RAILROAD WEEK IN REVIEW

March 16, 2018

"Capital spending for 2018 met with more optimism as estimated programs among Class I railroads total a slight increase over last year." — Mischa Wanek-Libman, Railway Track & Structures, February, 2018

Genesee & Wyoming revenue units are off 60 basis points year-over-year. As I look at the monthly stats, it's clear that the usual suspects — coal, ag products, aggregates, chems, forest products, and metals — continue to dominate the group that contributes 80 percent of GWR total carloads. What's up and what's down varies month-to-month, yet coal, ag products, and chems were down both months. Same-railroad was down two percent in Jan; less than a point in Feb.

GWR North American Revenue Units							
2018 by month, YTD							
	2018 month	2018 YTD	2017 month	2018 YTD	Change Month	Change YTD	2017 ch MTM
Jan	136,199	136,199	138,551	138,551	-1.7%	-1.7%	
Feb	127,344	263,543	126,488	265,039	0.7%	-0.6%	-6.5%
Mar	0	263,543	0	265,039	na	-0.6%	-100.0%
Quarter	263,543		265,039		-0.6%		

As for January, the *Railinc Short Line and Regional Railroad Index* has volumes down 2.3 percent based on some 500 roads reporting. Crushed stone, sand and gravel led gains for the fourth month in a row with a 13.6 percent increase, followed by petroleum products and STCC 24 wood products, at 12.9 percent and 11.2 percent, respectively. Intermodal led declines for the second consecutive month at 28.3 percent. Coal followed with a decrease of 19.1 percent.

Just for grins, I looked at the GWR Feb 2013 carload split between North America and everywhere else (only Australia back then). Five years ago NA accounted for 87 percent of total GWR rev units; in 2017 the NA count was down to 49 percent. I had sensed from the quarterly reports and elsewhere there is a gradual shift of focus from North America to offshore, and this would seem to confirm. By way of comparison, AAR North American revenue units through Feb are up only 70 basis points.

I continue to use the 100+ roads in the GWR NA collection as a proxy for the NA shortline community as a whole. Like the shortline community, GWR has its mix of top performers and dogs. I know of one non-GWR line that just added 5,000 cars of new business on its 60-mile railroad — that's 80 cars a mile with virtually no fixed cost addition and an incremental OR in the low teens, if that high. Then there's the 51-mile road doing only 4,000 cars a year for an

average of 39 cars a mile. My Rule of 100 says you need 100 cars per mile per year just to keep the doors open.

But GWR has something the others don't: shares traded on the NYSE. At the moment they're priced at roughly 33 times earnings. If they buy another railroad for 10 times earnings, results will be immediately accretive to earnings and share prices will go up. On the other hand, the dogs of Darien will keep the averages down. Perhaps it's time to exit a few and let other, smaller players active in those service areas have a go at these for maybe eight times earnings and put the resources saved against the better performers.

Benjamin Hartford, lead transportation analyst for Milwaukee's RW Baird, writes that Class 8 (heavy-duty) truck orders "are surging," and that " lack of driver availability remains the capacity constraint."

> While robust truck orders represent future supply growth, we note the dominant constraint to capacity during 2018 remains the lack of driver availability. We expect industry wage inflation of some five to ten percent year-over-year in 2018, but the magnitude of realized contractual pricing growth during 2018's bid season should, in our view, still provide for real pricing growth for carriers this year.

As a result, says Hartford, the continued acceleration in spot pricing growth during the 2018 first quarter sets the stage for a 2018 truckload bid contracting season that could be "one for the ages," with five to ten percent core contractual truckload pricing growth. Spot demand trends moderated in early February from the robust levels of early January. Baird expects seasonal demand improvement later in March, typically after the Ides of March.

Now consider that supply-chain managers on a budget watch transportation costs very closely, and a low truck rate in cents per hundred-weight may not be particularly cost-effective. A western shortliner writes that his customers may wait two weeks to get that truck, and by that time his customer's midwest customer will already have his order filled by another vendor.

My correspondent plus his friends at UP came up with a per-car rate and service plan that beat the trucker's total cost (freight plus delay time). Their plan: two days to get the car to the short line, three days on the short line interchange-on to interchange-off, and six days to actual placement on the UP. Truck: two weeks to get the car, one-week dock-to-dock — 11 days vs three weeks.

Now if we can duplicate that in the east with the new CSX car trip plan (WIR March 9), we'll all be ahead of the game and will have created new customers in the bargain. Higher truck rates will make that road-to-rail conversion all the more a likelihood.

"Increased steel tariffs could spur railcar orders before morphing into a threat," writes Cowen's Matt Elkott. He argues that higher steel prices due to import tariffs could be "a minor

headwind to railcar manufacturers and a minor tailwind for lessors." So if steel is less expensive, for now at least, so will be the price of new cars.

Cowen predicts that "some buyers may be inclined to preempt a steel price rally acceleration," and is modeling a 20 percent increase for first quarter 2018 — to 10,200 units from 8,500 units.

> Looking past 1Q18, we estimate that a hypothetical 25 percent increase in the total steel component cost of a railcar would be passed through by builders as a roughly 12 percent price increase to customers acquiring new tank cars or hoppers. Absent a concurrent improvement in underlying freight fundamentals, the new-build market would have to regain equilibrium via lower orders, manufacturer margin concessions elsewhere that would limit the price increase, or any combination of the two.

And because much of the slab and coiled steel going into new equipment comes from mini-mills, where electric-arc furnaces rely on scrap steel as feed stock, the price of scrap could rise. That would make the case for retiring and scrapping older equipment — like 50-ton, Plate C boxcars — even more compelling.

Elkott concludes that "the ongoing modest railcar recovery is likely sustainable" partially because rail service snafus mean more cars to handle the same tonnage. On the other hand, as trip plan compliance improves, "the risk of overbuilding has risen, something that should benefit the manufacturers for the foreseeable future but could pose a longer-term threat to the lessors."

> Admittedly, the all-else-equal assumption, with which we initiated our discussion for the sake of quantifying the impacts, has its flaws. Many other variables are likely to come into play. Accelerated bonus depreciation could make equipment purchases attractive enough to outweigh the potential lease advantage we highlight in the above scenario.
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> Steel tariffs could trigger trade wars that may be detrimental to international commerce and domestic economic growth. More than 40 percent of North American rail freight is believed to be directly or indirectly tied to global trade. Other moving parts include the duration of a tariff and how much of it is already baked into current steel prices.

Regardless, the message to short lines and regionals is clear: turn the equipment to keep freight rates, replacement costs, and fleet sizes under control for any given level of revenue ton-miles.

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