RAILROAD WEEK IN REVIEW

February 1, 2019

"Our appetite is to find ways to make more use of the existing network. We have main lines which are not fully utilized and have capacity to grow traffic volumes. We are looking for joint ventures that would bring more business to our main lines." — Canadian National President & CEO JJ Ruest

"We need railroads that respond to the needs of shippers, first of all by delivering freight when they say they will, and also staying price-competitive to trucks and other modes. You build reliability by preventing the failures that both screw up schedules and drive up costs." — Fred Frailey, Trains magazine

"Starting from 1976 to current time, the average age of vehicles has gradually increased. The vehicles are built better, last longer, and will have multiple owners through their life cycles. This is not in any way, shape, or form a good indicator of demand for new vehicles sales." — Daniel Ruiz, Blinders Off Research, on RealVision Jan 23

Canadian National wrapped up the official Class I 4Q earnings call season Tuesday. Freight revenue increased 17% to C$3.6 billion on 1.5 million revenue units, up 5%. Manifest carload revenue including auto was C$2.5 billion, up 19%, on 775,000 carloads, up 5%. System RPU was C$2,343, up 11%; manifest RPU was C$3,271, up 13%. Total revenue hit C$3.8 billion, an increase of 16% year-over-year.

Operating income was C$1.4 billion, up 19% as ops expense increased just 14%. The OR shed 84 basis points to a respectable 61.9, though not an industry low as both CSX and UP did better by a handful of basis points. Net income after adjusting for last year's tax benefits and other internal corrections was C$1.1 billion, up 22%. Net cash from operations was $5.9 billion, up 7%, free cash flow after capex (25% of revenue) and divs was C$1.1 billion, down 34%.

As for commodity detail, always key to short lines, CEO JJ Ruest provided excellent color on the call. Canadian grain revenue grew 17%; so far this crop year — which started last August — CN Canadian grain export tonnage is up 1.5 million metric tons year-over-year, an all-time company record. Potash, semifinished steel, and refined petrol products revenues were up double-digits; revenues for industrial chemicals and forest products were up single-digits. Volume-wise, the lumber business is down and CN currently has 1,200 lumber cars parked.

Out on the railroad, change happened quickly in the second half of the year. Comparing Q4 with Q3, train speed was up 4%, locomotive utilization was up 2%, and through-train yard dwell came down about 4%. This is highly commendable in an environment where GTMs grew to a record Q4 level — up 6% versus Q3, which was a quarter that already was itself a record.

Said COO Mike Cory on the call, “The growth, of course, is not linear. Our growth is more concentrated in our Western and Southern regions. On a year-over-year basis, our GTMs were up 11% over Q4 2017. Our network speed improved by 4%. Car velocity improved by 10%. And our through dwell improved by 15%.” Comme on dit en francais, “Pas mal.”

Tom Wadewitz at UBS tells us, “Week 4 industry-specific trends are opaque.” Construction materials dropped 8% yet industrial products rose 3%. Within industrial products, petroleum and petroleum products rose nearly 20%. Ag products was up just under 20%, coal was off 4%, and auto slipped 12% (see Ruiz below). Even intermodal was down — 3%.

A positive glimmer comes from the lumber March futures trend: to $430 from $350 over the last six days of trading. XHB (materials ETF) has just crossed the $36 resistance line and is riding the top side of the 20-day moving average at the 38.2% Fibonacci retracement from the highs a year ago. Twitter traffic suggests Wednesday’s dovish comments from the Fed helped — lower rates make new homes more affordable. Maybe Ruest will have to un-park some lumber racks.

Mantle Ridge LP has sold 2.8 million of its CSX shares at $64.42 each for a $38 billion payday; another block is pending. According to a note from UBS, based on a conversation with Mantle Ridge, the sale represents less than a ten percent reduction in their CSX position and that M-R is likely to maintain a sizable CSX position for years to come.

UBS concludes that the sale came at the expiration of a near-term lock-up period. The LP structure of the M-R position is such that “investors have multi-year lock-up periods potentially on the order of five years.” However, it appears that “one of the LPs had a shorter lock-up, which was likely a key factor driving the sale of shares by Mantle Ridge.” UBS adds,

> Based on the investment approach taken by Paul Hilal (Mantle Ridge’s managing partner) in the past (see the CP investment when he was at Pershing Square), we believe that Mantle Ridge is likely to continue holding their large position in CSX (still more than 40 million shares) through the period where CSX continues to make significant fundamental improvement in its business. This could last several more years.
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> Eventually, we would also expect CSX to develop a clear executive succession plan and we would expect Mr. Hilal (on CSX's board) to contribute to this plan. We conclude that there is limited risk of further selling from this strategic shareholder in the near term.

I’ve spoken with a number of shortline operators at various Class I short line conferences about their automotive terminal services. There are those who say that particular business could be softening in 2019.Daniel Ruiz of Blinders Off Research, a specialist in auto trends, tweets,

> In their recently released forecast, J.D. Power expects retail sales to fall by 2.4 percent for the month of January. Using the J.D. Power retail sales estimate, my day supply reading climbs to the **highest level in 17 months.** In the past, incentive spending has increased ahead of

production cuts in order to manage high inventory levels. In what appears to be a clear break with tradition, **incentive spending is expected to fall for the 7th month in a row** despite the rapid increase in day supply.

In my opinion, this is a clear sign that there's too much focus on increasing/protecting margin and not enough on proper inventory management. The fierce focus by most manufacturers on margin is putting production volume at serious risk. At this point, I would not be surprised if we skip step one (increased incentive spending) and proceed straight to step two (significant **production cuts**) in the early to middle part of this year."

Step two suggests fewer finished vehicles moving to dealer lots and less volume passing through RR terminals serving those dealer lots. You can read Ruiz at blindersoffresearch.com.

R. J. Corman Railroad Group, LLC is making some organizational changes to their Commercial Development team. Justin Broyles, Mike Robinson, and Chase Armstrong move to new Vice President roles. Noel Rush moves to Senior Vice President and will work closely with the President & CEO to develop and implement the company's long-term strategies and oversee the company's executive relationships and government affairs.

The commercial efforts have been segmented into three divisions. Broyles will oversee the 13 short line railroads; Robinson will run the switching and logistics areas, including DCs, transloading, and trucking. Armstrong will oversee the Contracted Services group: Railroad Services, Signaling and Material Sales. In addition, Ray Goss becomes President of the R. J. Corman Railroad Company aided by Mike Philpot – Vice President of Operations – South, and John Phillips, VP Ops for the North.

Altogether, R. J. Corman Railroad Group employs approximately 1,500 people in 22 states. In addition to short line railroad and switching operations, R. J. Corman companies provide a broad scope of services to the railroad industry such as emergency response, track material distribution, track construction, signal design and construction as well as building fuel-efficient locomotives.