RAILROAD WEEK IN REVIEW
March 22, 2019

“A recession is inevitable at the end of a cycle; it’s just a question of when. Looser financial conditions and a Federal Reserve in pause mode suggest a longer length of runway; however, ongoing trade policy uncertainty could keep business confidence and capital spending from rebounding, thereby shortening the runway. Retail fund flows have been anemic, suggesting that much of the juice for the rally has come from corporate stock buybacks, which are running at a record pace on an annualized basis. Business optimism remains fairly subdued.” — Jeffrey Kleintop et al, Charles Schwab & co.

“If businesses exist not to make things and employ people but instead to maximize profits for investors, labor can be done by temps, by poorly paid workers in other countries, or by robots, whichever is the cheapest.” – Jill Lepore, New Yorker, March 4

“Housing weakness spills over into domestic light truck sales as most full-size pickup purchases related to home improvement or contractor projects; housing will be a drag on full-size pickup sales, which led overall auto sales in 2018.” — Danielle DiMartino Booth, The Daily Feather, March 19

“The economy might very well be slowing, as expected, if rail traffic is any indicator. US intermodal volumes fell for the first time since January of 2017… That two big rail interested funds are getting together as Brookfield is buying 62% of OakTree (the $450mm backer of Watco) can only be good news for rail investment. — Tony Hatch

CSX is in flux. That was very apparent at the recent shortline workshop. Lots of new faces, lots of new opportunities, lots of openings for short lines. To facilitate the necessary door openings for these opportunities, CSX is making some very positive personnel changes. EVP Sales & Marketing Mark Wallace says he’s making the moves “to position the company to drive sustainable, profitable growth by changing the way we market and sell value to our customers.”

Wallace says the most compelling growth opportunities lie in providing “transportation solutions that address our customers’ logistics and supply chain challenges, and continues, “we are building a team of highly skilled leaders to allow us to more effectively seize these opportunities.” To begin, CSX has tapped two new vice presidents charged with finding ways to do just that.

The new veeps are Kevin Boone, VP of Marketing and Strategy, and Arthur Adams, VP of Sales and Customer Engagement. Boone will lead a newly-created marketing team that will focus on deep research and analytics to develop new business opportunities, and to identify and advance high-priority growth initiatives.

Adams will head an expanded sales team focused on business growth with small and medium-sized customers, as well as multiple sales and marketing functions focused on enhancing the customer experience. For a short time pre-EHH Adams headed up the CSX shortline support group, so the non-Class I roads have a natural ally in him.

In addition to Boone and Adams, the Sales and Marketing leadership includes: Maryclare Kenney , VP Intermodal and Automotive; Tim McNulty, VP Agricultural Products; and Dean Piacente, VP Industrial Products.

Commenting on marketing changes, my good friend and fellow pundit Tony Hatch writes,

> Conversations with attendees at the recent shortline meeting tell CSX has "increased the focus on port and short line development – not just short line creation but developing short line related partnership business. CSX concedes that they needed to refocus both here and on merchandise traffic in general, and didn't shy away from their plans to push down pre-blocking to short lines to continue the service-improvement momentum (addressing velocity/dwell but also meets, dead-heads, re-crewing, etc.) CSX plans to increase manifest train size significantly in 2019 and at the same time achieve 95% reliability – a tall order.

It *is* a tall order and I think Wallace has assembled a marketing management team that is well-equipped to manage the task. Morningstar says the shares are worth $75 vs today's $71, noting that the OR has come down "despite the loss of about half of its highly profitable coal business in the past eight years--a devastating blow." Intermodal has grown at a seven percent CAGR in the last ten years though "railroads cannot escape the broader economy's cyclicality."

UBS lead railroad analyst Tom Wadewitz last week hosted meetings with Canadian National CEO JJ Ruest and VP of Investor Relations Pat Butcher. Tom reports that discussions centered on "how the strength and reach of the CN network provides opportunities for growth which are differentiated from the broader rail group." He continues,

> CN has delivered leading RTM growth over the past 6 years and management appeared to be even more optimistic about growth potential looking forward. From mid-January into early March weather has been very difficult; CN indicated they believe weather has been the dominant driver of softness in their 1Q volumes — which is likely true for the industry also.

CN is looking to enhance future growth through acquisitions: joint-ventures in eastern ports, intermodal companies, and — get this — short lines. The goal is, of course, more revenue units and ton-miles while at the same time using technology advancements "to improve labor efficiency of inspection and maintenance work in the long term."

The operative terms, more revenue units and customer behavior, can contribute significantly. In STCC 24 forest products, for example, customers need robust supply chains that are also flexible enough to meet changes in demand and sourcing. CN seeks to integrate key processes around car ordering and service at the first mile. That includes buying more center-beams and opening more transloads (some of which are on short lines). CN keeps score too. The "Efficient Receiver" report tracks customers' dwell times so that car usage habits can be monitored.

The High Velocity Program is another CN tool for improving car cycle time and shortening customer supply chain lag. CN has identified a considerable list of OD pairs where there are sufficient volumes to warrant this expanded treatment. Click on the link and see the sorts by railroad, interchange points, stations, and even individual short lines.

So, in terms of short line opportunity, I think the common thread between CSX and CN is identifying the Total Addressable Market (TAM) for the given shortline service area. Both Class Is have said in so many words they want short lines to be bigger contributors in their TAMs. Whereas the TAM for trackside industry is limited, this is not the case for any business within, say, 50 miles of trackside, that can bring in raw material by rail or ship out product by rail. That becomes its TAM and will help prioritize business opportunities by serving as a quick metric of the underlying potential of a given opportunity.

Class Is can tap shortline TAMS either taking an equity position in the short line or acquiring them outright. Examples would be Norfolk Southern's partnerships with KCS in the Meridian Speedway and with Pan Am Rail in the Pan Am Southern. In both cases NS had the trains and the equity partners had the tracks, and all players expanded their respective TAMs accordingly.

Moreover, big rail freight users can increase their own TAMs through shortline equity partnerships or direct ownership. Shipper-owned short lines can expand beyond the market for their own products by selling freight services to anybody in the service area and using that revenue to offset the costs of shipping the owners core product.

The possibilities are limitless.