RAILROAD WEEK IN REVIEW
January 8, 2016

"Movement on a railroad must never cease, no matter what the day, the hour, or the weather." -- Edward Hungerford, Men of Erie, 1946

Railroad shares may have taken a bath in 2015 (top line, chart below), but over the longer term, *pas mal*, as the French would have it. For 2015, CNI and NSC emerge least-scathed by the downturn in railroad share prices. Longer-term, only NSC beats my long-term return goal of ten percent (because at that rate it doubles in seven years), and if you include the NSC 2.6 percent per year dividend rate, the story is still better. (BNSF omitted because you can't buy shares in it.)

	BNSF	CNI	CP	CSX	GWR	KCS	NSC	UNP
YOY Shares	NA	-18.9%	-33.8%	-28.4%	-40.3%	-38.8%	-22.8%	-34.4%
3-yr sh CAGR	NA	7.1%	7.9%	9.6%	-11.0%	-3.6%	11.0%	7.6%
Q42015 vols	-3.3%	-8.2%	-6.3%	-6.2%	TBA	-2.2%	-6.3%	-9.2%
Train Speed Wk 51	15.0%	13.0%	12.0%	1.0%	NA	10.0%	8.0%	8.0%
Dwell Wk 51	0.0%	-8.0%	-16.0%	-10.0%	NA	-14.0%	-4.0%	-8.6%
Sources: Shares, Wolfe; Performance, C-S								

KCS finished the year with a mere two percent drop in total cartload volumes; among The Big Six, BNSF was down but three points and I personally think not to having to pay homage to The Street has a lot to do with it. Ditto BNSF train speed performance. No surprises in the dwell department: Hunter Harrison is a Past Master at flattening hump yards and taking out dwell.

RBN Energy's Annual *Top Ten Energy Prognostications* speaks volumes for railroads in general and feeder lines in particular. Carloads of crude oil are down thanks in part to production declines and prices remaining suppressed. Ditto natural gas and gas liquids: too much gas with no place to go. As a result we're seeing weaker frac spreads, less wet-gas drilling, and less new plant capex. Thus access to capital drives markets as opposed the other way round up to now.

And so it is that the strong will devour the weak: If you've been out drilling and borrowing buckets of moolah to do it, you could be in deep doo-doo. Your debt fetches pennies on the dollar and equity is tapped out. Now comes the guy who isn't overextended, has dry powder, and time to wait. He will put you out of your misery. He will stop pouring money down those non-performing holes until restarting will pay off. And while he waits, nothing moves by rail.

Message to short lines? Know your drillers and keep the weak players on short leashes. First place to look: Are they unloading cars more slowly than before? Second place to look: Are they paying demurrage and car-storage bills on time?

Monday's Transport Outlook note from Stifel sets up a number of possible trends for 2016, each with its own ramifications for the non-Class I railroad community. In general, says Stifel, the successful carload carrier will fit the service to the customer supply-chain requirements (CSX, UP seem the best fit here), and the best harbinger of what's to come is the number and type of supply chain enhancements at Amazon. Perpend:

Bringing industrial production back to North America dictates locating manufacturing closer to the end user, meaning smaller inventories and smaller, more frequent replenishments. Long supply chains are falling out of favor; capacity constraints are forcing railroads to minimize empty miles and maximize RTMs. The emphasis is on high-velocity first/last-mile performance. On the downside, Stifel says we'll see more regulation from DC that could be harmful to short lines' financial health.

What short lines can do right now:

* Help speed up the Class I carload network. Because the Class Is are not coping equally well with the single-carload franchise, short lines must take a proactive role in tracking their Class Is' carload performance and forcing non-performing Class I lanes to work better.

* Show customers how to decrease rail transit time: release cars by destination on days of the week that take the least time to destination; block for the distant node and send a week's cars for each destination on one regular day; use the same car type for as many loads as possible, eliminating outliers; use intermodal for small, infrequent moves.

* Show Class Is how your blocking for the distant node (and getting paid for it) can balance lane volumes, increase car-miles per day, cut empty miles, and generate more loads per year per individual car.

* Become an extension of the Class Is intermodal sales staff, selling intermodal where the boxcar doesn't fit and keeping the revenue on the RR instead of going to the customer's favorite trucker.

* Concentrate new business development efforts on maximizing on-line RTMs and lowering on-line variable cost per carload. Two cars of plastics vs ten of wood chips, e.g.

The net result is a new model for Tony Hatch's *Railroad Renaissance*. Universally, the supply chain model is getting the finished goods as close to the end user as possible. That's why corn goes by the trainload to feed mills near growers. And why there are so many intermodal ramps in eastern Penna and NJ. One can apply the same model to the carload franchise.

Let Maine paper mills send out all their Chicago cars on Tuesday for interchange with CSX on Thursday. They are blocked into a Chicago non-stop departing Selkirk on Sunday and placed at receiver docks Tuesday. Wednesday, MT release and reverse route to Pan AM Rail Wed.The Amazon parallel is they gather inventory world-wide and aggregate the items in locations where they can be on the customer's doorstep the day after ordering, seven days a week. Applied to the railroad environment, the onus is on receivers to know what they want where and when.

The shift in manufacturing from doing everything one place to using suppliers closer to the user adds another dimension. A friend who's in the welding-supply business tells me they are busy, though not with the Big Company names of yesteryear, but with the smaller firms who are doing the welding that used to be done in-house. These outsource resources can hire the specific talent they need for the job at hand, and the talent is free to move between assignments where their specific skills are commanding a higher dollar than they could get with one employer.

My friend says the lack of enthusiasm for either the 40-hour week or the patience required for a successful apprenticeship makes many of today's high school grads unemployable. Meaning all the more work for those who did the apprenticeship and thus can pick and choose where and when they work and for how much.

Given the dispersion of the work and work force, raw material orders are smaller and deliveries (some by Amazon) are more frequent. The area rail yards that once delivered by the carload are silent. That's why we can still see some growth in the economy without corresponding growth in railroad revenue units. And that's what *Railroad Renaissance-II* is all about.

Greenbrier (GBX) posted solid earnings for the quarter ending Nov 30 on what Cowen's Matt Elkott called "a decisive beat to estimates and achieving year-over-year and sequential gross margin improvements." I'll say. Net sales increased 62 percent to $802 million, gross margin doubled to $185 million and net income more than doubled to $69 million.

On the call, Greenbrier CEO Bill Furman said, "The industry is going through a period of adjustment… and it's important not to over-react." But the market did over-react the very same day as the earnings release, sending shares down 12 percent to $25.20. Elkott came right back this morning to say, "Concerns about crude tank cars — 10 percent of the backlog —are overblown." I agree. GBX' discounted cash flow intrinsic value is $62, meaning you can buy the company for half-off and only five times earnings. I did.

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