RAILROAD WEEK IN REVIEW

July 12, 2019

"The Pennsylvania Railroad established an enviable record for conservative and non-speculative management. No railroad record or stock speculator ever had anything to do with the financial control of the company, and this tradition has been passed on from decade to decade." — Page 54, the Rail Road Builders, 1919

"The Pennsylvania Railroad has never been a football of the stock market. At no time in its history were any of its policies or plans for growth determined by stock market considerations nor have its affairs ever been shaped in the interest of financial manipulation." — Centennial History of the Pennsylvania Railroad Company, 1846-1946, published by the Pennsylvania Railroad, 1949

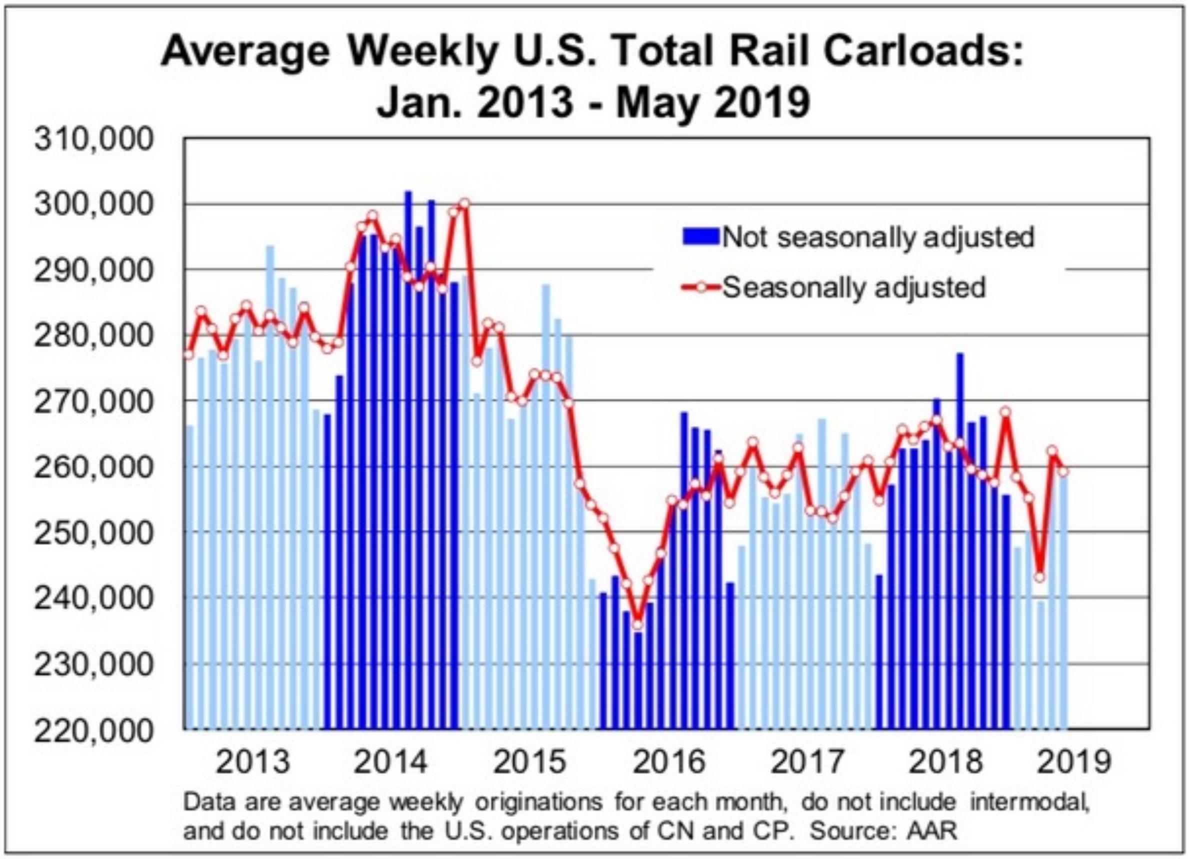
"Providing consistent on-time service to our customers is the key to revenue growth and realizing our potential. We invested more than $500 million since 1995 to develop, span and enhance our real time integrated information system as well as to constantly expand our suite of web-based applications." — Matt Rose, President, BNSF, 2001 Shareholder Letter

