RAILROAD WEEK IN REVIEW

August 3, 2018

"Cost structure is critical in our business. We are an asset-intensive business. Sweating the assets and making sure that we have the right level of people and other resources to get the job done is critical in our business." Norfolk Southern CEO Jim Squires

"In the railway industry, businesses around the world are using iPhone and iPad to support operations, training, passenger engagement and maintenance activities." — Luca Maestri, CFO, Apple, Inc., on FY3Q Analyst Call

The Cult of the Operating ratio is getting out of hand. Trains magazine contributor Bill Stephens writes (July 26), "NS reported record quarterly financial results. But its operating ratio did not keep pace with the progress at CSX under its shift to Precision Scheduled Railroading, the operating model of the late CEO E. Hunter Harrison." To be fair, Stephens quotes NS CEO Jim Squires who says a railroad has to invest for growth, and "We are focused on productivity going forward… So I think our plan will be the right plan for our shareholders in the future."

Let's face it. CSX is a work in progress; NS is not. Back in January, 2017, activist investor Paul Hilal said he wanted Hunter to run CSX and shares jumped 23 percent almost immediately. Since then, shares have nearly doubled to $70. Hunter's mantra was getting the OR down. His track records at IC, CN, and CP show he consistently took points out of the OR. But at what expense? Customers, in a word, revolted, and carload volumes dropped. As fewer cars moved, the variable expense line and the OR dropped.

After Hunter got the IC in shape, CN bought the IC to get Hunter. Over the next few years, the OR at CN dropped to the 60s from the 90s, though at the expense of some customer loyalty. After Hunter left, CN made the decision to run a "kinder, gentler railroad" (their words, not mine), and it's worked. In Q2, CN could boast the most growth in revenue units, RTMs, and carload revenues, yet with the lowest OR in railroad-dom.

I must also note that CN-after-Hunter embraced the term "supply chain partner" to show how and where to add value to the transportation product, proving you can have both a low OR and satisfied customers. But it takes investment. Between Chicago and Edmonton, CN is adding more than 60 miles of double track in seven sections, adding 11 new sidings and run-arounds, and upgrading through-put at eight yards.

As a result of this continuing Work in Progress, CN in Q2 posted significant operating improvements such as GTMs per train-mile, terminal dwell, car velocity in miles-per-day, and trailing GTMs per available horsepower. Nobody else has this degree of transparency in their quarterly operating results reports.

Getting back to the NS-CSX comps Stephens writes about, it is essential to keep in mind that the railroad is a service business, where revenues are entirely a function of a customer's need to get goods from where they are to where they need to be. Thus a key measure of customer perception will be volumes and revenues.

NS grew second quarter revenue units by six percent vs. 2 percent at CSX; NS increased total revenues ten percent compared to six percent for CSX. Finally, of particular importance to short lines and regional railroads, NS increased single-carload and unit train carload volumes by three percent whereas CSX actually saw these volumes drop a point.

Still, CSX saw the biggest gain in operating income — 34 percent — shedding 873 OR basis points in the bargain, to 58.6, second place only to CN. NS operating income only gained 18 percent and took the OR down 234 basis points, which is what Stephens is writing about. So, in terms of generating shareholder returns, CSX seems to hold the edge. For now. In terms of creating new customers and supply chain partners, the nod has to go to NS. That's why there is more to life than the operating ratio, and why I think the latter plan is more sustainable.

American Railcar Industries is to build a 7,650 unit mix of tank cars and covered hoppers for GATX. There is also an option for GATX to order up to 4,400 more cars from ARI through 2023. I take this as a mixed bag of both good and bad news.

Good news because GATX thinks there's enough volume growth in bulk materials to warrant growing the fleet. Bad news because terrible cycle times mean you need more cars to move the same amount of goods, driving up your per-ton cost — hardly an incentive to use the railroad if you can avoid it. . And I think I know why cycle times are terrible: Senior management isn't paying attention and incentives for local management measure the wrong things.

Recent examples: A hump yard super won't do block swaps because he's measured on the number of cars over the hump in a day. A class I doesn't have enough cars to fill customer requirements but the car fleet manager won't let the serving short line get cars because he's under the gun to cut car hire expense. Another terminal manager gets dinged for empty moves, so returns empties to the owning road rather than forwarding them for backhaul where cars are in short supply. Then there's the guy who sits on leased cars of MSW and C&D for days for whatever reason.

I could go on. But the fact remains that every one of these misdeeds could be nipped in the bud if the perpetrators got proper guidance. It's up to short lines to keep the heat on their Class I contacts to make sure the leaders lead, and for good reason. The tea leaves point to continued demand for good leased equipment. A Wednesday note from ecommerce.com says they have requests for nearly 1,200 cars ranging from tank cars (coil and non-coil), 60-foot double plug door (Plate F, I assume), and to LPG tanks.

The message from lessees to terminal managers: if you keep sitting on my cars, I'll find someplace else to use them, and your employer will lose my revenue stream. Lose enough revenue for poor cycle times and your employer will need to reduce head count. Will one of those heads be yours?

Russian potassium may be on its way to taking a bite out of Canadian potash demand. The WSJ reported on Monday that a new Russian plant run by EuroChem Group, AG, could get as much as a ten percent share by 2025. This added supply would exacerbate the potash glut that has kept prices down, hammering Canada's PCS in particular.

A fertilizer analyst at BMO Capital Markets says demand would have to grow by some three percent per year to absorb the new production "without knocking off kilter a market where some of the biggest producers carefully match output to demand in order to support prices." This can't be idle chatter, either. The July *International Railway Journal* reports that Uralki, a EuroChem competitor, it buying 500 hopper cars and expects delivery next year.

Both CN and CP have plays in the potash business, but have differing views for the rest of 2018. CN President Jean-Jacques Ruest predicts "a modest downtick in potash vols," yet John Brooks, Chief Commercial Office at CP, said on the call that "we feel confident that strong potash demand will continue to the back half of the year."

The so-called "watershed" states are once again in the limelight. The term has its roots in an 1879 proposal that, as the western states were brought into the union, they be formed around watersheds, rather than arbitrary political boundaries. That has spread to the railroads, where the watershed states are too close to the Mississippi River to be markets of interest to the Western roads on the one hand, and to the Eastern Roads on the other.

For example, the UP will have little interest in originating carloads in KC for delivery in Savannah on CSX. Or for CSX to care about carloads from Terre Haute to Tacoma. Intermodal only works where one carrier has both ends. Carload can work across multiple carriers where it's seamless to the customer. (Rule 11 is right out.)

Trouble ensues where the originating carrier has a different approach to car management than the terminating carrier: UP wants to back-haul loads off NS, NS marketeers won't allow it because the rate falls below their computer targets. In this regard, the railroads are their own worst enemy. Any suggestions?

The Railroad Week in Review, a compendium of railroad industry news, analysis and comment, is sent as a PDF via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 million annual revenues $150. Corporate subscriptions $550 per year. To subscribe, click on the Week in Review tab at www.rblanchard.com.