RAILROAD WEEK IN REVIEW

March 19, 2021

"While these results show the central role that our products played in helping our users respond to these challenges, we are doubly aware that the work ahead of all of us to navigate the end of this pandemic, to restore normal life and prosperity in our neighborhoods and local economies and, to build back with a sense of justice is profound and urgent." — Tim Cook, CEO, Apple, intro to 1Q2021 Earnings Call

Berkshire has repurchased more shares since year-end and is likely to further reduce its share count in the future. Apple has publicly stated an intention to repurchase its own shares as well. As these reductions occur, Berkshire shareholders will not only own a greater interest in our insurance group and in BNSF and in Berkshire Hathaway Energy, but will also find their indirect ownership of Apple increasing as well." — Warren Buffett, Chairman's Letter, February 27

"Our people day in and day out ensured that our railroad was positioned to succeed by delivering for our customers' changing needs, while seizing efficiency opportunities that produced record productivity levels and advanced our PSR-based operating plan." — Jim Squires, CEO, Norfolk Southern, intro to 4Q2020 Earnings Call

The way a chairman begins his review of the previous period's results is very revealing. It tells one right up front where the company's focus lies. The Apple focus is community, the Berkshire focus is the shareholder, and the NS focus is its own internal metrics. The difference is that the first two begin with the desired end result and move on to how they will achieve those ends. The railroad example — and they're all pretty much the same — starts with the internal processes, and largely *implies* the customer benefit.

One reads a lot these days about how railroad traffic levels are "rebounding" and how the "pent-up demand" will accelerate the rate of change in revenue units as the year progresses. First, I hardly think being up one or two points qualifies as as "rebound." The better phrase is "seeing a gradual recovery" because that's what's happening. Sorta.

Intermodal and grain are the big drivers. The general freight merchandise carloads of forest products, metals, aggregates, waste (metallic, C&D, municipal) and industrial chemicals continue to lag. Second, as for "pent-up demand," I don't see it. Government checks ("stimulus" and the like) are going to savings, reducing household debt, and just helping to get daily expenses.

Inflation is a huge drag. Even with the reported low headline CPI (consumer price index), if you strip out technology, leisure, and hospitality, you're left with that basket of things one needs to survive. So if rent, fresh food, education, health care, and insurance go up faster than real wages, the real rate of household inflation becomes that much higher. Worse, real wages rising at two

percent still won't cover the increased cost of that basket of essentials. That's one reason I see "pent-up demand" as a non- starter.

Back to transportation. You still need trucks and trains to keep that basket of necessaries moving. Shipper channel checks in all these commodities reveal truckload growth, rate increases, and capacity shortages. They also reveal impatience with railroad service, both local and intermodal, and higher rates for slower transit times. On the other hand, the non-Class Is are creating new carload niches by paying attention and being responsive.

Paying attention and being responsive requires customer dialog, and Zoom calls make it easier than ever. Ideally, one could do a three-way call with the regional carrier, the customer, and the Class I contact to determine (a) the desired transportation product, (b) the resources required to deliver said product, and (c) a rate. Ideally, one could ask for the order and close the sale in one session. The truckers do it all the time, and that's what wins business.

Vermont Rail System (VRS), as expected, "opposes the Board's processing" of the proposed CSX-Pan Am Rail transaction. The filing states that the combination "would re-shape railroad service throughout New England" and is particularly miffed at the selection of a GWR subsidiary to run the Pan Am Southern. VRS reminds the Board that PAS was created 12 years ago "as a means to compete with CSXT's dominant regional position."

As for GWR a subsidiary operating PAS, Vermont Rail maintains the filings "conceal a troubling consequence of the PAS Transaction," i.e the creation of a "roughly 70-mile two-to-one corridor, eliminating competition" between East Northfield, Massachusetts and White River Jct, Vermont, where PAS has complete rights over the New England Central, another GWR subsidiary. As is, VRS has two railroad connections at Bellows Falls — NECR and PAS — and another PAS connection at Hoosick Jct, New York. Eliminating PAS creates the two-to-one no-no.

