THE RAILROAD WEEK IN REVIEW

October 16, 2015

"Maintaining these under-utilized branches represents significant cost, particularly if the heavy traffic they once handled is gone forever," Ron Flannery, Trains, November, 2015

CSX third quarter revenue units were off three percent from the same 2014 period. Coal of course was the biggest drag, down 18%, nearly 60,000 cars, with most manifest carload commodity groups suffering losses as well. Total revenue skidded nine percent to $2.9 billion chiefly on volumes as RPU took a tiny one point increase. Operating expense came down 11%, with significant savings in payroll, supplies and fuel, so ops income took just a 4% hit to $933 million and the OR was a still-respectable 68.3, down 144 basis points.

Merchandise carloads comprise 43% of total revenue units with intermodal closing fast at 42%. You can see why: merch carloads as a group declined 3.7% while intermodal units rose 5.8%. Among the commodity groups that make up 80% of merch carloads, only auto, grain, petroleum products, and aggregates are in the black for year-over-year changes. The only other commodities in the black are processed foods, grain mill products and iron ore.

Same-store sales gained 4.6%, though lower fuel recoveries ($175 million, in fact) and mix offset this otherwise bright spot. In ag, positive grains and beans were overshadowed by the ethanol shrink and ferts were down thanks to lowish corn prices. Domestic intermodal vols increased 15% on highway conversions but international slipped 5% on market share losses.

As I look at the sea of red in the commodity volume change column, it's becoming increasingly evident that whatever can move in boxcars, open-top gons, or on flatcars of any type seeks other modes, leaving the long-distance bulk to the rails. One then begins to ask how much of the extant branchline structure and corporate overhead is really needed to make the shift to doing what the railroad does best: move large blocks of highway-unfriendly products point to point, largely forgoing the hunting and gathering network.

There's a saying that history doesn't repeat as much as it rhymes. The granger roads got in trouble years ago because they overbuilt their branchline reach. Maybe the remaining names are still running too many miles of light-traffic branches. The November *Trains* magazine gets right to the point. Though the context is coal, contributor Ron Flanary writes, "Maintaining these under-utilized branches represents significant cost, particularly if the heavy traffic they once handled is gone forever," and he goes on to cite specific CSX (and NS) line segments. Is it time to dust off the *Final System Plan* from the 1990s?

Perhaps. On the call COO Cindy Sanborn alluded to "structural changes in the coal network," saying "everything's on the table," from harvesting lines to shrinking facilities, to reallocating assets to more productive uses. The 28-hour operating schedule has increased train lengths 10%, which may be OK in the multi-track northern regions but not so hot in the south where density and train length were never an issue, so single-track routes prevailed. Now with density shifts, longer passing sidings are the order of the day, and creating them takes time. Shifting assets from the now light-density coal lines will help.

Below the line, CSX net income was $507 mm, down 40 basis points, but EPS grew 1.3%, 52 cents from 51 cents, because the firm sank $546 mm, a fifth of of cash flow from operations, into its share repo program. Were it not for the reduced share-count, CSX would have been obliged to report 51 cents a share, unchanged; however, free cash flow after capex and divs would have been a positive $91 mm rather than a negative $455 mm.

The railroad is running much better with on-time originations now 76% vs. 54% a year ago. Dwell came down an hour even though train speed is off slightly. Sanborn confirms that line-of-road capacity constraints are a factor in late arrivals — 46% of train-starts — and as they get fixed, OT arrivals will increase. The good news is yards can absorb the late trains and still make the connections, increasing car-miles and car-contribution per day.

On a personal note, I was well pleased with the firmness and conviction in the remarks of the two new lead presenters on the call, Cindy Sanborn and CFO Frank Lonegro, and the way Fredrik Eliasson shifted seamlessly to marketing from finance. Ward said on the call he's going to stick around another three years to get these guys firmly ensconced in these roles. From what we heard on Wednesday's call, I must say they own their jobs right now.

GWR North America runs 13 lines of carload commodities including coal and "other," excluding intermodal. Of the commodities that comprise 80% of GWR-NA vols, only three are in the black; of the remaining 20%, only two are positive. "Other" is particularly bothersome: it's essentially Class I overhead and really not a dependable revenue stream because it depends on factors wholly extrinsic to GWR.

Total rev units dropped 5.4%; Q3 vols were off 9.3%. New Rails, properties added in the last 12months, added 2,686 units; back them out and same-store vols drop 7.2%. Year-to-date carloads including new roads are down 5.7%; Sep was 3.4% behind Aug, making it five months out of nine lagging the preceding month. In the press release GWR ascribes the losses to "reduced shipments of metals, minerals & stone and auto & auto parts." Though they're not saying, it would not surprise me if the ag gains came on the RCP&E and the "other" losses were NS overhead coal in Ohio.