RAILROAD WEEK IN REVIEW
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"On the subject of shortline railroad valuations and acquisitions, we never assume we'll get the last look and we always operate on the premise that Crazy is undefeated." — Dan Smith, Watco

"The economy still feels like it's OK. There are over a million more job openings than there are people looking for work, wages are increasing, and the industrial market looks good, even with the question mark involving trade." — Lance Fritz, Union Pacific

The Wolfe Research 12th Annual Global Transportation Conference wrapped up Wednesday. There were some 500 registrants representing investment houses, financiers, and transportation professionals. The railroads were well represented with senior officers from four US Class Is and two shortline holding companies.

The program kicked off with Watco President Dan Smith and GWR President Jack Hellmann. Both provided overviews of their companies, their accomplishments, and objectives. Watco has 41 shortline railroads, 33 switching locations in 38 states, 19 mechanical shops, 83 terminal and port operations in the U.S., Western Australia, Mexico and Canada.

The company has four divisions: transportation services, terminal and port services, mechanical services, and supply chain services. Transportation Services covers railroads and contract switching and generates half of all Watco revenue, moving a million cars a year with more than 400 locomotives operating on 5,100 route-miles of railroad. The Terminal, Mechanical, and Supply Chain Divisions contribute 24, 12, and 14 percent of total revenue.

The Watco railroads are blessed with a balanced commodity mix: roughly half ag products, minerals, and chemicals with frac sand, forest products, metals, and coal rounding out the package. Full year 2018 revenue hit one $billion, a 15.5 percent CAGR since 2007; EBITDA over the same period grew at a 16.3 percent CAGR to $224 million.

Dan says every load has to be truck competitive, offering a service that customers will see as the superior option. Class I railroads may not always price the way Watco might wish they would, but "we start every morning as if the count were Oh and Two" (Dan's a premier big league pitcher) because the nature of the shortline business is that most things can be trucked around them. However, with the advent of PSR, the Class Is seem to be taking a fresh look at everything and that benefits Watco and its customers.

Genesee's Hellmann reports that their 3,000 customers (generating more than three million revenue units around the world) on 120 railroads have propelled revenue ($2.3 billion) and market cap ($4.8 billion) up about five times over the past dozen years. At present, geopolitical events are affecting all three operating geographies — North America, Australia and Europe. In

North America there is the trade tariff matter, Australia is coping with the China dynamic, and Brexit in the UK is bringing its own uncertainties.

Under the hood, however, growth in all three areas is better than expected. In North America, same railroad revenue unit growth is running abut five percent and the robust industrial development pipeline will continue to yield organic growth. In the UK, business has been quite good despite Brexit. In Australia, new coal train sets will add more than 100,000 carloads.

Hellmann says that truck competition is always a concern; however, in many cases the economics of railroad transportation can win — and service quality frequently makes price a secondary consideration. He expects to see merchandise traffic growth, up six percent with CSX last year, for example. And though there is intense focus on intermodal, the merch sector will be the growth driver going forward.

Hellmann confirms that the NorthAmerican M&A market is "very active," with potential transactions involving extant short lines, Class I spin-offs, and industrial railroads. He notes that whenever a property comes up for sale, there's always a "logical acquirer" in the neighborhood. The reason is there are advantages of having contiguous railroads, and, outside the multi-$million transactions in the sights of equity investment firms, the local player has the edge.

Kansas City Southern CFO Mike Upchurch says traffic is up about half a percent in Q1, trending favorably into May. Grain is running pretty well, refined products into Mexico are still growing at a triple-digit rate, chems are up, and KCS has added back some intermodal capacity. STCC 26 pulp and paper softness is a function of a slower economy. Previous guidance of vols up 2-3 percent for the year still holds.

KCS is in about the fifth month of pursuing its PSR initiatives and is pleased with the story thus far. AAR velocity and dwell figures are going in the right direction and are the best in years. Train lengths are increasing, approaching the 6,000-foot target. Cars on line are down year-over-year (lowering car-hire expense in the bargain) and they're getting nearly twice as many KTMs per gallon of diesel fuel as a year ago.

In sum, KCS is using the PSR initiative to make service better and more predictable, which benefits lease-fleet customer by moving more tonnage with fewer cars. Cross-border is up 15 percent or so every quarter and, though it's a bit early too make the call, the potential for manufacturing migrating to Mexico from China is real, especially as tariff negotiations drag out. The fact that Mexico has free trade agreements with virtually everybody is a great help.

