RAILROAD WEEK IN REVIEW
January 11, 2019

“Vena’s track record as a railroad operating executive at CN under both Hunter Harrison and Claude Mongeau provides instant credibility to the UP’s PSR strategy. Moreover, it appears he has negotiated with UP some unique terms that should provide breathing room to make difficult decisions.” Branscom Majors, CFA, Susquehanna Financial Group

“This partnership with Oaktree brings together complementary teams and allows Watco to continue doing what we love to do – growing our business, delivering the best possible service to our customers and creating value for all.” — Watco CEO Dan Smith

Union Pacific on Monday named Jim Vena Chief Operating Officer, effective Jan. 14. He perviously served as EVP and COO at Canadian National, culminating a 40-year career at CN upon retiring in June 2016. Vena, 60, will lead all aspects of Union Pacific’s operations, and will report to Lance Fritz, Union Pacific Chairman, President, and CEO. Vena’s direct reports include Tom Lischer, EVP - Operations, and Lynden Tennison, EVP - Chief Strategy Officer.

During Vena’s tenure as CN executive vice president and chief operating officer, the railroad generated the North American rail industry's best operating ratio and achieved the best safety incident ratio in the company’s history. Vena started his railroad career as a brakeman and held progressively increasing responsibilities in Canadian National’s operations as well as marketing and sales groups, including leading all of CN’s operating regions.

I’ve never met Vena personally, though I’m hearing he’s a strong leader who makes his desires known and who creates an environment where his leadership style can flourish. Most important, he, CFO Claude Mongeau, and then EVP Marketing (now CN President) Jean-Jacques Ruest made CN a “kinder, gentler” railroad, to quote Mongeau. They were successful in building on the Hunter Harrison operating principles while embracing the supply-chain partnership approach that Ruest has used to such good effect.

UP Shares jumped several points after-hours on the news, though by the Tuesday close share prices had settled down at $150 for a respectable eight percent gain on the day. The next level of share price resistance appears to be $165 and support is around $145, coincidentally the SMA 200 level. That gives buyers $15 up to $5 down, a nice 3/1 reward/risk ratio. I approve.

Continuing last week’s theme of shortline customer advocacy, *Railway Age* Senior Editor Stuart Chirls writes that the Delaware Lackawanna Railroad has rung up its second consecutive year of record carloads. The 100-mile DL is the designated common carrier railroad operator for the Pennsylvania Northeast Regional Railroad Authority (PNRRA), a bi-county creation of Pennsylvania’s Lackawanna and Monroe Counties.

The Delaware Lackawanna runs northeast from Scranton to Carbondale on former Delaware & Hudson Railway trackage, and southeast from Scranton to the Delaware Water Gap over the former Lackawanna main line. The railroad connects with NS and CP in Scranton; commodities include grain, forest products, paper, plastic, clay, steel, petroleum and fuel products, chemicals, coal, and stone. DL is one of four railroads owned by the Genesee Valley Transportation Company of Batavia NY, and celebrated its 25th anniversary in 2018.

Just recently the DL was awarded a $686,000 grant from the Pennsylvania Department of Transportation to rebuild another track in Green Ridge Yard in Scranton, to accommodate the growth of freight volumes on the PNRRA system. The track in question had been torn up by the previous owner some 40 years ago, yet now the need is there for more track capacity.

Elsewhere, a new $3 million federal grant will support the Quonset Freight Rail Enhancements and Expansion (Q-FREE) project to make freight rail improvements within Quonset Business Park, in North Kingstown, R.I. The Seaview Transportation Company is the designated operator of the Quonset Business Park's 14 miles of railroad that extend from the Port of Davisville to a direct connection to the State of Rhode Island's Freight Rail Improvement Project (FRIP) track on the Northeast Corridor. Quonset's rail lines handle more than 5,000 carloads a year.

Davisville is Rhode Island's largest port and acts as a gateway to markets throughout Southern New England and beyond. Railcar volume in Quonset Business Park has tripled since 2007, and officials say the newly-announced federal support will help QDC provide operational flexibility and expansion opportunities for the rail operator.

Watco and funds managed by Oaktree Capital Management (www.oaktree.com) are teaming up on a strategic partnership whereby Oaktree has committed $450 million of non-controlling equity capital to Watco. The investment and commitment support both Watco's improvement strategy and its multiple customer growth initiatives. Watco already has strategic partners in Kinder Morgan, Norfolk Southern, and SkyKnight Capital.

Oaktree is a global investment manager specializing in alternative investments, with $124 billion in assets under management as of September 30, 2018. The firm emphasizes an opportunistic, value-oriented and risk-controlled approach to investments in credit, private equity, real assets and listed equities. Oaktree has 900 employees and offices in 18 cities worldwide.

Oaktree's Transportation Infrastructure strategy is led by co-portfolio managers, Emmett McCann and Josh Connor, who have a combined 45 years of industry experience. They will be joined by Senior Adviser Dave Starling, former KCS head. Starling and Connor will be joining the Watco board of managers.

A thread on Twitter this week provides some useful insights on the automobile business, which we need to watch as auto sales affect railroad carloadings. The argument: The bottom is falling out of the mass market, whereas luxury brands continue to do well — Audi, Volvo, Cadillac, and even Lincoln appear to have had good years.

The writer posits that manufacturers have lost touch with the consumer. By the consumer he means the bulk of the population, not the very low percentage of folks that can afford luxury vehicles. He suggests that the focus is much more tilted towards pleasing investors by increasing prices in order to report higher margins. There's nothing wrong with that, but at a certain point volume is sacrificed. [Exactly what we've been saying about the railroads for a while. - rhb]

What most investors are missing here in the U.S. is that the additional margin is coming at a very steep cost, mainly replacement cycles. The longer the loan term used to purchase a vehicle, the longer it takes for the consumer to return for another new vehicle. The U.S. auto industry was bailed out by abnormal appreciation in used vehicle values (think of it as additional purchasing power since most new vehicles sales include a trade) during 2018, but that's not in the cards now.

Unless investors want to plug that type of used vehicle value performance into their financial models going forward, the writer would recommend patience: auto stocks are not cheap and we're just getting started. The Twitter writer has company. Economist Max Wolff said on RealVision that GM is selling a lot of cars and light trucks because gas prices are relatively low and consumer sentiment has been high.

He guesses there's no way consumer sentiment stays that high, particularly for the vehicles that GM has really doubled down its future on — those very pickup trucks, SUVs, or what are called crossovers as they move away from the passenger vehicle business. The good news is, from a railroad standpoint, you can't fit as many Silverado pickups on an auto rack as you can Sonic compacts. Thus you need more carloads for a given number of finished vehicles.

Addenda: Last week I wrote, "The six Listed Class Is have sent in order of magnitude maybe $40-50 billion as cash to investors in dividends and buybacks." To which my good friend and fellow pundit Tony Hatch adds, "Some would say the cash to investors is a fiduciary duty. But you might also mention that since 2006, they have spent ~$150B in capex!

"At roughly 18-22 percent of annual revenues in that span, it is clear that they saw the need to grow and to back that need with real money. There is surely much to complain about in railroading, but serving their owners (shareholders) by spending on the network can't be quibbled with."