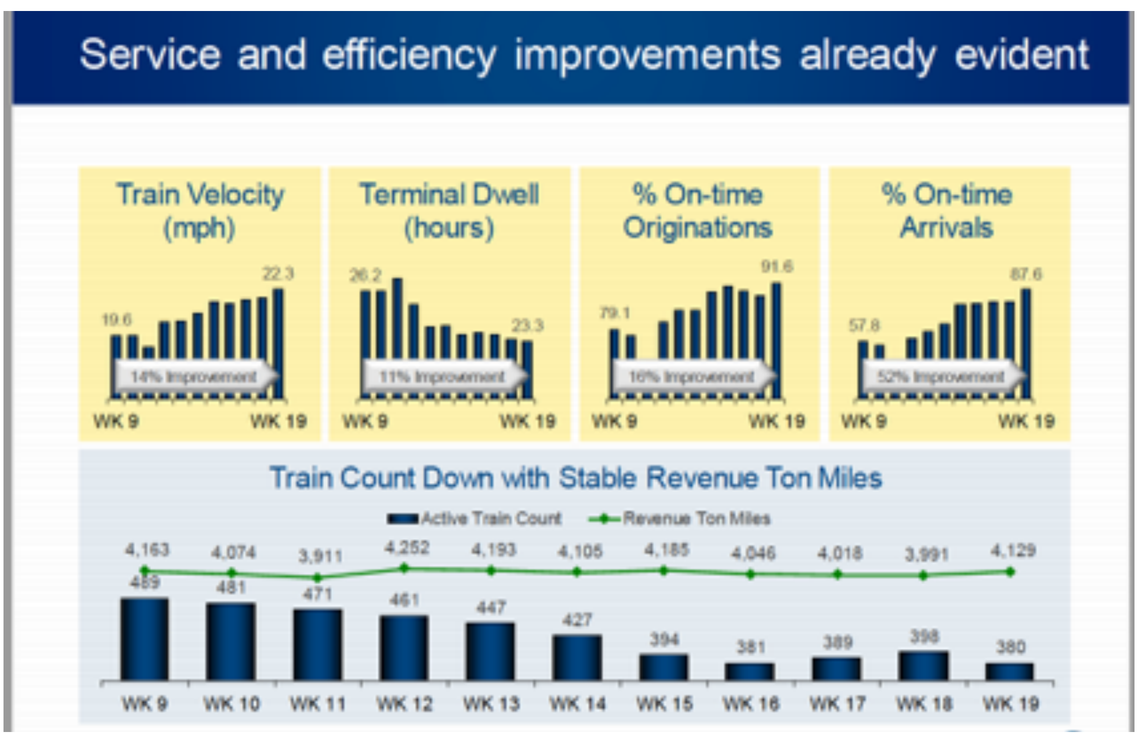
RAILROAD WEEK IN REVIEW

May 26, 2017

"Falling excess liquidity and lower operating margins are two main themes that will likely dominate how the rest of the year will play out." Variant Perception, April 2017

Last Friday (5/19) I spent the morning and early afternoon eavesdropping on railroad presentations at Royal Bank of Canada (CP, CN) and Bank America Merrill Lynch (CSX, UP, KCS, NS). The overall thread was the encouraging start to Q2 vols with (for UP and CN, at least) the surge in frac sand (for UP, mainly receiving for Eagle Ford, Permian with an 80/20 white/brown mix); KSC dominating the auto sector; and coal vols still very much dependent on nat gas prices. All told, most of these presentations were all pretty much business as usual.

CSX was the exception. CFO Frank Lonegro spoke directly in terms of where the railroad is and where it's going, two months into the Harrison presidency. Insights as to what's important to Hunter and how he's driving change are revealing.



This shows how RTMs have remained stable while train-starts are down and four efficiency measures are improving. Hump yards in Atlanta, Hamlet, Louisville, and Toledo are gone because there's not enough local business to merit them, and if most of what goes through the yard is going elsewhere, just keep it moving non-stop. (Asked why, if fewer hump yards is better, CSX hadn't already done it, Frank said just that the previous CSX mind-set saw hump yards as a key part of railroading, yet Hunter, like Sportin' Life in *Porgy and Bess*, says, "It Ain't Necessarily So." And the past nine weeks' performance proves it.)

