RAILROAD WEEK IN REVIEW

February 24, 2017

"While the UK, for example, has been restrained by its EU membership from fully participating in the global economy, Mexico has been sheltered by NAFTA from the fiercely competitive forces from the rest of the world." — EurizonSLJ Capital

Michael Ward steps down as CEO of CSX May 31 vs. after 39 years with the company and having been CEO since January, 2003. Also retiring May 31 is Clarence Gooden, President, who's been with CSX for 40 years, most notably as Chief Commercial Officer. Fredrik Eliasson, the present Chief Commercial Officer, assumed the office of President effective February 15.

Moreover, CSX has begun an involuntary separation program for some 1,000 management employees , to be completed over the next few weeks. CSX says its offering "enhanced separation benefits" to those affected, most of whom are in the Jacksonville area. For the year 2016, CSX averaged just under 27,000 employees.

Both events — the retirements and the separation announcement — come hot on the heels of the CSX Board conversations with activist investor Paul Hilel and his Mantle Ridge investment firm about installing Hunter Harrison as CEO following Ward's retirement. These conversations actually began about two months ago, causing the CSX share price to gap up to $45 from $38, on the bet that Harrison could lead CSX to higher earnings in short order.

A note from the RW Baird investment house says succinctly, "CSX share price increases are speculative; likely HH will become CEO. Transport share prices are at/near the top quintile; caution is warranted." Could be. The way I see it, Harrison becomes CEO and takes a few points off the OR with sizable layoffs, coal settles out at a lower level, intermodal and merch carloads creep up. Nothing spectacular. More share repos, less capex as a percentage of revs.

Scott Group over at Wolfe Research posits that FY 2018 CSX carloads could be up 2.1% over where they are now, posting average RPU gains in the 3.3% range, and putting total freight revenue up 5.6% over present levels. He sees operating income gains of 9.2%, which suggests operating expense growing at a slower rate than revenue, resulting in a 67.8 operating ratio vs. the 70.6 for the 2016 full year.

The 27th Annual CSX Short Line Workshop runs Mar 5-7 at the World Golf Village just off I-95 north of St Augustine. I'm sure the changes at the top and the specter of Hunter Harrison looking over all will have the entire assemblage a-buzz with what-ifs, and some homework most likely is in order.

Thus I feel it is appropriate to be thinking about questions to ask in the larger meetings, in the commodity breakout sessions, and in one's individual meetings. I put these questions in the context of Hunter Harrison as the next CEO and the impact on your railroad's interchange volumes with CSX.

A recent Reuters report shows total revenue and operating income 2014-2016 drifting south, while total debt heads in the other direction. Total cash from operating activities is down 10%, yet cash going to share repos doubled 2014-2016. Please note I'm looking only at GAAP numbers (because what's in them is constant Q to Q) and at volumes because that's what short lines are paid on.

CSX Revenue Carloads (thous.)	**2016**	**2015**	**2014**	**3-year change**	**Remarks**
Ag Prods	**469**	503	419	11.9%	
Fertilizers	**294**	301	330	-10.9%	formerly Phos & Ferts
Food & Consumer	**-**	-	94	nm	to Ag Prods in 2016
Chemicals	**688**	726	620	11.0%	includes frac sand
Metals	**255**	284	276	-7.6%	
Forest Prods	**269**	290	307	-12.4%	
Waste &Equip	**-**	-	158	nm	split between chems and metals in 2016
Minerals	**307**	306	293	4.8%	
Total Carload	**2,282**	**2,410**	**2,497**	**-8.6%**	
Automotive	**476**	450	435	9.4%	
Coal	**826**	1,063	1,262	-34.5%	
Intermodal Units	**2,768**	2,838	2,728	1.5%	
Revenue Units	**6,352**	6,761	6,922	-8.2%	

What matters most is the carload volume trend. The CSX quarterly financial reports have merch carloads excluding automotive down 8.6% over three years 2014-2016. Total revenue units 2014-2016 are off 8.2% with coal off a third — a huge hit, though short lines are not typically big contributors to the CSX coal number. That's why the "total carload" line is key, down 8.6%. Chems includes crude oil and reflects the bump we saw in 2014-2015. I'm including auto below the line because there is still some carload biz and the category represents 2% of shortline vols per GE Trans RailConnect.

Getting back to the shortline meeting, I'd specifically be asking about where the fertilizer business went and why they are down while ag products are up. If ag is up mainly on export, what are the 2017 crop estimates? What's pushing chems — cheap nat gas for plastics? What's the break between wood and paper in forest products — single-family housing starts for millennials, paper for food packaging and Amazon boxes vs single sheet for office use and newspaper/supplements? The minerals group includes aggregates and road salt — what's the break and outlook? You get the idea. I'd be interested in your take after the fact.

Mexico is the world's eleventh largest economy by GDP, yet it seems stuck in a rut, and the undervalued peso appears to be the root cause. From the UK's EurizonSLJ Capital comes a report by Morgan Stanley alum Stephen Jen, SLJ founding partner and CEO, that Mexico itself has some bootstrapping to do.

To wit: The Mexican peso could be undervalued by as much as 40%; today's economic growth rate in Mexico has lagged both its own recent history and that of its Latin America peers, never mind NAFTA membership; and Mexico is a lot like Central Europe — "the more developed partner country (the US and Germany in the two respective areas) provides the technology and owns the factories in the lower labor cost countries."
Furthermore, writes Jen, even though both the peso and the British pound sterling are undervalued, the UK seems to have the superior fundamentals, economic and otherwise; "Mexico has been on the wrong side of China's rise," being more a consumer of Chinese goods than a producer of goods going to China. Finally, Mexico has been unable to break out of the middle income trap. Jen concludes,

> The inconsistencies between trade regionalization and trade globalization are evident. While the UK, for example, has been restrained by its EU membership from fully participating in the global economy, Mexico has been sheltered by NAFTA from the fiercely competitive forces from the rest of the world. We see Mexico as being at the crossroads of many of the issues that are being discussed at present, and the only positive for the peso is its cheap valuation.

From a railroad perspective, I think KCS gets it right. Mexico is truly at what Stephen Jen calls a crossroads, and the tea leaves point to better times ahead, not worse. To the extent that KCS can weather Mexico's present weaknesses, and continue to build its remarkable pipeline of new industries (refined petroleum products, finished vehicles, ag products, the port at Lazaro Cardenas, e.g.) it will do fine. As will its railroad connections on both sides of the border.