RAILROAD WEEK IN REVIEW

November 8, 2019

"The increase in revenue is primarily due to a five percent increase in average revenue per unit as this increase was partially offset by a four percent decrease in unit volume due to severe winter weather and flooding on parts of the network,."— BNSF 10-Q, September 30, 2019

"United Rail clearly under estimated the requirements of approval. No public entity can empower just one guy to sign contracts on behalf of the taxpayers. That is why a Board of Supervisors exist. Sounds like expedience hit United Rail instead of diligence. Not a good sign that they would be a very good operator." —Trains Newswire comment on Saratoga & North Creek negotiations

"The railroads have been staging a delicate ballet: PSR-induced employee layoffs, a soft economy, freight loadings down year-over-year. It is not surprising that, as a result, the perception of the railroads and the service they provide is also evolving." — David Nahass, Railway Age

BNSF third quarter revenues slipped two percent to $6.0 billion vs. a year ago. Though BNSF does not report quarterly carloads in its 10-Q, one can get a sense of direction from the AAR quarterly carload report through Sep 28. Revenue units of 2.6 million were down less than three percent.

Within the merchandise group, eight of the 18 listed commodity groups were up — a better showing than any of their peers. According to the 10-Q, "The increase in revenue is primarily due to a five percent increase in average revenue unit as a result of increased rates per unit and a favorable outcome of an arbitration hearing. This increase was partially offset by a four percent decrease in unit volume due to severe winter weather and flooding on parts of the network."

The BNSF commodity groups were mixed. Industrial Products carloads were down three percent on metals, aggregates, paper/lumber, partially offset by chems and crude oil and LPG. Ag products shed eight percent primarily due to export competition from non-U.S. sources and the impacts of changes in international trade policies. Coal was down ten percent mainly on nat gas competition. Consumer Products (auto and intermodal) were off thanks to five percent fewer automotive loads and intermodal being down a point-plus.

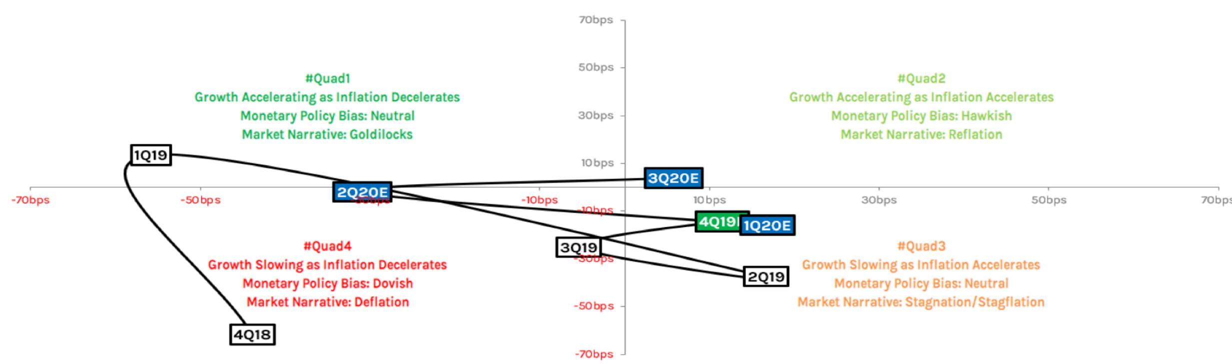
I find it useful to compare BNSF merch carloads with the US Class I group. BNSF's total volumes have declined almost three percent vs. a year ago, relatively better than the other large-cap U.S. rails. There are no obvious signs that BNSF is chasing share with lower rates, and it appears that BNSF reported slightly better yield growth than UP.

That said, I think that if BNSF were to be any more aggressive on rates, UP might pick up some cars from BNSF where there is less price elasticity. This fits with a conversation I had at the 2018 BNSF shortline meeting in Fort Worth about the hazards of chasing business with price. After all, one has to know what price the traffic will bear while still making livable margins for the railroad. (As an aside, CP's John Brooks said essentially the same thing at their shortline meeting last week.)

Re the PSR discussion, the record shows that BN (before it added the SF) got the scheduled carload ball moving when Hunter was there in the 1980s. (*Railroader: The Unfiltered Genius*, Howard Green, page 89). As you know, I spent some quality time learning about BNSF from the likes of Dave Dealy and Rollin Bredenberg, so saw much of the work up close and personal.

In sum, BNSF has the tools for freight car scheduling, is pricing to what the market will bear without giving away the store, is positioned to reap the rewards of an improved China story, and has the commodity balance and diversity to be a first-rate shortline partner. But attention must be paid and being nimble is the watchword.

Regular readers of Week in Review are used to the economic tea leaf readings I publish from time to time. Given the carload volume funk in which we seem to be mired (see AAR chart on page 3), I thought you might find this hedgeye.com model useful. In it, the economy is divided into four quadrants, or "Quads."



It charts growth (x-axis) against inflation (y-axis), is predictive, and gives some direction as to where the economy is headed. For the nine months, we've been in Quads 3 and 4 with decreasing growth with inflation running both hot and cold. The common thread of Quads 3 and 4 is one of retrenchment, and the AAR carload stats bear out the thesis. We only see the first glimmers of positive Quad 2 deltas in Q3 of 2020.

Thus the prudent shortline operator will query customers as to first half capex and hiring plans to get a feel of where car counts will be in the first half. Then you can start budgeting your own capex and hiring for 2020. Do let me know whether you think these signals help.

AAR Carloads continued their downward trend through October, taking us a third of the way through the final quarter of the year mostly in the red for the week — only grain was up. More telling, year-to-date carloads are off more than three percent; only petroleum — which is largely crude oil and does not see any significant shortline participation — saw any gains.

North American Rail Traffic

Week 44, 2019 – Ended November 2, 2019

	This Week		Year-To-Date		
	Cars	vs 2018	Cumulative	Avg/wk[1]	vs 2018
Total Carloads	**346,309**	**-8.0%**	**15,574,310**	**353,962**	**-3.3%**
Chemicals	43,474	-4.5%	1,990,591	45,241	-0.6%
Coal	80,165	-17.7%	3,776,288	85,825	-7.1%
Farm Products excl. Grain, and Food	25,598	-2.4%	1,095,948	24,908	-2.3%
Forest Products	16,538	-6.4%	737,677	16,765	-5.6%
Grain	34,411	6.9%	1,424,166	32,367	-4.1%
Metallic Ores and Metals	38,937	-10.0%	1,820,242	41,369	-3.9%
Motor Vehicles and Parts	26,140	-1.9%	1,143,045	25,978	-2.2%
Nonmetallic Minerals	43,785	-10.0%	2,016,301	45,825	-5.3%
Petroleum and Petroleum Products	23,549	-4.2%	1,036,749	23,562	14.4%
Other	13,712	-4.2%	533,303	12,121	-2.2%
Total Intermodal Units	**351,681**	**-7.9%**	**15,573,320**	**353,939**	**-3.3%**
Total Traffic	**697,990**	**-8.0%**	**31,147,630**	**707,901**	**-3.3%**

[1] Average per week figures may not sum to totals as a result of independent rounding.

If the economy keeps lumbering along in Quad 3 or 4 (page 2), then the trend is unlikely to reverse until at least the second quarter as customers start preparing for the Quad 2 expansion in the second half of 2020.

But there's more. These slowdowns in carloadings are going to hit the marginal short lines particularly hard. As revenues slip, money gets tight and the first place to cut is always track and power. That's a shame, because it makes service irregular and keeps the short line from enjoying the eventual benefits true freight car scheduling will bring to customers' supply chain planning.

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