RAILROAD WEEK IN REVIEW

August 4, 2017

"The pace of change at CSX has been extremely rapid, and while most people at the company have embraced the new plan, unfortunately, a few have pushed back and continue to do so. This resistance to change has resulted in some service disruptions." — Hunter Harrison

CSX service irregularities have had a direct effect on shortline performance. Hump removals, re-routings, train removals and new blocking patterns, new interchange locations, and so on, have added to shortline car hire, labor, fuel and loco hours. In a recent note to investors, Cowen's Jason Seidl writes,

> Over 80% of respondents to our CSX Service Quality survey say they have experienced service issues since the company began Precision Railroading. Nearly 40% have switched some freight to NSC and 67% have transferred freight to a trucker… How much are they switching? 20% of shippers are shifting less than 25% of eligible freight to NSC while 14% are transferring between 25% and 50% of freight.

It got to the point that, on July 27, the STB sent a letter to Hunter Harrison "expressing concerns about deteriorated service resulting from the railroad's recent operating changes." The Board has asked CSX to outline its service restoration plan covering such areas as "congestion at critical yards and gateways, interchange operations with other Class I railroads, availability of equipment and manpower, and local spot/pull reports."

Those who know Hunter could not have been surprised when he responded with a personal "Letter to Customers." After the customary soothing remarks, he offers this tidbit:

> The pace of change at CSX has been extremely rapid, and while most people at the company have embraced the new plan, unfortunately, a few have pushed back and continue to do so. This resistance to change has resulted in some service disruptions… We will continue to address these internal personnel matters and… resolve any service issues as quickly as possible.

Long-time Hunter watchers will recall his remarks during similar changes during his early days at CP. The message was simple: Everybody who wants to contribute to the success of the company and who wants to be part of the team will always have a job here. Those with other ideas might be better off seeking employment elsewhere.

Railroading is an absolute. The train is either on time or not, the cars are either placed according to commitment or not, the crew is where it's supposed to be or not. Consider: the five Guiding Principles of Precision Railroading concern service, cost control, asset utilization, safety, and

people. And, since "everything we do depends on people making it happen, doing their jobs with passion and integrity"[1] is essential.

It's not going to happen overnight. CSX is itself an amalgam of five or six — at times unfriendly — railroads plus the Conrail overlay, with every one of the fallen flags having its own way of doing things and work-arounds. To be sure, there are apple carts to be upset and "bumps in the road," as Hunter said on the second quarter earning call. I've known Hunter personally since his IC days, and his approach to railroading is entirely in synch with CSX Core Value Number One: "It starts with the Customer." Absolutely.

Genesee & Wyoming's second quarter results may not be barn-burners but they show a consistency of purpose and financial responsibility. Turning first to North America, where I view GWR as a proxy for the broader short line, regional railroad, and switch carrier community, same-store loads were off a mere 10 basis points to 385,564 units; new railroads added 11,483 units, total 397,047, up 2.8% year-over year.

The commodity shortfalls are evenly distributed by geography:

*metallic ores in the Mountain West and Coastal Regions;
*petroleum products in the Northeast and Mountain West Regions;
*metals in the Southern and Coastal Regions;
*chemicals and plastics traffic in the Mountain West Region;
*pulp and paper traffic in the Southern and Coastal Regions;

Offsetting losses were ag products out of the Central and Mountain West Regions; minerals/stone in the Central Region, and waste out of the Northeast and Pacific Regions.

Total North American freight revenue was $223 million, up 5%; RPU gained 2% everywhere except metals and metallic ores, with most of that attributable to reduced copper concentrate shipments plus an aluminum plant closure. Total revenue including switching services was $316 million, up 4%. Total operating expense was $236 million, up 5%; operating income came to $80 million, up a point, and the OR finished at 74.8, up less than a point. (Pretty much the same ratios are expected for Q3.)

Five commodity groups (coal, ag prods, chems, mins/stone, pulp/paper) each account for more than 10% of the commodity mix and together comprise 62% of all revenue units. The common characteristic of this group of commodities is that they are largely bulk commodities that weigh out before they cube out, are fungible — one lump of coal or kernel of corn is like any other — and they reflect what I see as the the direction of the shortline industry as a whole (*More on this below. - rhb*)

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[1] *How We Work and Why: Running a Precision Railroad, Hunter Harrison, 2005*

Recognizing the importance of commodity mix spread between itself and the Class Is as a whole, GWR broke out same-railroad carloads ex-intermodal showing where their mix varies from the Class I mix and by what degree (*slide 5 in the presentation*). This is an interesting exercise and could be helpful to others seeking to benchmark themselves against a specific Class I.

Here's how it works. Start with Class I commodity carloads for the two years in question and get the percent change in volumes. Then get the commodity change in carloads as a percent of the whole railroad change in carloads. This is your percent change in Class I mix. Repeat for your railroad. Then compute the spread between your mix change and the Class I mix change.

Class I ag products, for example, were up 9.8% and represented 1.2% of the total carload change. For GWR, ag products were up 7.0% and represented 0.9% of the total carload change. Thus the ag products commodity-weighted variance is 0.9-1.2 or (0.3%). You can now see why the negative weighted variance is greatest in coal: it's a third of Class I volumes vs. less than half that for GWR. Or why the variance is most in favor of GWR Consumer Products due to GWR's larger presence of those commodities in the total mix.

Just to give a nod to overall results, consolidated revenue (North America, Australia, Europe) was $540 million, ops income $101 million, up 16%, OR 81.2 vs 81.6 a year ago. Net income is $48 million, down 5%, and earnings per share shed 10% to 75 cents thanks to the 6% diluted share-count increase partly as a result of their JV partnership in Australia.

The GWR results confirm what I see as largely the bulk-commodities direction of the shortline industry as a whole, and until short lines can do a better job of creating customers through supply chain solutions, the trend will continue. The Class Is too must be more proactive, empowering their field reps to be aggressive shortline customer advocates, and with market managers not foisting off leads to interns who have no institutional knowledge of how things really work. Class Is must lead, follow, or get out of the way; as of this writing there remain pockets where they're doing none of the above.

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