The VRS filing concludes that its member railroads —Vermont Railway, Washington County Railroad, Green Mountain Railroad — "are vital parts of the New England railroad network." Moreover, the underlying rail properties are all owned by the state of Vermont. "Hence, any adverse impacts of the proposed transactions that could befall VRS are equally of concern to the state."

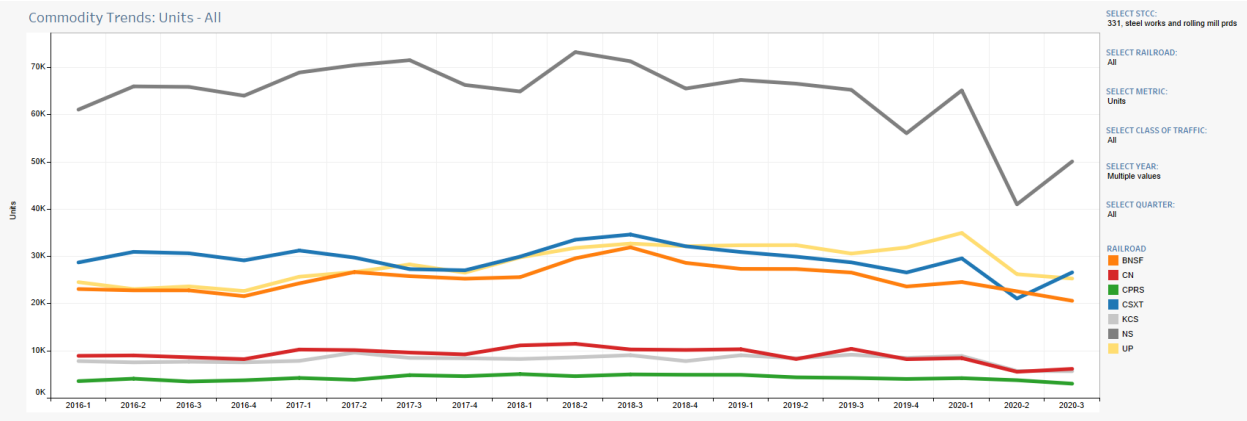
The details in the filing, FD 36472, would be a fascinating read for anybody familiar with the northern Mass/southern Vermont railroad landscape and history. And since I spent my formative years in the Hartford area, have clients in the area, and have family connections in the north, I qualify. Think I will grab a Harpoon IPA and watch.

There's an argument going around that higher diesel fuel prices will push truck rates up to the point where rail freight is more attractive. I disagree. Truckers and their customers are already absorbing ten percent increases in spot prices, taking mid-single digit hikes in contract rates, and still the truck share increases.

The fact remains that the railroad transportation offering is still slower and less reliable than truck for moving non-fungible goods worth major $$ in inventory and thus working capital. Take dimensional lumber: as much as $500/thousand board-feet (mbf), up from $400 not that long ago. Put 100 mbf packages on a center-beam and it's half a $million in working capital the receiver can't touch while the car's in transit.

If the train is ten days and the truck is two, guess who gets the nod. So, until the railroads solve the consistency/reliability problem, they will always be at a disadvantage, fuel prices notwithstanding. That is not to say receivers are blameless, at times causing their own problems. A reader writes, "The lumber shipping patterns are often very chaotic, so much so that delivering local freights can't get in and have to log the incomplete work as 'failures on delivery or pick up.' That costs at least a day."

The February 5 Rail Time Indicators from the AAR reminds us there is a strong correlation between railroad carload commodities and quarterly GDP changes. Take steel and steel products (STCC 331) for example (chart courtesy RSI Rail Impact):



STCC 331 carloads peaked in 2Q2018 and drifted lower until the pandemic hit in 2Q2020, recovering somewhat in 3Q2020 per the above. RTI kind of fills in the blanks between then and now, noting that "primary metal products," of which steel is a major portion, was off just three percent in January, 2021 — the smallest decline in two years.

The AAR reports the broader category of met ores and metals was off just two percent year-over-year in Week 10 (March 13) for the North American railroads; ditto for year-to-date. The take-away for railroads handling steel and other metals is that the group is on the mend so resources should be arrayed accordingly. Moreover, this uptick bodes well for ingredients like scrap metals.

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