RAILROAD WEEK IN REVIEW

February 2, 2018

"The language of freight transportation is changing, and we need to make sure we speak the same language as other industries." — Linda Bauer Darr, President, ASLRRA, in Progressive Railroading magazine, January 2018.

All the Class Is that hold quarterly earnings calls have done so; BNSF Q4 and full-year results will be in the Berkshire Hathaway report, expected later this month. In the meantime, however, we can look at the BNSF carload report for Week 52, Q4, and full year (through Dec 30) as sent to the AAR and posted at bnsf.com .

Assuming the load report through Dec 30 is a valid proxy for quarterly and annual results, I'm comfortable comparing Class I volumes accordingly. BNSF ran 2.6 million total revenue units, up four percent. And since BNSF only reports four commodity segments — Industrial Products (IP), Agriculture, Coal, and Consumer Products (auto and intermodal) — I like to parse the AAR tables to see what's where.

What I call "merchandise" commodities" are Ag plus Industrial Products (auto is not in this group, unlike all other Class Is) were up seven percent and represented 28 percent of total units. Coal (and coke) — 19 percent of vols — was down nine percent. Consumer products — 54 percent of units — gained seven percent; intermodal ex-auto also gained nine percent.

Among merchandise carloads, Ag (mainly grains and grain mill products; STCC 20 processed food in boxcars is in IP) was down three percent, mainly in grains. Industrial products carloads increased 12 percent, with particular strength in metallic ores, metals, and aggregates including frac sand. In all, 16 of 18 commodity groups comprising my "merchandise carload" group (Ag plus IP) posted gains. Of the lot, grain is six percent of total railroad volume, and is the largest of the merchandise group.

By way of comparison, BNSF lagged five of the six reporting Class I peers, beating out UP with its mere one percent gain in total revenue units for the quarter. On the other hand, and of critical interest to non-Class I railroads, BNSF led in the merchandise category with a seven percent gain — and that doesn't include auto, whereas all the others do.

Now that the press of reporting the Q4 numbers passed, a closer look at the earnings call transcripts is in order for additional tidbits. One in particular that jumps out is this exchange between an analyst and CN.

> Question: What are your thoughts on just the end of Precision Rail. Is this becoming now a cyclical business purely dependent on volumes and adding capacity along with those volumes?

> Answer: We have been on the same strategy since 2010: to balance service and operational excellence, continuing to grow [carloads] a little bit faster than what the markets would normally have. It's not a straight line, and sometimes it happens a little more quickly than you'd hope…
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> You made a reference to the Precision Railroad. Look, this has been an extremely tough quarter — the lack of resiliency we've had in our major corridors, the concentrated growth on those same corridors, and some pretty tough winter conditions. But when it comes to sweating assets, controlling costs, managing the process tightly, we're all Precision Railroading disciples.

Once again, it is clear to me that the analysts commenting don't always do the homework. By way of review, Hunter says in his book, *How We Work and Why*, that Precision Railroading comprises five elements: safety, service, asset management, cost control, and people. Precision Railroading at CN has over the years brought its operating ratio down 30 points from the 90s to the 60s, has built on revenue unit volumes consistently and at generally faster pace than the other Class Is, and now champions the Supply-Chain Partners cause.

As proof of the Precision Railroading pudding, we have CN as Exhibit A for work accomplished, CP as a Work in Progress, and CSX as the new kid on the block. So in two out of three cases we can see Precision Railroading at work and the results that it can achieve. At CSX, the process is still in the early stages and we can see glimmerings of improvement around the edges.

At the end of the day, the Precision Railroading moniker merely sums up what any railroad ought to be doing in order to create a quality service in the eye of the customer, manage the assets to deliver that service in a safe and cost-effective manner, and put the people in place who can make it all work.

Said CEO Luc Jobin on the call, "So it's not all about growth, and it's not all about cost. The reality lies somewhere in between. Given the cards that you're dealt as the business comes on, you do the best job possible in the short term to accommodate it." And put the capex in place to accommodate that growth long term. That's what Precision Railroading is all about.

Continuing that theme, VP Ops Ed Harris said on the CSX call,

> We are going to continue to follow Hunter's plan of pursuing a scheduled railroad environment that in turn will lead to fewer train starts, more engines in storage, less equipment in service, and a more fluid network. The table has been set as, per Jim Foote's earlier remarks, the heavy lifting has been done. I totally agree.

Part of that heavy lifting involves the network itself. CSX has to know where customers need to go and how to go there best. CSX is at a bit of a disadvantage here. Consider the Rock Island example: the line failed partly because, no matter where they went, somebody else went there better. In the case of CSX, today's network is an amalgam of fallen flags that paralleled each other while serving the same OD pairs. Yet at the same time these parallel lines can feed carloads to each other; keeping the volumes while lowering cost (Precision Railroading Principal Number Three) is a critical part of the process.

A quick look at the CSX map will give you a good idea of what we're talking about. In the deep south, the former L&N between Jacksonville and Pensacola roughly parallels the former ACL-Central Georgia-L&N route between the same OD pairs but via Montgomery. Or look at Jacksonville-Birmingham. There's the former CG-ACL route via Waycross and Columbus or Jax-Montgomery as above plus the old L&N for the last leg. Work your way north and see still others. And figure out which you would pick if you had the option.

Then there's the branch line network. I was in the Tampa area last week and saw several light-density lines that must be expensive for CSX to run. Terre Haute to Decatur over the former Big Four and B&O sticks out like a sore thumb. The former B&O Cincy-St Louis alignment is another. The former Western Maryland — all of it — would better off in other hands. And in the northeast, the whole Boston Cluster (which Conrail was set to sell to RailTex 20 years ago) needs a new evaluation.

For new operators of these lines, my sense is CSX is going to be looking first at healthy short lines that are direct connections with its lines under review. If there are none, then CSX could perhaps consider another operator in the same area who can work the line without adding assets and crews. And failing either of these, I see conversations with healthy shortline owners already doing business with CSX elsewhere. Weak operators or new entrants need not apply.

Railroad share prices make no sense. I thought quarterly and annual results were respectable. Total FY 2017 returns including divs for a market basket of shares bought on a market cap basis returned some 30 percent. KCS led the pack, up 33 percent (I omit ranking CSX, up 63%, on the Hunter premium a year ago and not sustainable); GWR brought up the markers at 12 percent.

Today's charts have CN bouncing off its 200-day SMA, almost as a support line. UP gapped down to the SMA-50 on the call and has recovered somewhat. CSX, NS, and CP are all hovering around their 20-day lines while KCS alone is well above its 20-day line. GWR's 50 looks like support and the trend is generally up with higher highs and higher lows. So no matter what the analysts are writing today, I'd say the rail sector as a whole is encouraging. Buy the dips.