RAILROAD WEEK IN REVIEW

October 5, 2018

"We're practicing Precision Scheduled Marketing to fill up our merchandise trains now running at just 75 percent of capacity… Short line connections are crucial, touching 59 percent of our merchandise business and growing by 23 percent year-to-date." — Coby Bullard, VP, Merchandise Sales & Marketing, Canadian Pacific

Back in August, I wrote, "As I make my rounds visiting short lines and watching Class I mixed freights, I'm struck by the fact that boxcars are shrinking as a portion of the total consist. Moreover, the strongest short lines are the ones with the fewest boxcar commodities."

Face it. Just about every highway trailer or container contains something that could be moving in a boxcar but doesn't. Yet the railroad industry has an ace up its sleeve: natural resource commodities in bulk. Generally speaking, the term "Natural Resources" includes anything moved or collected in raw form, and which has a "store of value" — agricultural products excepted as being less durable and so questionable stores of value.

Natural Resources Carloads by Railroad 2Q2018 YTD

	BNSF	CN	CP	CSX	KCS	GWR*	NS	UP
Industrial	964							
Pct tot RU	18%	35%	31%	28%	46%	62%	19%	38%
Tot mdse		1,467	677	1,331	539	708	1,262	1,669
Auto		-136	-56	-230	-82	-19	-207	
Ag prods		-307	-207	-219	100	-136	-307	
Other		0	0	0	-46	-37	0	
Net NR	964	1,024	414	882	511	516	748	1,669
Revenue units in thousands						* NA only		
Source: Company Financials								

Here's how the North American railroads compare in terms of natural resource carloads as a percent of total revenue units for the 2018 second quarter year-to-date.

I count eight STCCS in the grouping:

10 metallic ores
14 aggregates, not-metallic minerals
24 wood products from wood chips to 2x4s to OSB
16 paper from container board to tissues
28 chemicals
29 petroleum products
33, 34 metals from coiled steel to aluminum ingots and copper plates

The reason I find the Natural Resources category important for non-Class I first-mile/last-mile railroads lies in its non-cyclicality. You'll note it's still a heat and eat world, except the "eat" portion includes fertilizers and packaging rather than edibles as such.

Moreover, global demand is constant and growing for four reasons. First, rising incomes. As earnings go up in developing countries, the demand for precious metals, building materials, and other natural resources tends to increase as well. Which leads to more global infrastructure construction and repair prompted by population growth and increasing urbanization.

Political buying is a third factor. A number of nations have begun buying up natural resources to ensure a consistent supply of crucial raw materials. And finally, there is the Store of Value of many natural resources, particularly the metals. These resources become more attractive when inflation threatens supply chains.

The bottom line is the Class I railroad with a strong natural resources franchise is best suited to weather the inevitable economic downturns when they occur. And railroad members of the non-Class I community with the strongest a non-cyclical commodity franchises will be best served in a cyclical world.

Canadian Pacific hosted its 2018 Investors Day on its Calgary campus this week. The thrust of the program was the next phase of CP's long-term strategy which is, as we heard at the Short Line Conference (WIR September 14), focused on driving sustainable, profitable growth. The theme of this week's session was growing at low incremental cost, something short lines need to think about as they propose new merch carloads to CP — or any railroad, for that matter.

What follows is a summary of remarks that short lines can use to add value to the CP goals and strategy (you can view the **presentation slides** here). The day was largely marketing-driven. Only CEO Keith Creel himself spoke of operating accomplishments and directions, and CFO Nadeem Velani did the the obligatory financials. But it was SVP and Chief Commercial Officer John Brooks who set the tone.

Over the past five years, said Brooks, CP has transformed itself into a marketing-based railroad that sells against the Precision Scheduled Railroading model, where services sold match operating capabilities, providing more revenue dollars per asset dollar. Doing so means knocking down the internal silos and learning to say No to a customer. He talked about the need for a level of "constructive tension" and collaboration across departments to sell strategically and grow profitability.

