RAILROAD WEEK IN REVIEW
November 30, 2018

"The fixation on short-term profits is jeopardizing the future of American business, and creating social instability that has contributed to our current state of political polarization." — John Saitch, CEO, Panera, newyorker.com Nov 23

"Rising market power by dominant firms has created less competition, lower investment in the real economy, lower productivity, less economic dynamism with fewer startups, higher prices for dominant firms, lower wages and more wealth inequality. The evidence from economic studies is pouring in like a flood. — Bloomberg Nov 25, retweeted by Danielle DiMartino @dimartinobooth

The railroads, in a nutshell, are inconsistent, and nowhere does it show up more quickly than in the shortline universe. On the one hand, a short line not only wins a new 275,000 square-foot building products manufacturing facility but also an expansion of same a few months after the Grand Opening. On the other hand, the same short line can't make a move work thanks to the unreliability of the connecting railroad.

Re the former, the new facility will have 430,000 square feet, is scheduled to begin operation in 2020, adds 35 new jobs to the 50 it has already created and is expected to expand from there. In a news release, the customer says they chose the location in part because of the "excellent service" the short line and its connecting Class I are known for.

Re the latter, that short line has developed intrastate rail traffic that is truck-sensitive to several customers less than 150 miles away. The short line wooed and won these moves based on economics. Typically cars move in shipments in single cars or blocks using railroad and leased equipment, so cycle times are a major concern. Yet the destination railroad can take two weeks to go one way, making the move totally non-competitive.

Unfortunately, when the originating road calls customer service on the delivering road, the former is instructed that they are to call the latter's operations management team and there it dies. Yet the connecting carrier has done well in the stock market, with shares up some 23 percent in the last year and a half and boasting a double-digit CAGR over nearly 20 years.

From this one must conclude that the financials don't necessarily translate into customer satisfaction. And to the customer, it's just "the railroad" that produces these results. A short haul market exists, but a lack of consistent performance will doom any existing and future rail traffic — of any distance.

I bring this up because I don't think Listed railroad managers are thinking like owners. Perhaps Warren Buffett sums it up best in his 1996 "Owner's Manual" for Berkshire shareholders to help them understand Berkshire's "managerial approach." Principle Number One:

> Although our form is corporate, our attitude is partnership. Charlie Munger and I think of our shareholders as owner-partners, and of ourselves as managing partners. We do not view the company itself as the ultimate owner of our business assets but instead view the company as a conduit through which our shareholders own the assets.
>
> Charlie and I hope that you do not think of yourself as merely owning a piece of paper whose price wiggles around daily and that is a candidate for sale when some economic or political event makes you nervous. We hope you instead visualize yourself as a part owner of a business that you expect to stay with indefinitely, much as you might if you owned a farm or apartment house in partnership with members of your family.

Here's an example of what Buffett is about. The railroads' intense focus on operating ratios and earnings per share isn't really benefitting the customer — the guy who's putting freight on your railroad and paying your bills — or walking into your store to buy some merchandise or a meal. A recent piece in *The New Yorker* recounts the experience of one John Saitch and his Panera restaurant chain and speaks eloquently to the matter.

> Panera built a chain of restaurants that served food that customers could eat without guilt, in cozy cafés where they could hold meetings or Bible-study groups. "They wanted food that they felt good about, they wanted environments that engaged them, they wanted people that cared," Saitch said. "Basically, they wanted to feel respected by their food.
>
> Saitch says the current business environment is far less amenable to the process of building companies like Panera. Wall Street has embraced the idea that companies exist solely to serve the holders of their stock. Under this way of thinking, managers of companies should focus their actions on driving short-term value for their shareholders, and should pay far less (or no) regard to other constituents who may have a stake in the business, such as employees, customers, or members of the community.
>
> His conclusion is that activist hedge funds are partly to blame. They may buy shares in companies with the aim of pushing their management to make decisions that drive their stock prices up within a few months, which makes it more difficult to invest in long-term projects, and create sustainable jobs.

In a similar vein, Ben Hunt (www.epsilontheory.com) warns us to beware the capital-N Narrative — the public statements attributed to everybody from pundits to presidents that create *Common Knowledge* (emphasis his) that go into the "everybody knows" category. Thus "everybody knows" shareholders prefer to buy equities with the best chance for rapid share-price appreciation.

The downside, as we're seeing with the railroads, is that not one of the Listed railroads has seen any share-price appreciation since earnings were released in October. Worse, technical analysis of share prices suggest the downdraft is likely to continue, even as managements continue to sink $billions into share repos to goose the bottom line. This is not a new topic for *Week in Review*. Last summer I wrote about the dangers of railroads being "financialized" by putting investors ahead of everybody else:

> The financial manager's incentive is completely different than the entrepreneur's. He doesn't have three generations invested into this factory. He needs to make his stock options work over the next three to five years. The ownership of business becomes financialized and you end up with a company that's run by people who are interested in the next 24 months. The former operating-owner who used to have something that was robust and potentially multi-generational becomes a speculator.

Each week Scott Group at Wolfe Research in NY publishes his Group Thoughts letter wherein he looks at transport trends in terms of volumes and share prices. Based on these numbers, Scott provides some clues as to what's ahead. He notes that oil prices continue to fall ($73 to $50 over the past eight weeks) but will be "EPS Neutral" for the railroads, though he doesn't mention the effect on volumes.

Later on, Scott shows the petroleum group as a strong volume performer for railroads, and that's mostly crude oil inasmuch as the QCS stats show STCC 29 petroleum carloads as essentially flat over the trailing four years. A good friend who has studied the interaction of railroad results and oil prices writes,

> Price-wise, oil is a perverse commodity. When things look the best, it is time to worry, and vice versa. The logic is that when the all-clear is sounded, everyone emerges from their shelters and begins to pump oil. When it is time to run for the hills, you can't get a good place to stay. Figure out the appropriate leads and lags in the price movement and you would be a genius.
>
> At present, in my view, there is plenty of oil available at $65 per barrel. Nearly every oil project is cash-flow positive at that point. So, I don't see any justification for $80 oil, at all. It's a reference number for Goldman Sachs and other speculators. The exception, of course, is the intervention of some world political event, which is always perched on the front page of tomorrow's news. Yet, structurally, the oil markets have become even more volatile of late because of the rise of fracking, which can be turned off and on at relatively short notice.