"We attribute the increase in on-time performance to company-wide focus on velocity. This initiative, which began in 2005, focuses on the number of times that equipment is handled and the throughput of our assets. We will continue to stress this initiative through 2009 to achieve the dual benefits of improved service for our customers and increased efficiency throughout our operations." — Matt Rose, BNSF, 2008 Shareholder Letter

Short lines, switch carriers, and regional railroads are closing ranks by getting closer and closer together. Pretty soon they'll be connecting end-to-end to cover ever wider swaths of real estate. It's happened before. Recall the original Alphabet Route, stitched together in 1931 to give railroad customers in the northeast a better option for reaching their markets in the west. Cars from New York could get on the CNJ at Jersey City, join up with the Reading at Bound Brook and head west, picking up Philadelphia cars along the way.

At the Western Maryland connection in Shippensburg, Pennsylvania, Baltimore cars were added and the train went on to Connellsville and the Pittsburgh & West Virginia. The Wheeling & Lake Erie got the cars at Pittsburgh Junction, Ohio, adding their cars, and connecting with the Nickel Plate at Bellevue for movement to Chicago. I think that's nearly doable today, with a few changes in names and connecting points. (Alphabet Route specifics courtesy of Frank Wilner, *Railroad Mergers*, page 96)

AAR Traffic first half 2019 volumes for the U.S. declined 3.1 percent year-over-year, which by itself sounds pretty dreadful. But it's only part of the picture. Here's the chart I ran June 21, but with a different twist.



The mid-2018 spike was the result of the tax breaks and inventory build ahead of increased tariffs. The trend since early 2016 has actually been a bit up, though mostly sideways. Expect this trend to continue for another year against global uncertainties, stagnant wages, and decreased capex spending. Employment is mired at 62 percent of the workforce actually employed, though there remains a significantly large cohort of those shown as "employed" who are holding down two jobs to make ends meet.

As a result, I see second half comps mirroring the 2016-2018 trend: peaking in mid year, falling off as the days get shorter. With car-counts dwindling, the business of boosting earnings per share by buying back shares — called "financialization" in investor circles — will have to end. It does nothing to enhance the core value of the business and can never replace the original founders' entrepreneurial spirit. See PRR quotes, above.

The fact that GWR is going private is old news at this late date. But perhaps some background color is in order. You will recall that roughly 80 percent of GWR results come from North America. Yet the NA carload results over the past five years have been less than stellar. The year-to-year swings are I think greater than what GWR likes to see -- recall their fondness for using non-GAAP results in their presentations to present the best possible picture.

Of the 100+ NA names in the GWR portfolio, perhaps half fail the Rule of 100 smell test. Granted, my data base has been assembled over the past 5+ years and so is hardly *au courant*. Yet, looking over the names, those that were weak then (mostly inherited from RA) are very likely weak to this day.

The commodity mix is 40 percent bulk -- coal, ag products, aggregates, and 60 percent cyclical -- both forest products STCCs, chems including crude oil, metals scrap and finished. Coal is a toss-up, ag and metals are tariff-affected and metals are subject to the whims of what is now definitely in decline.

I think, given the Class I PSR approach to the single-car business, the time to get out of weak properties is now while the Brookfields et al are still vying for cash-generating infra plays. The international presence has to be attractive to Brookfield and I suspect GIC is in the mix to cover the Aussie angle.

Brookfield is "one of the world's largest infrastructure investors, owning and operating assets across the utilities, transport, energy and data infrastructure sectors" and owning 7,000 miles of railroads, the largest piece of which is in Brazil. GIC is a Singapore-based global investment firm with a presence in some 40 countries.

I can see Brookfield and GWR stitching together regional networks forming alphabet routes to compete with the Class Is in the medium-haul single-car merch biz. Roll up connections with the Wheeling & Lake Erie, the Carload Express lines, and the Ohio Central to go Rochester to Chicago, Columbus, Cincinnati, and St Louis, for example. This may have been Hellmann's vision all along but he lacked the capital to do it. Now he has it.