Union Pacific's six Key Performance Indicators (KPIs) are all moving in the right direction as the railroad rolls out its Unified Plan 2020, said UP President Lance Fritz. Not only have they shown year-over-year improvement, but the continued focus on car utilization and minimizing carload classifications has helped lower headcount by four percent and put 2,100 locos into storage as of the end of April.

Q2 total revenue units are down two percent vs. last year due to weakness in the Energy (coal, crude oil, frack sand— down 50 percent) and Premium (auto and intermodal) commodity groups. The Industrial (strong plastics and construction materials) and Agriculture (ferts, grains up) groups mask some of the others' shortfall. Seven-day carloading are about where they were last year, approaching 190,000.

The 2019 outlook remains at low single-digit volume growth, rate increases in excess of inflation, and a sub-61 operating ratio. UP starts to lap the sand losses in Q3 and sees increased moves in plastics, steel, non-metallic minerals, construction and ag. Forty percent of UP business originates or terminates off UP, Mexico and Canada carloads remain robust. The China tariff impact will hit beans, but it's hard to say where it goes from there.

Unified Plan 2020 is the multi-phase UP program for PSR rollout. Phase I, the initial network implementation, is done. Phase II is rationalizing terminal capacity. Touching cars fewer times means you need fewer assets devoted to sorting and classification. Intermodal is consolidating ramp locations and is moving to more steel-wheel interchange in Chicago. The end game is a better service product and it's clear UP is making significant headway.

CSX Chief Commercial Officer Mark Wallace continued the service improvement theme saying the company is continuing to set records, both financially and operationally, and they've only just begun. The transformation is just over two years old and there's a lot of unrealized opportunity. Service is vastly improved and customers are happy, yet there is still more to do.

Excluding intermodal, vols are up three percent YTD. There is perceived strength in the merch sector, such that previous guidance of 1-2 percent unit growth is still reasonable. Export coal still projects to be in the low 40 million ton range. Operational improvements have resulted in some 600 locomotives sent to storage, along with more than 20,000 freight cars.

There are no major lane rationalizations on the books. CSX continues to eliminate intermediate switching so that cars may move more quickly between OD pairs and at lower avoidable cost. That's how CSX is guiding to a sub-60 operating ratio on a sustainable path that generates increased net profits. Wallace sees a "huge opportunity" with short lines as CSX operational gains can translate into more and better shortline offerings.

A breath of fresh air comes in sales, where reps can now show customers how service value trumps price. As noted above, customer care more about predictability and reliability than a nickel's spread on cents per hundred-weight. This is truly good news because too often in the past railroads had to buy volumes with cut-price rates. Merch customers in particular have always kept a portion of their business for truck because CSX wasn't perceived as trustworthy. They're out to change that.

Norfolk Southern CFO Cindy Earhart brought the markers on the railroad presentations. Q2 vols through Week 20 (May 18) are off a point, though ag carloads jumped five percent thanks largely to the improved service and accelerated car-cycle times. Forest products drifted south on reduced shipments of pulpboard and lumber. Pipelines and NGLs have taken the edge off the chems group, and metals/construction slipped on fewer steel moves. For the full year, merch carloads are expected to be unchanged.

In terms of service, train speed and terminal dwell have improved at a double-digit rate of change. All the dispatchers have been moved to Atlanta to create a stronger network, where everybody can see what everybody else is doing and why, eliminating separate networks for coal, intermodal, merchandise, and bulk. Now NS can put the power and crews where they need to be, allowing six- or seven-day service to all customers.

Back in Feb about a third the loco fleet was AC — a smallish percentage compared to their peers. One way to fix that is with the NS program to reconfigure more than 500 DC units to the AC platform, creating essentially new power for a fraction of the cost of this year's model off the shelf. The goal is to get AC power to as much as 60 percent of the fleet, facilitating heavier trains and more use of distributed power.

I get the impression that NS has turned a corner, reimagining the operating and commercial disciplines that held when the original TOP plan was put in place some 20 years ago. Cindy makes it clear NS is done doing things because they always have. It's about time.

Elsewhere, the Wolfe conference provides a great chance to hear what the other modes are doing and why. For example, and in no particular order… Truckers have the flexibility to quote one-off rates to meet a long-time customers' short-term needs. More than 5,000 small trucking firms have shut down over the past year. The railroads' lack of service consistency harms intermodal volume growth. BNSF is running a precision railroad without making a meal of it.

Crucial to the railroads is the fact that weights per shipment are trending down and frequency of shipments is trending up. First/last mile performance can make or break a move, and the classic four trucks per rail car is actually a disadvantage in this environment.

In all, the Wolfe conference is a great value and a grand place to get caught up with current trends and outlooks. Do it if you can next May.