The hump-to-flat yard discussion was timely as a few days previously I saw first-hand how Conrail Shared Assets has done the switch at Camden's Pavonia Yard, and much of the discussion revolved around how it backs changes to the CSX operating plan YTD. Then I rode SEPTA's ex-Reading line to West Trenton for a look at what CSX and the commuter road have done to stay out of each others' way Neshaminy Falls to West Trenton. And CSX obliged by running two eastbound trains in short order for living proof that it works.

Pavonia uses one man on the ground to set the route into the bowl, control loco speed, make the cut and kick the car to stop. He knows by experience how fast the loco needs to go to make the cut, depending on weight of the car and distance to stop. He can even cut several cars at once if they're all going to the same place (and there's room on the bowl track), furthering the case for short lines pre-blocking for their Class I service locals.

Once the route is set on the screen in the kiosk at the head of the bowl, nothing can change until the car has passed each controlled point. Only then can the moving parts (switch points, derails, etc.) be reset for the next move. The number of safety features and fail-safes built into the system has increased yard production in terms of cars switched per hour and on-time departures, to name just two metrics, using fewer assets from track space to locos to man-hours. Now imagine replicating that ten or so times across the CSX network.

Out on the road, the two trains I saw had originated timetable-west of Philadelphia with destinations further east. Yet these trains can set out and pick up in one of two Philadelphia support yards, with NJ cars taken to/from Pavonia on a transfer move. Using Frank's example, why should a Waycross-Chicago car be classified in Atlanta or Nashville when it can run right through? Back to Big Conrail's "block for the distant node" rule.

Here's the kicker for short lines and anybody else in the carload franchise: fewer days between OD pairs can, at some point, make carload competitive with truckload. The time-savings of flat-switching and pre-blocking are essential. Yet one of the reasons I keep hearing pre-blocking will never work is because class yard managers down the line don't like it -- easier to send everything over the hump. Happily, Lonegro says they're getting great buy-in from everybody in the food chain, thanks to leadership and accountability.

Last Monday more than 300 souls representing nearly 150 shortline and holding company names descended on Norfolk's spanking-new Hilton Main hotel for the 16th annual Norfolk Southern Short Line Meeting. The two-day session theme was "It All Starts with the Customer." Alan Shaw, EVP and Chief Commercial Officer, zeroed in on viewing NS service from the customer's eyes — a welcome shift from the previous Customer Service Metric that captures internal operating scores — in terms of predictability and a common message for all customers.

Backing Shaw up, we heard from Paddy O'Neill, Senior Director of Equipment Planning (how nice to see him on Center Stage as opposed to a boxcar-centric breakout session) on the rationale behind and benefits of reducing car types from hundreds to handfuls. (Added note re equipment: variations in chems carloads mostly crude oil, STCC 29 more constant; confirmed during Q&A in break-out. For pricing, ferts and ethanol are in ag, not chems.)

The two big take-aways from Mike Wheeler, Chief Operating Officer are: he encourages shortline pre-blocking for the distant node and NS includes time on the shortline in its car contribution-per-day score. In other words, short lines can speed cars through yards by pre-blocking and can add value by turning cars quickly.

And since NS measures train trip plan compliance against the initial trip plan (carload TPC is next), the faster the shortline turns the car and pre-blocks, the better the carload TPC and the better the operating margins. And the greater the number of commodity OD pairs in the NS same-store book.

According to shortline contacts I queried, NS gets high marks for understanding the short line business model and goals, overall service delivery, and moving to the standard Plate F, 60-foot, 100-ton boxcar. Areas that need work include rate-request response time, service consistency, and mutual understanding between short line and the marketing/pricing manager. But then, those are pretty much universal concerns among all the Class I shortline meetings I attend.

I think CEO Jim Squires sums up the NS-Shortline dynamic very nicely. Says he, "The cornerstones of our strategic plan are safety, service, productivity and growth. We are building on the momentum we've created and continue to focus on strengthening our company, positioning NS for growth and maintaining a disciplined cost structure." The take-aways from this highly effective session bear him out perfectly.

As an aside, we didn't hear directly from CFO Marta Stewart, but she and I had coffee Monday morning to compare some notes off-the-record. However, for the record, she presented at the Wolfe conference Wednesday and cited three "Key Focus Areas" that go squarely to the theme of this shortline meeting: optimizing volume and yield; improving productivity to deliver efficient and superior service; increasing asset utilization. In short, NS is telling the Street the same things it's telling the short lines. And that's all to the good.

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