# RAILROAD WEEK IN REVIEW

## September 15, 2017

*"Hurricane Harvey impacted volumes isolated to the KCS cross-border franchise business, though it's still too early to assess lost revenue vs. delayed revenue." — Pat Ottensmeyer, KCS President & CEO, September 6, 2017*

**The annual KCS *Strategic Partners Conference*** took place in Kansas City this past Tuesday and Wednesday. More than 200 souls were in attendance, representing not only the shortline connections, but also a significant number of ports and transload operators. The program itself was well thought out, from the app outlining the individual events, to the collection of speakers representing KCS, its customers, and even suppliers.

As regular readers of these pages know, it is my practice to listen in on KCS conference calls and financial events, so I took this visit to KC as a chance to sit down with Ashley Thorne and Meena Murthy in the KCS Investor Relations group. The thread of our conversation dealt with recent KCS accomplishments, KCS competitive advantages, and what they see coming up for KCS in the near future.

Needless to say, I came away impressed, and, if share prices are any indication, investors as well like what they hear and see. As I wrote last week, "KCS shares (NYSE: KSU) are up 23% this year, and that comes largely from the Mexico story, with strong franchises in automotive, and cross-border intermodal," not to mention new refined petroleum products moves (more on this below).

Starting with accomplishments, the balanced revenue mix is about evenly split among industrial and consumer, chems (including STCC 29 petrol products like LPG), ag and minerals, energy (coal, frac sand, crude oil), and intermodal/automotive. The revenue mix is about 75% merch carload, the highest of any North American Class I railroad, and making KCS the ideal shortline partner.

Through the 2017 second quarter, revenue increased 12% on 6% more revenue units, increasing RPU by 6%. Operating expense was, unfortunately, up nearly 13%, yielding just a 10% gain in operating income. Total merchandise carloads increased 7%, whereas intermodal was off a point. Frac sand, though only 1% of total revenues, jumped 77%, which is very good for the short lines in that business.

Top of the list for competitive advantages has to be Mexico. Top commodities moving south include auto parts (boxcar and intermodal), industrial products, straight general intermodal, and grain and related products; intermodal and finished vehicles dominate the northbound moves. However, cross-border revenue is up 8% year-over-year on an 11% volume gain through June 30, 2017, beating KCS volume averages north of the border.

As for coming attractions, KCS sees seven key new business opportunities in the Energy Reform movement in Mexico, and virtually all of it is in the carload sector. Number One is the importation of refined petroleum liquids owing to increasing demand, with the infrastructure in place at both origin and destination.

Next up is LPG to meet shortages in Mexico, where eight out of ten homes depend on LPG for heat, cooking, etc. Third comes heavy fuel exports from Mexico due to refining limitations. Then Mexico needs pipe for nat gas transmission, that will in turn facilitate crude oil swaps between the US and Mexico (opportunities 5 and 6). Finally, there's frac sand, which doesn't exist in Mexico but which is needed to extract the large amounts of nat gas that do exist in Mexico.

Finally, there there is room for growth in shipments to and from Lazaro Cardenas, the grain trade, cross-border intermodal, and finished vehicles out of Mexico running at an SAR greater than is predicted for the US and the whole energy story. So, in sum, the 44 KCS short lines and their 6,200 route-miles (nearly doubling the KCS organic reach of 6,600 miles) are in a very good position to contribute mightily to the partnership to the benefit of all parties.

**Regarding changes at CSX** and criticisms thereof, I'd like to run the risk of seeming too bold and ask how many of the critics have actually read Hunter Harrison's book, *How We Work and Why.* In it, he names the attributes of each of the five elements of Precision Railroading from asset management through safety.

I have spoken at length with him and other IC, CN, and CP managers about the process and have learned that, though it may have some rough edges, it essentially works: Precision Railroading is all about having what you need in the right place when you need it. It addresses the absolute-ness of railroading — the car is on the track or it isn't; the loco is performing or it isn't, etc.

My thinking – and I'm not alone in this – is that the industry has become so silo-driven that creative management has no room to grow. These silo managers need to be taken by the scruff of the neck and shaken thoroughly to wake them up to the real world. Hunter can be relied upon to do exactly that. Yes, I agree there are some rough edges – he even said on the second-quarter call that there would be some "bumps in the road" along the way to implementing Precision Railroading at CSX. So none of us should be surprised.

My continuing position is that CSX has long been a case of five angry railroads that couldn't play nice together in the sandbox. Former NYC folks would do things their way and former Seaboard folks would do things their way, never mind the fact that Conrail and the newer CSX existed between the time of those fallen flag names and the present. Nobody had taken the initiative to undo it. Until now.

I think it's time for everybody to pull their socks up and get on with it. Hunter is bringing discipline to an outfit very much in need of it, and a lot of feathers are being ruffled in the

process. I am also convinced that the discipline Hunter is forcing on CSX is at the same time forcing NS to take a closer look at its own silos and find ways to break them down.

In the final analysis, Hunter's coming to CSX will benefit both CSX and NS, as well as customers who can be provided service at a reasonable RVC ratio. Jason Seidl of Cowen gets it exactly right: RPU Is a greater driver of operating earnings than is volume. That, I'm sorry to say, can't be good news to short lines that depend more on volume than RPU. But the world is changing, and it's time to pull one's socks up and get on with it.

**Coming in late November:** RailTrends continues its years-long annual conference in NYC November 30-December 1 at the Marriott Marquis in the heart of NYC's theater district. Sponsored by *Progressive Railroading* and organized by my good friend Tony Hatch, we'll have theater enough with what Tony promises to be a "silo-busting, cross-disciplinary examination of the freight rail domain."

I'm eager to hear what presenters such as CP's recently appointed Chief Marketing Officer John Brooks, Ferromex President Alfredo Casar, and Amtrak's Wick Moorman have up their sleeves. And holding forth on the shortline scene, we'll hear from ASLRRA's Linda Darr plus long-time RailTrends favorites, Jack Hellmann (GWR) and Rick Webb (Watco). Get all the details at www.railtrends.com.

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