RAILROAD WEEK IN REVIEW

February 15, 2019

“As we implement precision scheduled railroading, our initiatives are focused on five key principles: serving our customers, managing our assets, controlling our costs, working safely, and developing our people.” — NS President & CEO Jim Squires

Norfolk Southern on Monday set out to demonstrate how NS will “reimagine” (their theme) itself into a more finely-tuned business, bringing more value to customers, owners, and the communities they touch. The Wall Street analyst community was evidently impressed: shares gapped up six percent and stayed there.

The Street gave NS rave reviews — “NSC issued a strong 2021 OR target!” — Jason Seidl, Cowen; “The new NS operating plan is focused on basic PSR-enabled principles!” — Benjamin Hartford, RW Baird; “There is real organizational buy-in to NSC’s PSR transition from the board level down!” — Bascome Majors, Susquehanna; “NS has guided to a 5% merchandise revenue CAGR during 2018-2021!” — Cherilyn Radbourne, TD Securities; “ Norfolk’s 3-year timeline to get to a 60 OR was 1-2 years faster than we expected!” — Scott Group, Wolfe Research.

The operating department presentation theme was built on five key themes: serve customers, manage assets, control costs, work safely, and develop people.[1] To this end, NS has developed the Clean Sheeting initiative with starts with local operations and seeks to add more flexibility and customer value at lower fixed and variable cost to NS.

This in turns rolls out into TOP21, clearly an updated version of the original *Thoroughbred Operating Plan* (TOP) developed during and around the Conrail transaction, exactly 20 years ago. Whereas Clean Sheeting is bottom-up, starting with the customer, TOP21 is top-down, starting with asset utilization, network productivity (train speed, dwell, revenue unit transit times, e.g.), and dock-to-dock scheduling.

NS will measure the new strategic plan five ways: service quality (they don’t say as determined by whom), T&E and locomotive productivity, train weights, and cars on line, where fewer is better. They are predicting signifiant improvements percentage-wise over the next two years, targeting a 60 OR by then, down from 65.4 in 2018.

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[1] Interestingly, these five themes look a lot like Hunter Harrison’s “five guiding principles” which are built around “service, cost control, asset utilization, safety, and people.” See E. Hunter Harrison, *How We Work and Why: Running a Precision Railroad*, © 2005, Canadian National Railway, page 10.

The commercial side has a mandate to increase its rate of change up and to the right in revenues, car-counts, and revenue per unit. Over the last six years (FY2012-FY2018), according to the data published in Norfolk's own reports, revenue has increased to $11.5 billion from $11.0 billion, up 3.8% (CAGR 0.62), revenue units rose to 7.9 million from 7.1 million, up 1.6% (CAGR 1.83), and RPU slipped a point to $661 from $667 million (CAGR 1.19).

The three-year revenue history in the NS 2017 Annual Report shows virtually no revenue growth 2015-2017, severely limiting the six-year growth rates cited above. Little revenue growth indicates lower revenue-unit growth, and flat vols on flat revs means flat RPUs. That being the case, NS is in an all-out turn-around effort. Chief Commercial Office Alan Shaw cites, for example, eight consecutive quarters of year-over-year freight revenue gains (slide 9).[2]

A bar graph of quarter-to-quarter revenue gains (Source: Charles Schwab) shows that revenue crept up from $2.6 billion to $2.9 billion — a respectable 5.6% CAGR. Moreover, Shaw predicts a 5.0% top-line CAGR 2018-2021 coming from growth trends in consumer spending, e-commerce growth, and a rise in the ISM Manufacturing Index.

This could be a challenge. We're in an economic environment Keith McCulloch on hedgeye calls Quad 4: slowing growth, shrinking deflation. As to the former, Bloomberg Wednesday said "Retail sales for December showed a decline of 1.2%, which followed a downwardly revised 0.1% increase in November. This unexpected monthly decline was the largest since Sep 2009.

The Russell 2000 small-cap index took a 27.4% hit September-December and has recovered about 60% of that loss to date. However, the IWM (Russell 2000 ETF) technicals say that what's growing now will start to slow in Q3 and reverse in Q4. The China Large Cap FXI follows the same pattern, albeit a little less bearish, but still showing a slowing economy.

There are two measures of inflation, and both are headed south. Bloomberg has *headline* inflation (total commodity price inflation including household staples (my "heat and eat" classification) at 1.6%, down from 2.3% last September. Bloomberg also reports *core* inflation (omits heat and eat, etc.) at 2.2%, down from 2.4% last June. What's important here is that Quad 4 is characterized by a slowing of demand for industrials, energy, and tech — the first two of which are critical to the railroads' merchandise carload sector.

So, getting back to NS and Alan Shaw, the outlook for consumer spending and e-commerce may actually be less robust than what they see, given the Russell 2000 outlook via the IWM. Automotive is highlighted as a growth opportunity (see WIR re slowing new vehicle trends), as is intermodal, though the slowing domestic and international economies (see China FXI, above) will challenge.

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[2] Hedgeye cites 6 consecutive quarters of Real GDP growth, Q/Q, SAR, 1Q2017-3Q2018.

At the end of the day, NS gets an A+ for outlining its plans to meet and exceed investors' and customers' expectations in terms of running a smarter railroad and improving service quality as perceived by the customer. And although Ed Elkins, VP for Industrial Products, forecasts a five percent three-year revenue CAGR, his forecasts for his core commodities' growth are more modest. Little is said about how they will increase share, other than through the operational initiatives. He gets a C.

As you can see from the trailing five-year numbers, NS can certainly do a lot better. They now have a much better mousetrap, and we all know what better mousetraps will do.

With the spring meetings season now nearly up on us, it's time to ponder questions to put before the presenters. Scott Group at Wolfe sent out such a list a few days ago and it got me thinking about which shoes might fit shortlines.

Pricing and volumes come first to mind. Where the short line is a handling line, rates are set by the Class I and the short line gets a "handling fee" that is paid out of the serving Class I's divisions. That fee has generally included a portion of the Class I's fuel surcharge revenue, but there are signs that may be coming to an end.

Should that be the case, handling lines need to take another look at going to the *Interline Settlement System (ISS)* to determine their own divisions and set their own fuel surcharge levels. Doing so will reduce reportable Class I revenue by the amount of the shortline divisions, making it harder for Class Is to goose the OR by raising rates. Question: "What would happen to your OR deltas if the short lines went ISS, reducing your reportable revenue?"

Short lines sometimes run into trouble getting the cars they need for their customers. Many short lines can and do buy their own cars to insure a supply of empties. Many of these moves have destinations on short lines, in which case the Class I is an overhead carrier. If the short line develops the move and supplies the cars, I see no reason why that car can't move FAK. Question: "Intermodal boxes that are customer supplied and moving in lanes developed by other parties go FAK. Why can't we?"

Let me suggest you ask your customers what questions THEY might have for the Class I railroads if given the chance. If you would, please ket me know what questions they and you would ask of whom. I'd like to do a WIR item around them.