RAILROAD WEEK IN REVIEW
December 2, 2016

"To grow or not to grow? That is the question." — Fred Frailey, Trains, January 2017

Whether 'tis nobler in the mind to raise rates on what business is left or to take less per car and get more truck-competitive? The US Class I rail industry truly "suffer the slings and arrows of outrageous fortune" in terms of shrinking volumes, middling net income growth, and small or no eps growth absent buy-backs or splits.

Take the 2016 third quarter. North American Class I railroad total revenue increased a measly 2.6% over the same 2011 period (CAGR = 0.5%!), units were up 1.7%, and RPU increased 0.7%. Operating expense came down 5.9%, but it doesn't do much for the revenue-units line, and that's the only measure that goes to the creation of customers.

	CNI	CP	CSX	NSC	UNP	BNSF
YTD 3Q2012						
Net income ($000)	$2,070	$469	$1,416	$1,336	$2,907	$2,410
Dil Shares	439.6	172.6	1044	327.4	477.9	
EPS	$4.71	$2.72	$1.36	$4.08	$6.08	
YTD 3Q2016	Split adj*				Split adj*	
Net income	$2,622	$1,215	$1,256	$1,252	$3,089	$2,576
Dil Shares	391.15	151.6	953	296.7	419.8	
EPS	$6.70	$8.01	$1.32	$4.22	$7.36	
Changes						
Net income	26.7%	159.1%	-11.3%	-6.3%	6.3%	6.9%
Dil Shares	-11.0%	-12.2%	-8.7%	-9.4%	-12.2%	na
Reported EPS	42.4%	194.9%	-2.8%	3.4%	21.0%	na
EPS same shares	$5.96	$7.04	$1.20	$3.82	$6.46	na
Same shares chg	26.7%	159.1%	-11.3%	-6.3%	6.3%	na
Split 2/1	12/2/2013				9/9/2014	

Below the line, I go back to 3Q2012, showing YTD net income, diluted shares, and eps at the end of the third quarter. I do it again for 3Q2016 and calculate the changes. CN and UP split shares 2:1 in the period, distorting the same-share theme, but see how the reported eps change differs from the same-share eps. CN's reported split-adjusted eps increased 42%; using the same share-count as for 3Q2012 cuts the gain to 27%. At UP, the reported split-adjusted eps gained 21%, whereas the same-share increase is six percent.

CP gets high marks because pre-Hunter they weren't charging enough and were spending too much running the railroad. Here, the same-share eps delta is still very strong. NS and CSX fare less well. The CSX net came down 11%, but reducing the share count 9% meant only a 3% eps hit. Using the same share-count and the decrease is 11%. Same for NS, except that the reported eps delta was positive and it goes negative without the share repos.

This little exercise shows how share buy-backs goose earnings even as revenue, operating income and revenue units increase but slightly. Worse, it shows how one can increase earnings to create the appearance of earnings growth even if the core business isn't growing.

It's time to get back to basics. I think it was Peter Drucker who said the purpose of any business is to create customers. And it was Tom Peters who said you have to create quality in the eye of the customer to justify a higher price.

Rod Case, Global Rail Practice Head at Oliver Wyman, told the RailTrends audience in NY two weeks ago that you need four things to create customers: providing transparency, meeting customer demand, being reliable, and engaging stakeholders. Doing so means being a nimble part of the customer supply chain; running bigger trains to save crew-starts and loco hours does not cut it, and runs counter to Drucker and Peters on creating customers.

Norfolk Southern VP for Industrial Products Mike McClellan, also at RailTrends, says the key to creating customers is being nimble. "We must enhance the customer experience, and harnessing the capabilities of our connecting partners [meaning non-Class Is]" is essential. He wants NS to be the "carrier of choice" when customers are making transport decisions. He says "reducing the friction" of dealing with the railroad is critical. How right he is.

Every day I get another shortline anecdote on how Class Is push business away. A short-haul move is missed because of car shortage or not meeting an internal hurdle rate. A longer-haul goes truck because it takes half as long and costs a third less. A reefer move back-haul goes begging because the Class I doesn't want its car on a short line. A regional railroad manager tells me he's doubled his sales force to make the calls his competitors are missing. In each case, the short line identifies the move by filing a supply chain need. The appropriate Class I response ought to be "Thank You," not "It doesn't meet our hurdle rates."

Case points out the dollar costs of failure. His research shows how half a million "unexpected events" (re-crews, unscheduled work, loco road failures, hold-outs, etc.) a year "consume capacity and constrain revenue growth potential." Every event stops a train and adds cost not only to the railroad but also to customers who can't get at their goods.

A perfect example of Doing the Right Thing can be found on the UP's Sunset Route just west of El Paso. It was one thing to double-track the line; it was another thing to, in Rod's words, "give those trains some place to go," eliminating hold-outs and other time-consuming unpleasantness. There, the new SantaTeresa facility gives trains on the double-track route "someplace to go."

As to the cost of NOT creating customers, Rod shows how Dedicated Autonomous Vehicle (the driverless trucks you've read about) lanes can support more than 40,000 tractor-trailers/day. If you're in the carload business, as most short lines are, that's 10,000 boxcar loads — ten trains-worth to a Class I. The average boxcar load is worth about $2000 to a Class I, so that's a cool $20 mm in lost revenue.

Truck spot rates remain 1-2% above contract rates in what Cowen & Co. reports to be a "very difficult bid season." Cowen says buyers (shippers) have the advantage when spot prices fall, so the opposite must be true as well. Take paper, e.g. Anecdotal evidence suggests transport buyers see markets as too unpredictable for making LT commitments to contract sellers, opting for the higher spot rate as the price paid now for not being locked into a contract rate that they may not be able to afford later.

Surely, with aggressive pricing and stellar service, some of this could move in boxcars, especially if we can find OD pairs with short lines on each end and a straight-shot Class I line haul in the middle. Knowing the customer is where short lines shine, and, as a result, shortline Week 46 YTD vols are down just 3% vs. the Class Is down 7%.

Thus the mystery remains: if short lines are better at finding new business than their Class I partners, and if short lines can find truck-competitive short-haul moves the Class Is miss, why don't the Class Is find a way to make these moves work? Do so and see the coal-driven volume spreads vanish. Otherwise the Going Out of Business Sale continues.