RAILROAD WEEK IN REVIEW

October 18, 2019

"Very low rates encourage the creation of debt. But the accumulation of those debts makes the economy more fragile, because when incomes fall, revenues fall, and indebted companies struggle to pay interest expense. If you don't pay the interest expense, you lose control of the company. You file for bankruptcy." — President of the Dallas Fed, early 2019, cited by Jim Grant on RealVision, October 3

"EBITDA was a creation of the investment banking generation in the late 1980s to facilitate leveraged buyouts. What is new now is the extreme of the add-backs to pro forma EBITDA. The investment banks will have one believe that after the present roll-up is completed, one will have one company with all of the efficiencies. But it often turns out that these promised add-backs don't really add up." — Jim Grant, ibid.

"Our shipper survey is negative this quarter with continued demand weakness, elevated inventories, and slowing pricing across most modes of transportation. Notably, same-store shipment volume expectations this quarter slowed to their lowest level in 13 quarters." — Scott Group, State of the Freight, October 14

"President Jimmy Carter signed the Staggers Act into law on Oct. 14, 1980. The legislation contained revolutionary regulatory reforms for the rail industry, and spurred the growth of short lines. Without the Staggers Act, Watco wouldn't be where it is today" — @WatcoRail, Twitter, October 14

CSX always opens the earning season and it did so once again after the close on Wednesday. It was not a pretty quarter. Year-to-date merchandise carloads barely treaded water; among the seven commodity groups running more than 100,000 units to date, four are down — including the all-important STCC 28 chemicals group. The positives are in low-rated commodities like aggregates and phosphates.

For the third quarter alone, total revenue units dropped five percent to 1.6 million; merch carloads including auto came in unchanged at 683,000 units. Merch revenue increased 80 bips to $1.9 billion, while total revenue sank 3.7 percent. Carload RPU picked up less than one percent while system RPU increased 1.7 percent to $1,829 thanks to gains in forest products, metals, and ag/food. On the call, CSX cited revenue declines in every commodity group save chemicals, auto, and forest products (mainly lumber).

Total operating expense came down a respectable 7.9 percent (though I would put the $27 million in affiliated lines earnings below the line rather than as a credit against operating expense). There were reductions in payroll, fuel (more distributed power, getting below one gallon per KGTM)), and materials (fewer train accidents and related clean up and repair expense). Operating income was $1.3 billion, down 0.5 percent, and the OR was a record low 56.8, down 1.89 points from last year's record. Net earnings dropped 4.3 percent to $856 million. Free cash flow after capex and dividends but before share repos increased 23 percent to $1.7 billion.

Looking ahead, CEO Jim Foote said on the call that CSX "has fundamentally changed the way we approach our business and our customers" and that he is "encouraged by our customers' positive response to our improved service." I can see that: departures are running 95 percent OT as yard dwells have hit a record low nine hours. I'd call that significant progress.

Union Pacific was up next on Thursday, reporting total revenue of $5.5 billion, down seven percent, on 2.1 million revenue units, down eight percent. Seven-day carloadings YTD were the lowest in three years. Ag vols were down two percent on lower grain and ferts loadings; energy vols dropped 20 percent on shortfalls in coal and long-distance frac sand offset by gains in NGLs and petroleum; premium dipped 11 percent on intermodal and finished vehicles. The industrial products group was the only volume gainer, up two percent on construction aggregates and chemicals, while wood and paper carloads slipped year-over-year.

Operating expense dropped ten percent, producing a two percent ops income gain to $2.2 billion and a record low 59.5 operating ratio, down 2.2 points. Key Performance Indicators (KPIs) reflect improvements in car trip plan compliance, locomotive GTMs per horsepower hour, and car-miles per day. Terminal rationalization and network changes continue along the Chicago-Kansas City, St. Louis-Houston, and El Paso-LA corridors.

Net income came in at $1.6 billion, off two percent. Cash from operations was $6.3 million, down 1.7 percent. Capex rose 2.8 percent to $2.5 billion; free cash flow after capex and divs but before share repos was $1.8 billion, off 17.3 percent. (Some $5.2 billion went for share repurchases.) The Q4 outlook sees flat vols continuing, continuing RPU gains as the traffic will bear, further payroll deductions, and a sub-61 OR for 2019.

For the rest of the year, chief Commercial Officer Kenny Rocker sees improving grain exports to China, more moves in biofuels and petroleum products, and improved outlooks for plastics, lumber, and construction materials. Frac sand is unlikely to recover and the auto over-stock will continue to slow finished vehicle production (as well as the raw materials going into it).

Kansas City Southern wrapped up the week on Friday. Total revenue increased 7.0 percent to $748 million on 598,900 units, unchanged; RPU gained 6.6 percent to $1,192 per revenue unit. Operating expense shed 7.4 percent largely on fuel and car hire stemming directly from the PSR initiative. Operating income was $282 million for an unadjusted GAAP 62.3 operating ratio, essentially unchanged. Net income gained 3.8 percent to $181 million.

The chemicals group led the merchandise carload gains with revenue up 20.9 percent on 12 percent more revenue units and a 7.5 percent RPU gain. Revenue for metals/scrap, grain, food products, ores/minerals, and stone/clay/glass all posted double-digit increases. Frac sand and crude oil were off double digits as one might expect. However, Chief Marketing Officer Mike Naatz points out that 70 percent of the commodities book will post gains in Q4, with only auto, intermodal and energy lagging.

The big changes were in operating practices and results. Sameh Fahmy, EVP for Precision Scheduled Railroading, went into considerable detail on the changes made and the benefits deriving therefrom. Combining intermodal and manifest trains on one corridor in Mexico cut train starts and switching hours significantly. Running faster unit grain trains has resulted in the saving of $millions in operating expense. Go to the slide set page 12 for the details.

I think there are many lessons on how to run a smarter railroad in this quarterly report, starting with Fahmy's remarks. CEO Pat Ottensmeyer continually reminds us that better service begets more revenue growth. That'll happen as the customer perception of the value/service proposition improves. KCS results for Q3 clearly show the way.

I've received a fair amount of response to my ongoing thread on Precision Scheduled Railroading and "batch processing" versus car scheduling. Turns out the concept of freight car scheduling (FCS) was first developed by Guerdon Sines, then the VP - Information and Control Systems of the Missouri Pacific Railroad. He is fondly remembered by one MOP alum as "the only IT guy I ever met who could talk down an operating guy."

The concept of FCS was to schedule each freight car - loaded and empty - on the series of trains that would carry it from origin to destination, just as an airline passenger is scheduled on a series of flights from origin to destination by the airline's reservation system. The FCS system would give railroad customers - both shippers and consignees - accurate estimates of when cars would arrive at destinations.

By the time the MoPac was acquired by the Union Pacific in 1982, the FCS was operating on the entire MoPac network. Shortly thereafter, UP closed down FCS. According to one correspondent, "It didn't work because the UP operating department was either unable or unwilling to run its freight trains on schedule, and, as a result, clerks had to reschedule every freight car on a new set of trains most every time a car arrived at a yard."

That's why, rather than reworking its train schedules or implementing a train control system that could help keep trains on schedule, the UP elected instead to shut down the FCS system, proving once again that if senior operating management doesn't sincerely believe in a process and enforce it, it ain't gonna happen.