RAILROAD WEEK IN REVIEW

December 24, 2015

"Empower your short line and regional connections to dig around for new business. It's out there, and you have lots of room to grow." — Fred Frailey Trains *blog*

The CP-NS question continues to dominate. The silence from Norfolk is deafening, and into this void come all manner of ideas of what NS must do to preserve itself as an independent member of the Big Six class I community. Fred Frailey, a good friend, sometime mentor, and source of rational thought, offers up "A Plan for Mr. Squires" in his December 21 *Trains* Blog.

Fred's entire six-point post is drawn from ideas already out there, many of which we and others have tossed around on the phone and in email exchanges. Of particular interest to WIR regulars in the non-Class I railroad community:

> **Revive the carload network.** Empower your shortline and regional connections, using incentive payments, to dig around for new business. It's out there, and you have lots of room to grow. You could even divide your entire railroad among these smaller partners, putting their people to work on marketing at the local level and their locomotives and crews to work on trackage rights to switch your customers outside of major terminals. You've nothing to lose, because the business is seeping away as it is.

As for empowering shortlines, CP commits to eliminating paper barriers (James Clements, WIR December 11). NS must do that now, then move onto short lines that NS created by spinning off the miles between the last big customer and the end of the line. Many of those customers have either gone away or down-sized, and, where they remain, they eat up NS assets (power, crews, track repair). Turn these vestiges of franchise-protection over to the short lines and even move the interchange to a serving yard where it makes sense (see trackage rights, above).

As for dividing the railroad, NS has already assigned in-house "shortline development managers" by region and by short line within the region. These managers' charge is to help turn opportunities into revenue from customers local to the short lines. I'd take that another step: let short lines offer their customers the NS product that best suits their supply chain needs — carload, intermodal, transload — and pay the short line a handling fee for every load so initiated.

The Hunter Harrison model appears to be one of trimming assets to fit the traffic available and making sure the traffic available makes best use of the assets. Twenty-five years ago he was able to turn grain trains between the midwest and New Orleans six times a month while single-tracking most of the IC main line. At CN he converted low-volume carload customers into higher volume intermodal customers. And at CP he eliminated hump yards to cut days per car-cycle.

In none of these instances did Harrison just take a chain saw to the single-car network. He used a scalpel to decrease the number of customers requiring custom treatment in a batch network, and, in the process, to increase the number of customers best-suited to the batch network.

The short lines, which NS staffers accurately call "market extenders," can facilitate this shift. They can build their outbound consists sorted by distant node, rather than delivering a mill-run of mixed-destination cars to NS. Doing so lets NS run distant-node cars directly to the departure yard from the receiving yard, skipping the hump, saving the customer a day's transit time, and decreasing car cycle time.

I know it can be done. I've done it myself and the hump yard managers I've spoken with say it would speed things up for them. So, like Fred says, "Mr. Squires, empower your regional connections. You have nothing to lose."

Credit-Suisse railroad analyst Allison Landry writes in her December 18 note, "The worst is behind us (we hope), but we're not out of the woods just yet." She doesn't see commodity carloads getting any better over the next few months. "That said, we see the comps looking less bad" in the 2016 second and third quarters, and a possible turn positive in the fourth. Seems reasonable: crummy comps this year on a so-so 2014 can only get better in 2016, even in a two-percent economy.

As for the CP vs NS argument, Landry compares share price multiples for three years. CP has drifted steadily south since December, 2014, to 16.5 from 20; NSC hasn't come down as many points, to 13.5 from 16. For me, this confirms CP was way overpriced a year ago. At that time I said CP was worth $140. It's now $126.

Getting back to Week 49 year-to-date revenue-unit trends, everybody's down (two percent, plus or minus). However, if you include the BNSF numbers from their weekly AAR report (Landry doesn't include BNSF in her analyst notes because you can't buy shares in it), you'll see that BNSF is actually up — not by much, but at least not negative. Even coal is up, and up by more than intermodal. The big downers are metals, steel scrap, met ores, aggregates including frac sand, lumber/panel, and petroleum, both crude and NGLs. Grain is the big gainer.

Not having shares trading on the street is, I think, part of the reason BNSF outperforms: they don't have to shape the earnings story to make Street points. Just imagine what NS could do without the Street breathing down their necks, should Matt Rose and Uncle Warren take an interest.

Shares of railroad car-makers from American Railcar to Trinity have been taking a beating as volumes and outlooks have headed south. On the other hand, Westinghouse Air Brake Technologies (WAB) has one foot in freight car components (the other is in public transit), which is a better place to be.

Says a December 21 note from Stifel-Nicolaus, “WAB should be viewed as a diversified and high-quality way to invest in rail globally, both freight and transit, without undue focus on railcar and locomotive production in the North American freight market.” True, WAB growth rates have slowed from double-digits 2012-2014 to anticipated single digits in 2016. Yet, “Little has changed with their story other than the company having somewhat more sluggish freight rail markets to contend with.”

> The company has proven that its business model has become resistant to downturns in North American railcar and locomotive production as it has grown its less-cyclical aftermarket businesses, grown its international revenue, and grown its transit businesses… WAB maintains roughly a 50 percent market share in North America for its primary braking-related equipment… In addition to manufacturing new equipment and components, the company serves the aftermarket by providing replacement parts and services.

In my opinion, WAB’s dominant role in replacement parts adds particular value. As cars make more miles per day and turn faster, stuff wears out faster. I don’t own it now but have in the past to good effect. Shares are up this week on the Stifel upgrade; tech-watchers still are negative on the relentless series of lower lows and lower highs since September. Schwab gives WAB a D (sell). It’s still below the SMA 20, 50 and 200. I’m staying away until shares cross the 20- and 50-day simple moving averages to the upside.

This is the last Week in Review for 2015. I’m hopeful not much happens over the next two weeks, so look for the first WIR2016 in your mailbox Jan 5. The tea leaves indicate a dull year carload-wise in what promises to be an eternal two-percent economy. That’s just as well. We’ll have excitement enough as the CP-NS saga plays out.

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