RAILROAD WEEK IN REVIEW

January 5, 2018

"We are surrounded by technological advances, from artificial intelligence to robotics, but you can find no sign of it in wages or productivity… Perhaps the U.S. is at a point when technology and an economy growing solidly with low unemployment become mutually reinforcing… The industries with the fastest productivity growth between 2010 and 2016 tended to more intensively employ digital skills." — Greg Ip, Wall Street Journal, Dec 27, 2017

Week 51 AAR Class I total revenue units for North America increased to 36 million from 34 million a year ago, up 5%. Strip out coal, intermodal, and auto to get merchandise carloads of 12 million, up 4% year-over-year. Within the merch carload sector, the STCC 14 non-metallic minerals group (think aggregates) really stole the show, up 14%, largely on frac sand. Metallic ores and metals (copper, steel, aluminum, e.g.) came in second best at plus 12%. Together, these two STCCs account for nearly 40% of all merch carloads.

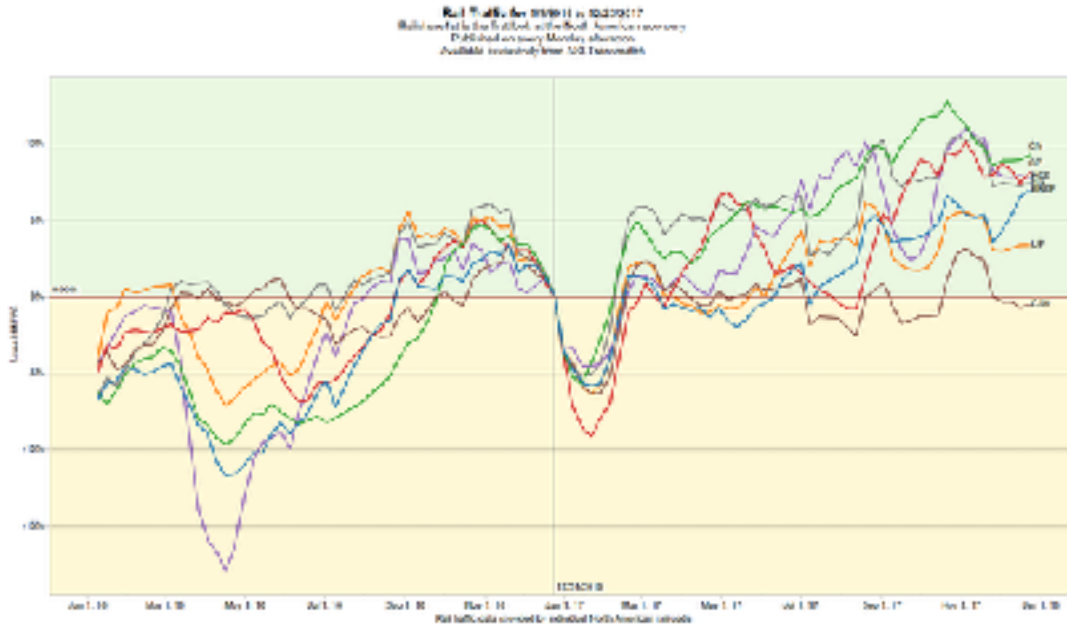
AAR NA Class Is	2017	2016	Delta	Pct Tot
Total Units	35,960,443	34,198,381	4.9%	100.00%
Intermodal	17,793,925	16,833,053	5.4%	49.48%
Auto	1,345,474	1,411,402	(4.9%)	3.74%
Coal	4,743,202	4,363,746	8.0%	13.19%
Merch Carloads	12,077,842	11,590,180	4.2%	33.59%
Source:AAR thru Dec 23				

Straight STCC 28 chemicals fall between metals and non-metallic minerals in sheer volume, up 2%. Elsewhere, grain carloads drifted down two points. Carloads of lumber are holding their own while paper products continue their southerly drift. In sum, five of the seven merch commodity groups show negative deltas. Intermodal and auto now combine to represent more than half the Class I revenue units whereas carload manifest traffic is only 34% of the total.

