RAILROAD WEEK IN REVIEW

February 22, 2019

“412 of S&P 500 companies have reported aggregate y/y EPS growth of +10.85% and that’s the lowest growth rate for the Q418 EPS season to-date with 3 Sectors already showing NEGATIVE y/y earnings growth with the aggregate PeakCycle EPS growth rate of Q2 and Q3 of 2018 > 24%.” — Keith McCullough, hedgeye.com, Feb 21

“There are three reasons for our success. First, we take care of the customer. Second, we take care of our employees. And, third, our owner has the guts and brains to constantly invest in the railroad.“ – Wayne Michel, President, Reading and Northern Railroad

AAR Revenue Units for Week 7 (Feb 15) increased a mere three-tenths of a percent year-over-year. Hardly a propitious start for a year in which the Class Is all spoke of better days ahead in their Q4 earnings presentations. As you can see, merch carloads are actually leading the pack, up nearly two points, but they had help from crude oil in particular — north of 20,000 units.

Commodity	2018	2017	Delta	Pct Tot
Total Units	4,832,295	4,817,798	0.3%	100.00%
Intermodal	2,425,742	2,428,168	(0.1%)	50.20%
Auto	26,834	27,666	(3.1%)	0.56%
Coal	615,612	626,693	(1.8%)	12.74%
Merch Carloads	1,764,107	1,735,272	1.7%	36.51%
Source:AAR				

I think the small YOY deltas suggest a slower rate of change going forward. Bloomberg has published charts showing estimated GDP for the first three quarters of 2019 declining from 3.1% in 4Q2018 to 3.03%, 2.6%, and 2.31% each quarter through the end of August, 2019. Schwab’s Randy Frederick notes that “with 404 companies (81%) in the $SPX reporting, 72% have beaten the consensus EPS estimates and 60% have beaten the consensus revenue estimates. Compare this to 82% / 60% respectively for Q3,” indicating some slippage but not a total rout.

The merch carloads line above is derived from the AAR report and includes the listed commodities from agriculture to other. But when these groups are reported in Class I financials, direct comps from railroad to railroad don’t always work. Take chemicals. The AAR and some railroads put fertilizer here; others put it in agriculture. Crude oil and petrol chemicals go in chems, too, so the spike in crude oil can skew the Class I’s reported chems number.

Nitrogen-based fertilizer can go in chems or ag, depending on the railroad. Phosphates and potash can also show up as non-metallic minerals. Knowing what's in each class I's chemicals and ag groups is critical when you read, for example, that potash is "the most stable" fertilizer commodity for railroads (Credit-Suisse, Feb 4) you have a conversation starter with your fertilizer customers. You can ask fertilizer customers to confirm and coordinate with your Class I partner to get a piece of the action.

Forest products is another commodity group that needs a closer look. Some Class Is break out lumber and paper; others don't. Lumber and panel are in STCC 24, wood chips (STCC 241) are in paper (STCC 26), as are everything from newsprint to Amazon boxes to frozen food boxes.

These breaks within the broad commodity groups are important to short lines as one may be a major lumber transload and another may be a warehouse consolidator for paper and related products. Ryan Nemeroff, VP Forest Products at Pennsylvania's Reading and Northern, writes that forest products — wood pulp, paperboard, scrap paper, lumber, and related— did about 10,000 carloads last year, a third of total volume. As an aside, Rian notes that the Class Is' move toward fewer trains between fewer OD pairs and higher demurrage fees will only help R&N.

Back in August (WIR 8/17, to be more precise), I wrote about the dangers of "financialization," i.e., when a public company becomes more of an instrument for financeers than a producer of goods and services for public consumption. I led off with this quote from Simon Mikhailovich, self-described contrarian investor and serial entrepreneur: "When a company gets financialized, the owner is replaced with a management team, and the management team's job is to get this thing prepped for float on the stock exchange, which is how they're going to make money.'

The theme lives on. Howard Marks, co-founder and co-chairman of Oaktree Capital Management, sat down with RealVision's Grant Williams two weeks ago and, among other things, outlines the dangers in a world dominated by moral hazard and political polarization.

> The global financial crisis — the 2006-7 bubble and crash —had little to do with the economy. It happened to *bring on* the worst recession in a long time, but it wasn't *caused* by a recession. It was caused by some funny things that some people were doing down on Wall Street. It used to be that the stock market responds to the economic cycle and recessions cause stock market crashes, but we seem to have flipped that.
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> I think the financial activity became excessive. Finance, investing, financial engineering, whatever you want to call it, kind of took over in importance from what you might call the industrial world sometime in the last 25 years. What we now have is the tail wagging the dog. The tail is finance, the dog is industry. Financing used to serve industry, and then it became a thing in its own right.

We saw it at work in Atlanta last week with the NS Investor's Day presentation. Of the 147 slides in the deck, the first 95 slides were all about improving financial results through operational initiatives. Alan Shaw, Chief Commercial Officer, and his team got only 25 slides for the merchandise, auto, and intermodal sectors, and most of that was on the economy and its potential for NS. In short, how marketing is providing improved financial results.

There is little in that side deck on improving customer perceptions or adding value to the supply chain. It was all numbers and The Street loved it. Shares gapped up 10 points within the week.

The Precision Scheduled Railroad theme continues to bubble along as if it were were the hottest thing since sliced bread. It isn't. Hunter wrote *How We Work and Why* in 2005. He was running the IC on those principles in the late 1990s and we had spoken about it at the time in the context of increasing turns per month on Illinois-New Orleans grain trains.

The PSR genesis is first mentioned in his autobiography, *Railroader - The Unfiltered Genius* (page 90 in the on-line edition), as the Major Corridor Service Measurement (MCSM) system for tracking transit times between OD pairs. This was 1987 or so on the BN, predecessor to today's BNSF. He summed it up thus: "This is what you're trying to do as a railroad — run cars. You're not trying to move trains."

The concept was alive and well elsewhere, too. A friend writes,

> The Katy always was a scheduled railroad (essentially PSR, but we didn't call it that back then), which helped a lot when you were surrounded by giants like the BN, Frisco, MoPac, ATSF, SP. We did roughly double market share in the trailing 10 years, and had the fifth highest return on investment in the industry, according to the ICC.
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> The lesson is that smaller is better, you can keep track of things and don't have to have big meetings to make decisions. I do not see a similar attitude on the seven big guys, even though truck rates are rising at a startling pace. The only reason the railroads have not benefited is directly traceable to the attitude that customers are a nuisance and that the service they want is unreasonable.