RAILROAD WEEK IN REVIEW

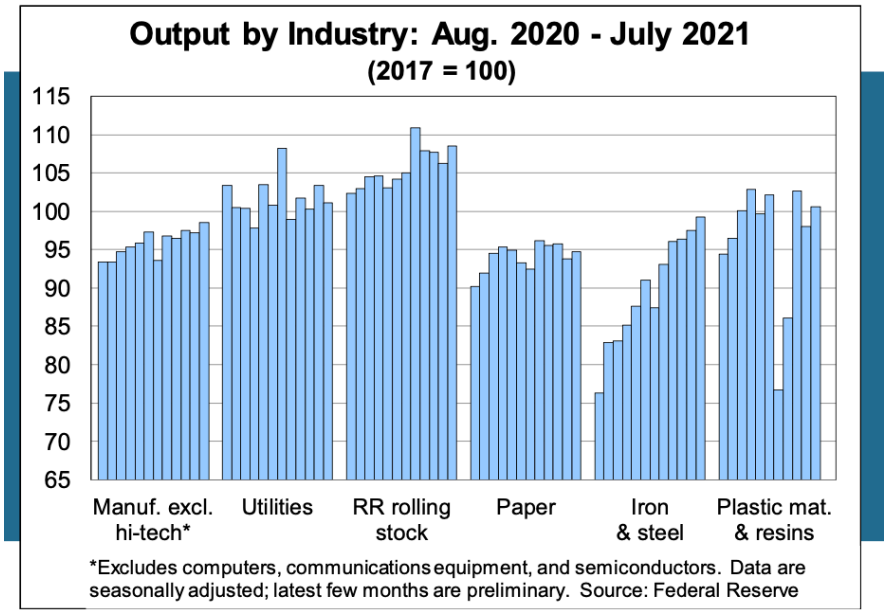
October 8, 2021

"Even at early stages of automation, the correlation between robot density and employee wages as a percent of revenue, or labor share, is clear: as a company becomes more capital intensive, labor's share of revenue declines, but automation increases productivity — potentially increasing both labor income and corporate profits, a win-win." — The Potential Impact of Automation on Manufacturing Profitability, ARK investments, August, 2021

"Ultimately, the transition to self-driving cars will dramatically change the landscape of what we're used to. It will affect the rental car industry. We'll see less traffic on the roads... reduced emissions due to fewer cars idling in traffic... and fewer parking lots built. And we'll begin seeing smaller autonomous vehicles like delivery robots that bring us our groceries or meals." — The Next Big Transportation Shift Is Coming, Empire Financial Research, September, 2021

"Total originated carloads on U.S. railroads in August 2021 were up 4.1 percent over August 2020 and down 11.4 percent from August 2019. The year-over-year gain in August 2021 was the smallest year-over-year gain since March 2021." — AAR Rail Time Indicators, September, 2021

The industries that are most apt to use the railroad have yet to regain their 2017 volumes of output per the AAR. Utilities are at par and RR rolling stock is a little better. But general manufacturing, paper, iron & steel, and plastics still lag.



There's a double-whammy at work here. Not only are commodities favorable to the boxcar not recovering from their 2017 levels, fewer low-skilled workers will be needed to produce what's left thanks to to robotics and smart manufacturing. That implies smaller workforces to produce the same volume of output and — most worrisome to railroads —smaller inbound shipments and more frequent, and smaller, outbound shipments to customers.

This trend is doubly worrisome. Not only does the addressable market for railroad shipments seem to be shrinking, but also the railroads' shrinking resource base is making it tougher to meet the needs of those customers remaining loyal to the railroads. Though capex as a share of revenues has remained in the mid-teens, revenues are not increasing, so actual capex dollars are decreasing.

Moreover, revenue units — the stuff that wears out and needs capex replacement — are in decline, meaning less wear-and tear on the infrastructure and fewer locos and fewer T&E crews to run what remains. As a result, railroads are having an increasingly difficult time justifying a $million in new capex today if there is no certainty the traffic will be there to support it five years out.

Happily, there is a solution. Non-Class I railroad feeder lines have the resources to keep cars moving and inventory flowing, both by direct-to-dock service and transloads a short truck hop away from the customer. Which brings up another mystery of Class I thinking: retaining ownership of branch lines with viable customers that they either cannot or opt not to serve (see coal examples last week).

If you can't justify the capex to keep the railroad running, you have two choices. One, let the business wither and force customers to find other transport means, thereby losing a revenue stream (this is what happened to many of the Southern's Carolina branch lines when they got out of the short-wood carload business).

Two, sell the line to somebody who can keep and grow the extant business base. You keep most of the revenue stream and leave the capex to somebody else. You can put locos and crews to better use elsewhere, perhaps even to improve service quality on the core railroad. Capex dollars can go to share buybacks, improving owner returns. Looks like a win-win to me.

Coal continues to represent roughly seven percent of all short line revenue units. I see a distinct opportunity for that to increase in the not too distant future. It is simply the law of supply and demand at work. The world is rapidly coming to the realization that you can't power electric arc steel making, air conditioners, electric vehicles, and washing machines solely on "renewables" — wind, water, solar, and so forth. As we saw in Texas last winter, there comes a point where these so-called green power sources just can't keep up.

Unfortunately, as the demand for electricity from alternative sources has increased, the demand for coal has decreased with mine closures and with the loss of resources to move it from mine to power plant. One of the results is a sudden spike in the price of US coal, Now $270 a ton versus $125 a ton as recently as July. So here we are on the cusp of the fall-winter-spring heating season faced with rapidly increasing utility prices. (*Graphic courtesy trading economics.com*)

The good that this ill wind blows is that the railroads that have maintained their coal handling resources — and helped keep their power plant customers open for business— can look forward to a continued stream of revenue from those black diamonds.

As an aside, I ought to add that AAR North American Class I coal carloads through Week 38 (Sep 25) increased 14 percent year-over-year. Everybody increased double-digits in the teens or more, except that UP gained a mere 120 basis points.

The year through the third quarter seems to be shaping up as not too shabby. I think the non-Class I roads will continue to see growing customer bases, tempered only by the Class Is' ability (or willingness) to provide the level of service they are being paid for.

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