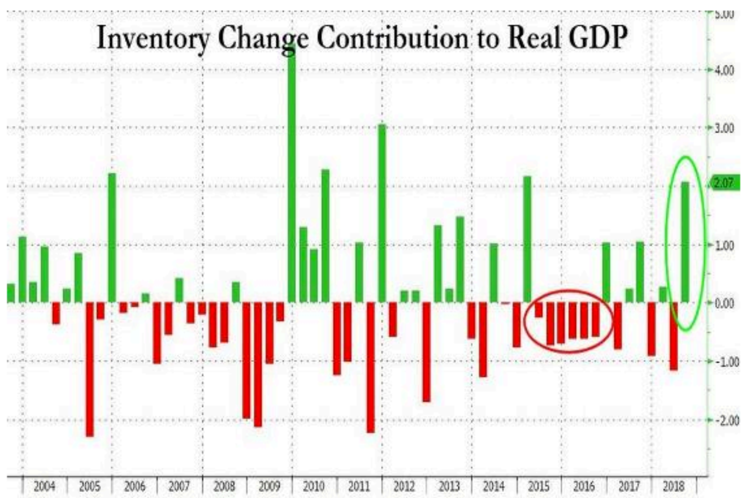
RAILROAD WEEK IN REVIEW
November 2, 2018

"In North America, our business was strong and our incremental margin of 65% exceeded our typical expectation of 50%. Volumes are about 4% ahead of guidance." Jack Hellmann, GWR

Dennis Gartman writes that the Commerce Department has reported that the gross domestic product grew at a 3.5 percent annual rate in the third quarter, down from 4.2 percent in the second quarter but better than the pre-report consensus expectation amongst Wall Street economists who had been looking for something closer to a 3.3 percent increase.

We note then that this increase was fueled in part by a 4.0 percent rise in consumer spending. However, as noted in the chart below, far too much of the increase was also fueled by inventories being suddenly accumulated.



As our friend and mentor, Dr. A. Gary Shilling, taught us: recessions begin from an abundance of inventories accumulated and, although one quarter's change does not a new trend make, this is worthy of note nonetheless.

Could be the inventory buildup caused the 3Q surge in rail volumes and the tight truck capacity leading to that. That more merch carload commodities are down than up going into Q4 reinforces that thought. And the Street sees it.

As of noon last Monday, all seven traded railroads (BRK is a proxy for BNSF) are at or below their 200-day moving averages. And if railroads are a leading indicator of future economic activity, caution is warranted. Look to "heat and eat" for solid growth.

Genesee & Wyoming third quarter North American freight revenues came in at $273 million, up 12 percent; total revenue, including freight-related and other, was $356 million, up 12 percent. Consolidated revenue, including off-shore operations, was $603 million, meaning that NA revenues are now less than 60 percent of the total, whereas traditionally it has been closer to an 80-20 split.

North American carloads increased nine percent to 446,219 with double-digit gains in Metals, Waste, and Other (mostly empties). System RPU crept up three percent with year-to-date Ag Products, Chemicals, Metals, Pulp/Paper, and Minerals & Stone revenues up double-digits and accounting for 74 percent of total freight revenue. NA operating expense gained seven percent, operating income gained 25 percent to $102 million and the OR dropped three points to 71.2.

On the call, CEO Jack Hellman cited carload increases in 12 of 14 commodity groups, adding that volume strength was due to both demand and modal conversion. In the southeast, Hurricane Michael caused significant damage to GWR roads in Florida and Georgia. Leases on the Godrich & Exeter and the Southern Ontario railroads expire in Q4 and won't be renewed, taking out some 27,000 annual carloads. That said, Hellmann notes that "With current leverage at 2.7 times net adjusted debt-to-adjusted EBITDA, we have the capacity to pursue both investments and share repurchases simultaneously."

Regarding PSR, GWR faces "some operating uncertainty with respect to the implementation of precision scheduled railroading by our Class I partners. While there may be a long-term benefit to the fluidity of the Class I network, there is the risk of interchange disruptions for our short lines." The annual 45G tax credit is worth about $36 million to GWR so that should help.

Looking ahead, NA carload growth will be in the five percent range with continuing strength in coal and metals, which were among the commodities seeing the highest Q3 rate increases. Utilities in the Midwest and Northeast increased Q3 coal volumes by 9,500 loads, up 16 percent, and metals carloads jumped 29 percent on scrap, finished steel and pipe. CFO TJ Gallagher says these trends will continue.

Freight car builders and suppliers report generally positive conditions for all the right reasons, most particularly more product to move going forward. Greenbrier's 2019 outlook includes a higher number of expected railcar deliveries, a potentially better mix of railcar types, with tanks representing a larger portion. The Street expects that Trinity will see margins improve as orders remain strong on improved volume/ mix/ price and leasing results remain on an even keel.

But carbuilder growth is a two-edged sword. As individual railroads shrink fleets, the shippers who can are leasing equipment for availability and control. Leased fleet size is a function of car-miles per day, so fewer is better for lessors and more is better for lessees. So the question remains, is increased demand for cars to own and to lease a function of more freight to move, or is it a function of needing more cars for the same tonnage as rail service remains erratic?

Taking the wider view, Bascome Majors, rail analyst at Susquehanna Financial Group, writes to say they are "bullish on the NA railcar cycle for over a year now, with the leading indicators (rail carload volume, rail network fluidity, railcars in storage) display positive trends.Generally, the consensus is that the market is improving, not deteriorating, particularly for tank cars."

Scott Group (Wolfe Research) finds that the volume trend going into 4Q is generally soft, with all the commodities short lines depend on — grain, chemicals, forest products, metals, aggregates — showing a southward drift. Bascome Majors shows total U.S. revenue units over the last four weeks up two percent vs. up five percent for the second and third quarters.

Hunter Harrison first started taking about what has become "Precision Scheduled Railroading" at the BN in the early 1980s, striving for "precise schedules, better pricing, and a more efficient operation." The concept truly bloomed at the IC, was imported by CN when it bought the IC, went to CP with Hunter, then to CSX, and is now on the hit list for UP and NS — even if not in so many words. PSR is truly a Rail Trend, and so it is RailTrends 2018 will feature three practitioners: CN (Jean-Jacques Ruest), CP (Nadeem Velani) and CSX (Jim Foote).

Playing obbligato are NS marketing head Alan Shaw, Lantz Fritz, UP's CEO, and Brian Hancock, EVP and leader of the technology charge at KCS. As RT co-founder Tony Hatch writes in late October, "The range of Precision Scheduled Railroading (PSR) has been expanded from 'All-In' (CNI, CP, CSX) to now include 'measured PSR' (UNP), 'Neighborly PSR' (KCS, interlining so much with UNP), and now BPIPSR — 'Best Practices Including PSR' (NSC).

"I had argued for just such a more measured approach before, but I also have to acknowledge that, so far, PSR has only been implemented in a revolutionary, go-for-broke manner, so can PSR-Lite (or PSR 2.0) work?" Join us at RT Nov 29-30 and find out from those who've been there, done that.