THE RAILROAD WEEK IN REVIEW

October 2, 2015

"The simpler approach to government shutdowns may be just to ignore the near-term noise and focus on your long-term goals." — Randy Frederick, Managing Director of Trading and Derivatives, Charles Schwab & Co. Inc.

It's all kabuki. When the federal budget becomes a hostage in the political process, there is always contention over what swords to die on. This year the menu includes:

Funding of Planned Parenthood
Military spending increases
Domestic spending increases
Recent congressional approval of the nuclear agreement with Iran
Raising or suspending the debt ceiling again
Replenishment of the Highway Trust Fund
Tax provision extensions
Proposal to repeal the carried-interest deduction for hedge funds

And while government shutdowns can cause short term heartburn, Schwab's Frederick writes they've never done lasting damage to stock market performance. We've had 17 government shutdowns in the past 19 years and while

> the impact was negative for the stock market only about half the time, the decline never exceeded 5%. The 2013 shutdown resulted in the largest gain (+2.4%) among the 17 shutdowns. However, it didn't start out that way. Six business days after the shutdown began, the S&P 500 Index was down by 1.6%.
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> But then rumors began to leak out that a deal was being struck in Washington, leading to the biggest single-day rise (+36.2 points) since the first day of 2013. That rally was followed by additional gains in three of the next four sessions, for a total of +40 points (+2.4%) overall since the shutdown began.

So you pays your money and you takes your chance, and, as it happened, the adults in Washington prevailed this week and the bullet was dodged. Ignoring the near-term noise is the best defense.

The near term noise we can't ignore has to do with third quarter earnings. Through Week 38, revenue units for all the rails but BNSF are flat to down year-over-year. I've done some expense and revenue projections using last quarter's average and am having trouble seeing any uptick in earnings unless through non-GAAP "extraordinary events" or share buy-backs.

Scott Group of Wolfe Research writes, “We continue to believe strongly that pricing and productivity are much bigger drivers of rail earnings than volumes.” I guess that works as long as prices go up at a faster rate than operating expenses. His argument is that even in a soft economy rails can grow net income by running fewer, faster trains with fewer crew starts and fewer gallons fuel per GTM.

I, on the other hand, am of the old school that says the more cars you can put behind each loco the more revs you’ll have supporting not only that train start but also the fixed costs that go for bridge maintenance and the President’s salary. Problems arise when marketing tries to make every car pay for itself, chasing low-margin vols off the railroad.

Group concludes, “We increasingly hear concerns that volumes will remain weak and pricing will slow and the rails won’t be able to return to double-digit EPS growth. We disagree with this view and take comfort knowing that CP, UNP and CSX have each averaged flat to negative volumes over the past 10+ years.”

And we also know that share buybacks have helped a couple of percentage points each quarter, that operating expense ex-fuel continues to creep up, and that low-rated commodities drift further south a bit each week. We’ve watched as intermodal terminal footprints expand and carload class yards shrink. What I think Group et al are saying is intermodal is nearing the point where its low point-to-point ops cost and dense-pack trains approach merch freight loads in RPU margins.

Keeping It All in the Family Department. GE Rail Services this week reached separate agreements to sell its tank car fleet and railcar repair facilities to The Marmon Group’s Union Tank Car Company, UTLX, and its remaining railcar leasing business to Wells Fargo’s First Union Rail (FUR). The tank car purchase is effective immediately. In a separate transaction, to be completed by the end of 2015, Marmon has also agreed to acquire certain GE Railcar Repair Services’ repair and maintenance facilities.

Well, if anybody were to buy GE Rail Services, Marmon and First Union Rail are the natural buyers. Marmon is a Berkshire Hathaway property, and Berkshire is a major shareholder of FUR parent, Wells Fargo. Berkshire also owns 10 million shares of GE common stock. Combine that with Berkshire’s BNSF ownership and you’ve got a pretty solid corner on the surface transportation of crude oil. Keeps it All in the Family. Even Meathead would approve.

Deborah Harris (Deb) Butler, NS Executive Vice President for Planning and Chief Information Officer, took her retirement this week, but her legacy lives on. The main NS (formerly Southern) yard in Memphis is now “Harris Yard,” in her honor.

Deb first signed on in 1978 as a customer account auditor, working her way up the chairs to assistant vice president transportation customer services in 2000 and vice president customer service in 2002, before being named EVP planning and chief information officer in 2007. It was when she was running customer service in Atlanta that I first met her and found her expertise in car management and distribution invaluable.

Early in her career, she oversaw modernization of many of NS' core transportation systems, such as ITMS for transportation information sharing, TYES for yard management and inventory, RIT for remote work orders, and the Pacesetter customer portal. Deb knows NS and how it works, especially in car management and getting trains out of yards and over the road. Having the Memphis yard named in her honor is entirely fitting. Thanks, Deb, for all you've done to help the shortline community strengthen its partnership with NS.

Short Line Carload Channel Check. On the west coast, a short line has successfully scoured up new business by "beating the bushes for new business when it looked like business was softening earlier this year." At the same time, my contact says "the class Is kept raising rates, and price hikes do nothing to encourage new business. Seems like since business is down, rather than trying to find new business, they are trying to cost-cut their way to better ORs."

Another WIR regular and former Class I senior manager confirms: "Roy, as usual, you are right on. I've seen business run off that that was within 95 percent of target threshold. It surely appears management leadership is playing to the financial community." All seem in agreement that, in the words of yet another retired Class I officer, "You need them all: volume, pricing and productivity," meaning you can't afford to run off low-rated business because, "with a big infrastructure to maintain, railroads absolutely require positive cash flow" from any source. "It just takes takes smart management to figure out the most profitable mix of traffic!"

Another bullet dodged. Maybe. The PTC Sword of Damocles may not be hanging by quite so narrow a thread. *Railway Age* Editor-in-Chief Bill Vantuono puts the case most eloquently:

> The House Transportation & Infrastructure Committee, after flogging railroaders and regulators in numerous let's-beat-another-dead-horse hearings on why PTC won't get done on time, and egged on by the Thune in its side, finally did the right thing by introducing H.R. 3615, the Positive Train Control Enforcement and Implementation Act of 2015.

If H.R. 3615 becomes law — Bill says there's little reason to believe it won't and I'm not holding my breath — the industry will have at least three more years to turn on a fully operational and interoperable PTC network. Lets hope reason prevails.