Jonathan Wahba, Vice-President Sales & Marketing – Intermodal and Automotive, zeroed in the importance of having room to grow, principally in real estate that can be developed with no outside interference. And though shortlines per se don't do much in either intermodal or finished vehicles, the emphasis on expansion is a perfect fit for short lines having more property than they need to run the trains. The idea is that by giving a customer *Lebensraum*, you create a "sticky" customer that can be worth $millions in new revenue with little incremental expense.

Joan Hardy, Vice-President Sales & Marketing – Grain and Fertilizer, talked about "Precision Farming" practices that have increased farm yields dramatically, and how the growers take their crops to the elevators with the best rail service. Grain is CP's largest line of business, thanks to the railroad's superior service levels. Elevators are being built with loop tracks to load 8,500-foot trains, up from 7000-foot trains, and, with the new high capacity hoppers, can move 25 percent more grain per train, meaning more dollar return per dollar of assets and crews.

Coby Bullard, Vice-President Sales & Marketing – ECP (energy ex-coal, chemicals, plastics) and Merchandise, says his diverse book of commodities calls for what he calls Precision Scheduled Marketing to fill up those non-unit trains. He wants to get all the business he can from the customers where trucks now handle as much as 50 percent of their supply chain needs. But not every business — just those moves that can generate sufficient contribution per car-day to meet ROIC hurdles. He wants to use short lines to extend his reach (see GWR in SE Ohio), estimating an additional 10,000-20,000 loads can be thus captured.

I could go on for pages on the shortline opportunities opened, but suffice to say the shortline contribution got more air time than one usually sees in analyst meetings. The energy and enthusiasm for Precision Railroading — Creel calls it "the gift that keeps on giving" — was infectious. And do look at the slides, particularly for ag and merch. It'll be time well spent.

Norfolk Southern's Week 39 YTD numbers are revealing. Total revenue units increased 4.4 percent to 5.9 million units. Intermodal was 54.8 percent of the total; coal+coke, 12.3 percent. Merch carloads including auto are down to 32 percent of total rev units. Ex-auto and petrol prods (crude+STCC 29) merch carloads represented 1.5 mm units, 24.7 percent of the total. Ten of 18 merch commodity groups, 56 percent, are up for the year. The down commodities include grain, grain mill, and ferrous scrap, all solid shortline contributors.

NS has said in the past that short lines touch about 20 percent of total vols. If that be the case, short lines bring in one out of every five revenue units. Hard to believe. To be charitable, let's say short lines bring in 20 percent of non-auto, non-petrol merch cars. That group represents 750,000 NS carloads, 13 percent of total revenue units, about equal to coal.

There's a reason intermodal makes up more than half of all NS revenue units, and it goes to the fact that truckload carriers are adding loads at twice the rate of railroads, and that has much to do with what's in those trucks. Most truckload (and intermodal) moves are finished or quasi-finished goods. And because intermodal (and automotive) shipments are largely consumer discretionary items, they are the first to go when money gets tight.

My sense is the carload sector is increasingly dominated by more natural resources or raw materials and less of everything else. Natural resources are those goods that come out of the ground, are mined, or are the first step in creating materials the can be made into something else. Potash and frac sand and oil are the first kind, coiled steel, copper plates, and aluminum ingots are examples of the second. And, as such, they are less cyclical than intermodal and autos and represent a more sustainable revenue stream over time.

If you break out the NS quarterly financials you'll find that most of the 750,000 merch carloads referenced above are in natural resources. For that reason, ag products (but not fertilizer) are omitted. The natural resources category dominates the shortline sector (GWR North America is 62 percent) and I'm willing to bet the sector as a group runs someplace north of 50 percent. Anybody care to support or refute the argument?

Matt Rose will retire as BNSF Executive Chairman next April. Rose will have been Executive Chairman for six years, and CEO for the prior 13 years. He also served in senior leadership for marketing and operations before assuming the CEO role in 2000.

During his tenure as CEO, he helped guide the 2009 acquisition of BNSF by Berkshire Hathaway. Rose's tenure is characterized by his commitment to growth with customers, advocating at every point in his career that customer service is what drives profitability, the virtuous cycle of reinvestment, and provides the public license to operate.

Bravo and best wishes. It's been a pleasure knowing you and I'm grateful for all you've done to nurture and encourage the non-Class I railroad participation in BNSF's accomplishments.