to conclude that Shaw will get his arms around the embedded NS culture and we can expect to see more revenue units earning higher RPUs and improving margins in the process. I am relieved.

CPKC wrote *finis* to the Stephens conference with remarks from Nadeem Velani, long-time CFO for CP and now CPKC. It looks like the $350 million benefit from the KCS combo will split roughly 60-40 in favor of the carload sector vs. intermodal. Velani sees CPKC really hitting its stride in 2024 as their self-help initiatives start to pay off.

The pricing environment is favorable, the operating metrics are much improved, and shareholders should see double-digit growth in per-share earnings — *without any help* from share buybacks. The 2024 capex investments will go toward enhancing car velocity and with it service reliability, offering single-line commodity OD pairs that didn't exist before the merger.

Finally, the company is making changes in its railcar fleet to accommodate new commodity OD pairs. For example, CPKC will introduce its relatively new 5,431 cubic foot covered hoppers to the US/Mexico grain market. By way of review, these new cars let the railroad build an 8,500-foot-long, power-on model for its dedicated grain trains.

CPKC has the infrastructure to accommodate additional carloads and bigger trains. Class I collaborations such as the MNBR to CSX will open new markets, for example Dallas for automotive traffic out of the southeast and vice versa. And that's just the beginning, says Velani. I believe it. I've said for years there's an attractive fit between KCS and CP. Velani's comments show just how attractive the fit really is.