RAILROAD WEEK IN REVIEW

May 10, 2024

"The 2022 supply chain issues at the West Coast ports backed us up so we moved into a business level structure to match. But we didn't anticipate the rapid return of the underlying demand. Thus we are now working very hard to revise our business structure and allocate resources where they need to be." — Greg Abel, Berkshire Vice Chairman of Non-Insurance Operations, at Berkshire Annual Meeting

"If March was a bright spot for the Manufacturing PMI®, April was a return to what's unfortunately become the new normal: the index registered 49.2% in April, down from 50.3% in March. (March had been the first time it was above 50% in 16 months.)" — AAR Rail Time Indicators, May 6

"If anything goes wrong here, and there's another derailment and people die, this is on you, having ignored the recommendation of the proxy advisers, the unions and the company's largest customer [Cleveland -Cliffs]. You gave us literally no support, and we still won three board seats without you. What happens at Norfolk Southern is now on your firm's and your conscience." —Jim Chadwick, President, Ancora Alternatives

BNSF brought up the markers on the 1Q2024 railroad earnings calls and it's once again the fuel-surcharge-as-culprit story. Reported freight revenue dropped four percent to $5.5 billion even as revenue units increased seven percent to 2.3 million; RPU dropped ten percent to $2,241 as a result.

Operating expense was down five percent and ops income fell seven percent to $1.7 billion. The OR crept up 45 bips to 69.6, most disconcerting when compared with UP's 60.7, though UP's car count was unchanged. Below the line, net income dipped eight percent to $1.1 billion, largely the result of the FSC shortfall carrying through. Owner Earnings (ops cash flow less capex) won: up 28 percent to $969 million.

Getting back to FSC, it's hard to tell who gets charged how much and why. According to the BNSF 10-Q, "Fuel surcharges are calculated differently depending on the type of commodity transported. BNSF has two standard fuel surcharge programs – Percent of Revenue and Mileage-Based. In addition, in certain commodities, fuel surcharge is calculated using a fuel price from a time period that can be up to 60 days earlier."

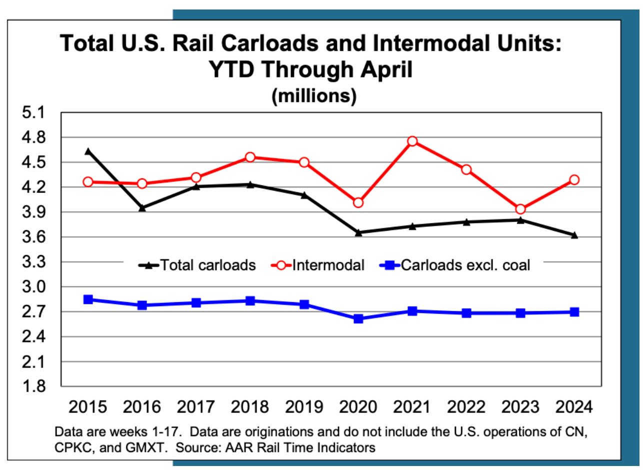
To which the Q adds, "In a period of volatile fuel prices or changing customer business mix, changes in fuel expense and fuel surcharge may differ significantly." No fooling. Last year Q1 FSC collections were $781 million, dropping to $575 million in the 2024

Q1, making freight revenue ex-FSC about equal to last year's $4.9 billion. So the press piece that blares "BNSF Revenues Down Four Percent" doesn't properly reflect the true state of the railroad.

The commodity mix is revealing. Of the 18 commodity lines reported to the AAR, only half posted gains — led by grain and industrial chemicals — and together the winners accounted for only 20 percent of total units. And it doesn't look much better going forward. The current tally tells us:

▪ **Consumer Products volumes** increased, primarily due to higher intermodal shipments resulting from higher west coast imports and the gain of an intermodal customer, along with an increase in automotive volume from higher vehicle production.
▪ **Agricultural Products volumes** increased, primarily due to higher grain exports and fertilizer shipments, partially offset by lower volumes of domestic grains.
▪ **Industrial Products volumes** decreased, primarily due to lower mineral and aggregate shipments, which was mostly offset by higher volumes of petroleum products, plastics, and taconite shipments.
▪ **Coal volumes** decreased, primarily due to moderating demand as a result of lower natural gas prices.

Greg Abel continued his Annual Meeting remarks on demand thusly: "The reality is total demand is gonna be flat, but it does move and change within sectors. It can be the consumer products. It can be an industrial. It can be agricultural products. But unit volumes are generally gonna be relatively constant."



Such is indeed the case as one can see from this AAR chart of revenue units since 2015. No surprises coal is down but intermodal is stuck at 4.2 million units and merch carloads are trending slightly down. The Railinc non-Class I car counts show solid gains, which suggests that Class I vols would be down even more were it not for the smaller roads. Which tells me Abel is right.

Elsewhere in the Berkshire Hathaway collection of wholly-owned companies, the Union Tank Car division of Mormon Industries posted revenue growth "driven by higher renewal rates in railcar leasing and price increases in railcar repair." Unfortunately, "The earnings impact of higher revenues in the Rail & Leasing group was largely offset by increased maintenance costs driven by a higher volume of tank cars requiring regulatory inspection and maintenance procedures."

The upbeat GATX reports from the analyst community support the UTLX comments although nothing was said about the "higher volume of tank cars requiring regulatory inspection and maintenance procedures." Susquehanna's Bascome Majors writes, "GATX continues to capitalize on the best railcar leasing backdrop since 2014/15… There is a robust secondary market and supply/demand dynamics remain extremely healthy in the core leasing business."

Over at TD Cowen, Matt Elkott tells us "Absolute lease rates seem unlikely to dip materially below the consistently strong levels of the last several quarters. The renewal success rate was 83.4% in 1Q24 vs 87.1% in 4Q23 and management noted that 2024 investment prospects remain favorable and that the year is progressing in line with their original expectations; as such, guidance is unchanged."

IMHO, the "higher volume of tank cars requiring regulatory inspection and maintenance procedures" could represent a downside to earnings in this space. I would have liked to see Majors and Elkott mention that in their notes to investors.

The long-anticipated results from the NS shareholder vote on the Ancora onslaught are in. Looks like 10 of 13 extant NS board members survived the challenge along with embattled CEO Alan Shaw. Evidently this was the second time Ancora had tried to get a CEO slot for ex-UPSer Jim Barber. No mention of Boychuk. I think Gil Lamphere and Sameh Fahmy are positive picks. Lamphere was running IC when his COO Hunter Harrison was scheduling *everything* there. Fahmy was Mr. PSR at KCS.

The early returns from the analyst community are favorable. Cowen's Jason Seidl says, "NS continues to reorient towards traditional PSR implementation." (I should hope so. As we've seen with all the US Class Is who've tried abbreviated PSR programs, they just don't work.)

Baird's Garrett Holland writes, "The outcome reflects shareholders' recognition of change underway and progress CEO Alan Shaw, COO John Orr, and team are working to deliver." But it ain't over till it's over. Holland adds, "Ancora says there is no standstill agreement, and it plans to continue its campaign for changes in leadership/strategy."