RAILROAD WEEK IN REVIEW

June 30, 2017

"Railroads are where they go; a good route structure often outlasts the corporations that owned them" - Jim McClellan, My Life with Trains, page 80

"If a company has a lousy track record and a bright future, we will miss the opportunity." -- Warren Buffett

The 2017 second quarter has ended. It'll be another week or so before we see the final volume counts, but the view from Week 24 (ended June 17) is encouraging. AAR year-over-year North American carloads at that point were up 5.7% on double-digit gains in grain, coal, metals and ores, and aggregates. Intermodal gained less that 4%, so the bloom is off that rose, at least for now, as truckers scramble for loads and keep the pressure on spot rates.

I want to look particularly at BNSF and UP with their long-haul merchandise routes, wide exposure to grain and oil, and proximity to each other. To do so, I'm using Jason Seidl's Track Work Weekly missive from Cowan & Company to see how they were doing year-to-date in the broad commodity groups found most often on short lines, 11 weeks into the second quarter.

BNSF/UP Comps Week 24 YTD

Commod Grp	BNSF 2017	BNSF 2016	BNSF Chg	UP 2017	UP 2016	UP chg
Ag products	447,173	407,088	9.8%	371,531	349,750	6.2%
Chems ex petrol	206,011	207,267	-0.6%	416,820	401,293	3.9%
Forest products	72,484	74,572	-2.8%	101,103	98,871	2.3%
Met ores, mins	113,503	108,675	4.4%	81,178	79,752	1.8%
Non-met mins	213,667	178,976	19.4%	308,998	276,036	11.9%
Waste & scrap	22,176	19,755	12.3%	35,253	32,469	8.6%
TTL SL Commods	1,075,014	996,333	7.9%	1,314,883	1,238,171	6.2%
Source: Cowen Week 24 note						

From this abbreviated table, it appears that BNSF has the edge in ag overall, though UP does better in grain. UP has the lead in chems growth ex-petroleum products (STCC 29) and crude oil (STCC 131) , possibly due to the greater Gulf Coast presence thanks to its former MP and SP properties. BNSF has a clear lead in non-metallic minerals, essentially aggregates.

As it happens, you can get a little closer look at the UP picture from the *slide set* CFO Rob Knight presented at the Citi Bank conference two weeks ago. As you page through slides 3-8, several themes emerge. There are three broad merch carload groups -- ag, industry, chems -- representing roughly 60% of the UP franchise, equally distributed among the three. Chemicals are actually up if you exclude crude oil, so merch carload categories are all in positive territory.

Moreover, the chems drill-down shows upticks in plastics and ferts. The former I sense is due to UP strength among the gulf coast polyethylene producers; the latter driven by the strength in grain. I'm particularly encouraged by the food and refrigerated biz, where short lines have a critical first-mile edge (see Watco potatoes in Idaho, e.g.). The construction group includes everything from lumber to rebar to aggregates. Softness in steel is to be expected. Again, positive for short lines.

Auto may not be a big shortline commodity, but the raw materials — steel, glass, plastics — going into auto products are. I've been warning about a slowdown in autos for a while; here it is on slide 6. According to a Merrill Lynch study, auto production is going to drop from the projected 17.9 million for this year to 13.8 million in 2021, due to lease roll-offs and other pressures. Subprime auto loan defaults are rising, as are student loan defaults.

That's why the tea leaves suggest there is a crisis building in auto sales as deep discounts on new vehicles depress used car prices. There are signs everywhere that we are much closer to the end of this business cycle than we were in 2012. There are so many data points that seem to be rolling over. We are not at the end yet, but we're a lot closer. UP reports 2Q results July 20. I'll be there.

There has to be a better way to compare Class I railroad capex spends. Tony Hatch writes, "I continue to seek a better measurement of capex for rails beyond the historic *percentage of revenues,* given the traffic mix changes plus fuel surcharges and rate increases. These last two really aren't associated with 'work levels' or relative impacts on the network infrastructure."

I have to agree. One alternative is to compare railroads on capex per gross ton-mile. Tonnage is what wears stuff out and more than half the annual capex budget is for repair and replace. The more tonnage you move, the more horsepower and cars you need. The more cars you move, the greater the need for places to put them. And so on.

Measuring capex by GTMs makes sense to me because the railroad is a *consuming* industry. You're in business to move stuff, and moving stuff wears out what you use to move it. Revenue per revenue unit or fuel surcharges or demurrage fees don't affect how fast stuff wears out. That said, the Class Is seem to be spending $4-6 per GTM in capex. Makes sense. They're all moving pretty much the same things and are using the same technology to move it. Any suggestions?

As we hit the end of the second quarter, expect to see chemicals carloads coming in with negative deltas year-over-year. That's because the AAR reporting system lumps crude oil (STCC 131) in with STCC 29 petroleum products from LPG to asphalt to lube oil. And since traditionally Class Is report STCC 28 (industrial chems from butane to ethanol to plastics and fertilizers) and STCC 29 together, the drop in crude oil volumes will seem to drag down the 28s and 29s.

Happily, the STB's *Quarterly Commodity Statistics* lets you sort it all out. Upload the quarterly spreadsheet for your Class I connection and scroll down to the lines for STCC 131 and 29. That'll give you the relative sizes for the two commodities in column J. CSX, for example, in 1Q2017 moved 7,473 cars of crude and 47,609 in the entire STCC 29 class. Which tells me the 29s outnumber the 131s about 7:1 at CSX.

But is it always this way? Here you need to compare successive quarters, and the Report Wizard in *USRaildesktop.com* is the easiest way. Here, I use LPG as a proxy for the entire 29 group because it's half the group. The STCC 29 trend is decidedly up, while CSX crude oil peaked at more than 30,000 cars in 4Q2014 and has come down steeply since.

The *desktop wizard* also lets you compare all railroads in any commodity. BNSF crude oil peaked at more than 100,000 units in 3Q2014 and is now less than half that. Everybody else saw peak crude oil loads about the same time, but volumes were more modest — under 40,000 — and all have seen declines pretty much mirroring the CSX experience.

On the other hand, LPG has remained in a pretty consistent range for all carriers in the same time frame. Crude oil is not big on most short lines, and that tells me the short line with a solid STCC 29 franchise can pretty much ignore the swings in crude oil. You can take to the bank what the rails say about their chemicals business trends given that crude alone is driving the negatives.