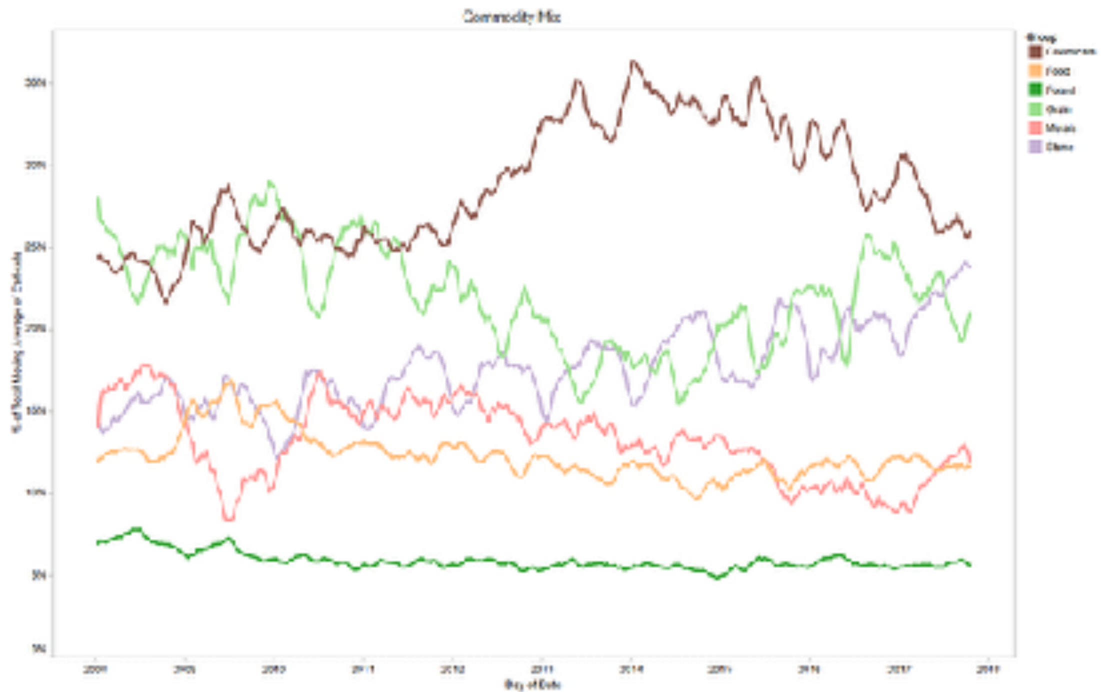
Yet the AAR *RailTime Indicators* for November offers some encouraging words about the carload business: "Many traffic categories that are more sensitive to the economy did relatively well in November (e.g., steel, up 6.9%; stone, clay, and glass products, up 6.0%; chemicals up 3.6%) — a good sign for the economy going forward."

Strength in frac sand, metals, and industrial chemicals supports the argument. The latest Railcar Report from PFL adds, "Fracking will continue to gain momentum driving the need for frac sand cars and other cars for commodities associated with the fracking process."

I have often said the Class Is are the biggest customers of the regional and shortline railroad community. Naturally, you want to do the most business with the strongest customers. Here's where Drew Robertson's ASI-Transmatch graphs are particularly useful — 2017 revenue units up in the high single-digits for five of the seven roads tracked.



The real value comes from the companion charts showing commodities by railroad. At BNSF, for example, you can see chems (in this case including crude oil and STCC 29s) falling off as crude



oil shrinks as part of the mix. But grain and stone are picking up, with metals, food, and forest holding their own. Thus any non-Class I connecting with BNSF ought to be able to have a constructive conversation about new carloads, whether from existing customers or from new business developed by the connecting railroad.

I think the technology trends cited in the quote at the top of page 1 show why the most popular railroad commodities are those that are fungible — one ton is indistinguishable from the next and there is little time value as a result. On the other hand, consumer staples (soap, diapers) and discretionary items (cars and clothes) cost more to make, store, and sell, and have a time value. That's why trucks are capturing a larger share of these moves.

Quite possibly, 2018 may turn out to be The Year of Commodities. RealVision's commodity guru Greg Weldon sees uptrends in "base metals" (industrial, non-ferrous metals), the age (particularly beans and soybean oil), and refined petroleum products, all of which begin as crude oil. Heat and eat remain the railroad themes, and here Dennis Gartman adds a subsidiary theme of interest to short lines — fertilizer. He writes, "We are more and more certain that commodity prices are inordinately 'cheap' relative to stocks generally, and that fertilizer [dealers] will benefit greatly."

Short lines continue to identify short-haul carload moves, only to get shot down by railroad pricing managers who have their mandates to follow. Seems to me a $million in new revenue at a 1.3 RVC is better than no revenue; however one must consider the market manager who has to explain to his boss why he's taking the move. Theoretically a 1.3 RVC equates to a 67 OR, not low enough when Wall Street expects incremental margins to have ORs under 65.

But carriers don't operate in a vacuum. A friend who's been around the railroad finance business many years writes, "Logistics is really a giant game of liars' poker where every element congratulates itself on doing very well within its own silo but is systematically divorced from the economics of the adjoining silos, giving no credit to the role, perhaps central role, of the next silo in completing the transaction." Transloads and intermodal are classic examples.

My friend suggests that what's wrong with my 1.3 RVC picture is that the the railroad is seeking a 40% operating profit while "the competition (using other people's money) is seeking a pre-depreciation EBITDA margin of 10% — the difference being the cost of holding and depreciating assets." In short, the rail silo ought to be watching the truckload silo very carefully.

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