RAILROAD WEEK IN REVIEW

September 23, 2016

"The Fed is plenty willing to disregard the "financialization" of the economy, which has made it cheaper to buy your competitors than to compete with them, and has resulted in reduced capital spending and lower employment." — John Mauldin.

Competitive advantage is what gives a company an edge. Railroads need it to woo carloads away from — and keep from — the truckers; railroad customers need it to win and maintain market share. To keep and maintain means that competitive advantage has to be *durable,* which requires three things:

1. Companies with Durable Competitive Advantage (DCA) can demand higher prices for the goods and services they sell because consumers view whatever the competition provides as inferior.

2. DCA translates into larger profit margins, more sales, and for the railroad owner, improved free cash flow and improved earnings deltas.

3. DCA means less volatility in revenue, ops expense, and ops income, especially important when markets are not being kind to the competition. DCA companies have stronger balance sheets with more cash than their peers. As a result, they can cost-average expense-line items fearlessly.

What's more, DCA companies don't have to rely on share buy-backs or other financial engineering to make their earnings growth rate look stronger. Happily, most non-class I railroads are privately held, which means solid changes in ops income and leverage ratios.

So let me propose this: Measure your total revenue by customer and then revenue by customer ton-mile. Then measure operating expense by customer and customer-ton-mile. You'll see which customers are generating the best yields and which demand the lowest variable expense exposure per carload and per-ton-mile.

Finally, find out how big a moat (an economic moat refers to how likely you can keep competitors at bay for an extended period) there is around your service offering: the bigger the moat, the stronger the DCA. And then exploit it.

Maintaining that moat and DCA is what the Northeast Association of Rail Shippers (NEARS) fall meeting was all about this week. Some 280 souls representing six class Is, eighteen short lines, and thirty railroad customers who gathered at the Sable Oaks Marriott outside Portland,

Maine, were treated to more than a dozen presentations and panels covering all the usual bases — and then some.

It was most refreshing to detect a common theme running through all the presentations: what the rails are doing to build on their inherent competitive advantage in the supply-chain marketplace, what the shippers would like the railroads to do to become easier to do business with, and what suppliers can contribute to facilitate both.

As to the first, Pan Am Rail President David Fink set the tone in his keynote remarks, citing successes in meeting customer logistics objectives, creating a safety-oriented culture that drives enhanced customer value and lowers operating costs in one bite. Canadian National AVP for Industrial Products Kelly Levis nailed it with her discussion of the relationship between and among car-miles per day, customer dwell times, and chaos in the marketplace fostering innovation. Norfolk Southern's Mike McClellan, VP for everything that moves but intermodal and coal, showed what his road is doing to enhance customer expectations through predictability and ease of doing business.

Dan Wahle, newly-tapped VP Marketing and Sales for the Housatonic railroad, provided an instructive overview of demurrage: what it is (a reflection of delay), how customers can avoid it (turn the cars), and why Class I trip plan compliance is crucial in avoiding cascading delays. John Giles, President, Central Maine & Quebec Railway, noted how the road celebrated its second anniversary with strong customer acceptance of the new owners, winning back community trust, and enlarging on Wahle's theme of how customers can help themselves get more bang for their railroad dollar.

On the customer side: On the one hand, we heard how Nestle's Poland Springs Water division (the Number One consumer brand in the NY metro area) employs short-haul intermodal to improve market access, lower transportation costs, and do both in an environmental-friendly way. On the other hand, Central National Gottesman, a privately-held international supplier of paper products, wishes it could do more rail. Trucks dominate their supply chain with more than 25,000 loads a year, but, with easier access and greater predictability, rails could win a sizable bite of that apple.

Rounding out the rail/shipper/supplier discussion, the Rail Equipment Panel (TTX, National Steel Car, Trackmobile) all pointed to a soft market. An over-build of some car types and improving turn times point to present vols being moved with fewer cars. Boxcars are seemingly stuck in the 30-day cycle rut, providing little incentive for further investment in them.

These observations are in line with a report that there was a breakout session discussion of boxcar economics and potential shortages at the recent Indianapolis ASLRRA Eastern Region meeting. The takeaway was the only way out is a TTX-type pooling arrangement. I have to disagree.

The answer to the cycle-time question is two fold. First, customers must load/unload cars ASAP and rails must block cars for the distant node, skipping days in class yards. Second, a further step would be having customers load by destination so all their Atlantas will go Monday, Mobiles on Tues, Houstons on Weds, etc. CN's Levis (above) says CN has sorted customers into high-velocity and low-velocity lanes and if velocity gets too low the customer is embargoed.

As usual, the conference wrap was the Wall Street View, courtesy of Cowen's Jason Seidl, a good friend who is no stranger to these pages. Expanding on the coal loss impact to the rails, Jason notes that, on a per-unit basis, a carload of coal has three times the dollar yield of one intermodal box, so it's going to take a lot of boxes to replace those loaded hoppers. It also means the rail managements have to do a better job running their properties in a coal-less environment.

In other words, they must start generating more free cash flow and stop playing games with "inflation-plus pricing" and other sleights-of-hand with the top line to get ORs down and stop using share repurchases to improve year-over-year earnings per share changes. The reason, says Jason, is that long-term institutional investors are turning more to free cash flow and less to earnings-per-share in making investment decisions. The former has not been stellar.

On Tuesday the ASLRRA presented the first in a series of financial webinars designed to provide a basic understanding of financial statements and techniques for extracting key operational and financial data therefrom. Bowers & Co's Joe Mocciaro provided a thorough review of the financial statements that are commonly used in business, and defined essential terms to aid in understanding of individual line items.

He couched his review of trends in balance sheets, income, and cashflow statements in terms railroaders can relate to — revenue per car, car hire, comp & benefits, demurrage, e.g. — thus making the whole topic that much more approachable. He also put the income statement line items in terms of per-car results: revenue per car, transportation expense per car, maintenance-of-way expense per mile, and the operating ratio. My only quibble is that I would have preferred he began with his excellent statements discussion rather than a description of audits, but perhaps I was being impatient.

About two dozen souls registered; I wish it could have been two or three times that. I remain convinced that knowing the numbers is the only way to run a short line right. Happily, thanks to Joe Mocciaro and Sabrina Waiss, ASLRRA VP for Education & Business Services, those attending this webinar are now better prepared to take the mystery out of their railroad's financial statements. And, since this was only Part One, there will surely be more to come. Stay tuned.

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