RAILROAD WEEK IN REVIEW

October 14, 2016

"There is a seeming disconnect between declining rail traffic and the overall economy, which continues to move forward, albeit at a slower pace." — David Nahass, President, Railroad Financial Corporation

The official AAR North American rail traffic score for Week 39 has total revenue units off 6.6 percent, but it's useful to know where the strengths and weaknesses lie, especially as they affect non-Class I railroads. This table starts with the AAR's 2016 numbers, adjusts them by the change percentages to arrive at the 2015 numbers, and then, to put all the changes in perspective, shows what percentage of the whole each commodity line represents, and how each commodity group contributes to the whole. The green highlights the only two positive commodity lines.

AAR North American Rail Traffic Week 39					
Periods ending		**10/1/16**			
		YTD			
	2016	**2015**	**Pct Chg**	**YTD % Total**	**Cumulative**
Motor Veh/parts	**1,079,757**	1,050,347	2.8%	4.2%	4.2%
Grain	**1,217,356**	1,197,007	1.7%	4.7%	8.9%
Chems	**1,680,150**	1,681,832	-0.1%	6.5%	15.3%
Farm ex-grain	**970,478**	977,319	-0.7%	3.7%	19.1%
Forest Prods	**704,616**	733,211	-3.9%	2.7%	21.8%
Non-met Mins	**1,606,510**	1,692,845	-5.1%	6.2%	28.0%
Met Ores and Mets	**1,444,756**	1,607,070	-10.1%	5.6%	33.6%
Petrol and Pet Prods	**701,678**	876,002	-19.9%	2.7%	36.3%
Other	**472,418**	430,645	9.7%	1.8%	38.1%
Total Carload	**9,877,719**	10,246,280	-3.6%	38.1%	
Coal	**3,231,831**	4,274,909	-24.4%	12.5%	50.6%
Intermodal	**12,823,572**	13,233,820	-3.1%	49.4%	100.0%
Check Total	**25,933,122**	27,755,009	-6.6%		
Source: AAR					

You can see that petroleum and petroleum products were down 19.9 percent, yet represented only 2.7 percent of total vols; Met ores and metals were down nine points less, yet account for twice as much volume as a percent of the whole than does the petrol group. Manifest carload freight represents nearly four out of every ten revenue units, intermodal boxes half, and, happily, coal is down to one in ten units and shrinking. Manifest carloads were off only 50 basis points more than intermodal, suggesting there's still lots of life left in the non-coal carload franchise.

The $64 question is why, with rail traffic trending southward, car builders are seeing any orders at all. David Nahass, in his September *Railway Age* column, says the seeming disconnect is tied less to economic issues that grab headlines — the strong US dollar, e.g. — than to weakness in the overall global economy. But the fact remains that "railcar loadings have always been an economic indicator, and they are in decline."

The disconnect comes with the Fedspeak of an economy growing at two percent a year and a frugal consumer. Schwab's Liz Ann Sonders writes ("Household Leverage Down," Oct 10),

> The rub for the economy this time is that households have become significantly more frugal as it relates to the balance between spending and saving. The recent Gallup Economy and Personal Finance Poll shows a growing and significant bias toward saving over spending. For an economy nearly 70 percent dependent on consumer spending, this helps explain the slow pace of growth since the recession ended in 2009.

As I've noted here before, two percent growth is still growth, any anything growing at that rate will still double in 36 years. Lower rates of consumer spending growth are still spending growth. As stuff wears out it needs replacing; we consume groceries, they need replenishment. So it makes sense to add jumbo hoppers as they wear out and small cube hoppers as drilling activity restarts, and new boxcars as increased manufacturing demands faster turns.

Matt Elkott, the rail equipment analyst at Cowen Co., writes that, even as some car buyers/ lessors are trimming orders, many of the same guys who added to fleets in the past will be adding again, with roughly two out of five potential buyers looking to add 500-2000 units. Elkott believes there is a replacement market in new OT hoppers for construction aggregates, covered hoppers for grain, and even small-cube covered hoppers for frac sand as cars come out of storage to feed horizontal lines from existing down-holes that are being extended.

CSX was the lead-off batter for the third quarter earnings season, with perhaps the best CSX call I've ever heard. The tone and pace were robust and positive, even though the revenue and volume story was largely negative. After CEO Michael Ward's opening remarks, CFO Frank Lonegro largely carried the call. He did most of the talking during the Q&A, with COO Cindy Sanborn and Chief Commercial Officer Fredrik Eliasson chiming in on cue.

Merchandise carloads — everything but coal/coke and intermodal — slipped less than five percent in the quarter and just four percent year-to-date, even though total revenue units were off nearly eight percent. We saw modest gains in some merchandise RPUs, such that the group average was up half a point vs. down eight percent system-wide.

System revenue, $2.7 billion, dropped eight percent in the quarter, though fuel surcharge collections were half what they were a year ago; absent FSC, revs were off less than six percent. Total Q3 revenue units slipped down to 1.6 million units, with a third of the 138,000 unit drop in the coal group. Even intermodal is off nearly seven percent — 50,000 units. The only bright spot is automotive, up six percent.

As noted above, the merch carload sector car-count, which includes auto, lost less than either coal or intermodal, not only in percent but in actual numbers. Moreover, the merch sector brings in 66 percent of total revenues on 65 percent of total RTMs. Coal, on the other hand, consumes 25 percent of RTMs and bring in only 18 percent of revenue. Replacing coal with the ag-chems-forest products-metals sector is a smart move.

Operating expense was down seven percent, a good sign with rev units down eight percent and revs ex-fuel surcharge down just six percent. Fuel expense was down 22 percent, half on price per gallon, half on better use: 14 percent fewer gallons to move eight percent fewer GTMs, eight percent more GTMs per gallon, and a record low 1.03 gallons per thousand GTMs.

The year-to-date cash flow story is encouraging, too. Cash from operations was $2.5 billion, off a mere one percent against a 16 percent drop in net income. Free cash flow after capex but before dividends was 94 cents vs 61 cents a year ago. And net cashflow after capex, divs, share repurch was ($393) vs ($455) a year ago.

The street loved it. As of 1400 hours Thursday, shares had broken north of $31, up three percent on the day and above the 20-day simple moving average. That's a 47 percent gain since the $21.31 low hit last Jan 20 in a classic trend line with higher highs and lower lows.

On the call, Lonegro said only auto is "favorable" for Q4, and the 18 million unit SAR estimate for 2017 looks reasonable. In the neutral carload category are "heat and eat," ag and ferts plus export coal. That's it. However with the strides made in doing more with less, I expect to see operating expenses drop, RPUs increase, and the coal drag diminish. I also expect CSX short lines, regionals, and switch carriers to benefit. But to to so, attention must be paid, and in the words of Frank Lonegro, one must remain nimble.