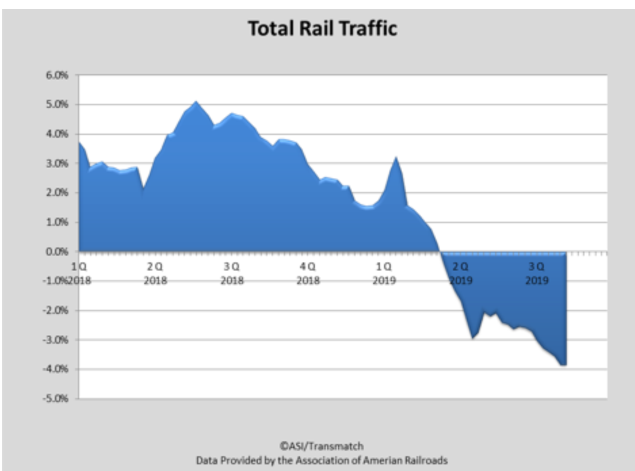
RAILROAD WEEK IN REVIEW

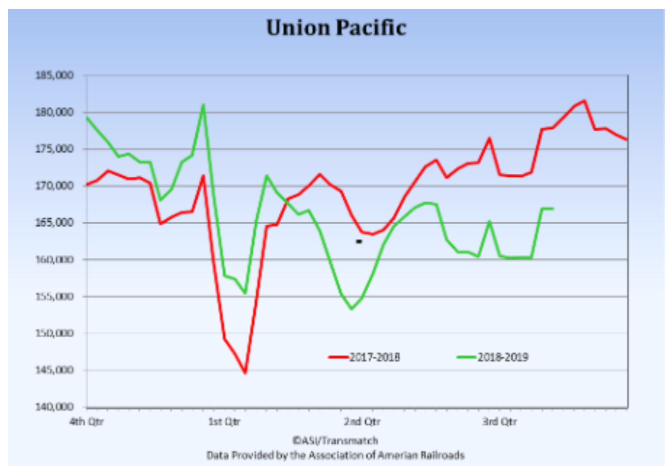
August 16, 2019

"Americans say they can't afford a vacation. More than two-thirds of US adults opted out of recreational activity due to cost at some point in past year." THIS is what happens when weekly earnings slow from 4.0 percent in January to 2.6 percent July. Discretionary spending dies."
— Danielle DiMartino Booth

"The manufacturing sector—which is more sensitive to trade and tends to be a leading indicator of economic activity—has shown signs of weakness; there is the increased likelihood of a decent-sized pullback in the near future." — Liz Ann Sonders, Charles Schwab & Co.

One continual theme in the railroad business over the last six months has been the steady decline in revenue units. These two charts from Drew Robertson's *ASI Transmatch* put the rate of change in proper perspective. The peak in 2Q2018 created some tough comps for the quarter just past and, as you can see, 3Q2019 is already facing tough comps.





Drilling down, Drew provides trends for each Class I railroad. Here you see how, like everybody else, UP's 2018-2019 total revenue units lag those of the 2017-2018 period. Point is, even as earnings per share go up thanks in part to rate increases and share buybacks, there is less stuff moving on the railroads. One must ask how long the railroads can continue to make more money by moving less freight and where more cash flow is spent buying back shares than for capex.

If investor actions in the railroad space during Tuesday's sell-off are any indication, not long. Every carrier name now trades below its 50-day moving average. Norfolk and CSX are below their 200-day line. The IShares transportation ETF (top ten holdings include NSC, UNP, FDX, JBHT) likewise trades below its 200-day average.

Genesee & Wyoming has filed what I suspect will be its last quarterly results because of their going private. And because I use GWR as sort of a proxy for the shortline/regional community as a whole, I want to focus on first half results rather than what was done in the quarter. North American revenue units were off four percent at 800,752 whereas freight revenue increased a point to $510,944. RPU gained six percent to $638.

As usual, the fungible — where one piece is no different than any other piece — bulk commodities saw the largest gains: ag products, chemicals, metals, aggregates, and the STCC 26 group. Most posted respectable inflation-plus RPU gains. I seem to recall about half the 100+ names GWR has in North America are ISS roads, which means they have some control over their divisions and that helps the RPU increases.

As for specific commodity groups in North America, agricultural products carloads increased five percent, mainly on farm products and soybeans from the western US plus grain and DDGs in the Midwest; Canadian grain was down. STCC 28 chems loads were down four percent, though there was a slight increase in sulphuric acid in the western region. Total revenue was $674,293, an increase of less than two percent.

Metallic ores were off 16 percent thanks to reduced copper moves in the US and fewer alumina loads in Canada. Aggregates ("minerals & stone" to GWR) gained on rock salt and sand in the Northeast though less sand in the west and south took some of the froth out. Petroleum products (STCC 29) gained two points gained on more LPG in the west and south and unspecified petroleum shipments in the Northeast. LPG moves were off of in Canada. Waste jumped six percent on trash and C&D out of the northeast.

In addition to straight freight revenues, GWR also reports "freight-related" revenues from contract yard switching, track access fees, storage, and self-worth. The Other Revenues line includes revenues from third-party rail car and locomotive repairs, property rentals, and ancillary revenues not directly related to the movement of freight.

North American operating expense was $520,717, up 1.8 percent. Comp & benefits continues to consume a reasonable one third of revenue and was up 2.1 percent, but fuel used in trains ops was down three points YOY. Perhaps the biggest tell on running a better railroad is the six percent reduction in equipment rents. Operating income was unchanged at $153,756 and the OR was 77.2, up 29 basis points.

Total revenue for all regions (NA, Australia, Europe) slipped three percent to $1.1 billion and operating income dropped nine points to $174 million. That said, NA still produces sixty percent of total revenue and 88 percent of total operating income while incurring only 55 percent of total operating expense. I have to say that GWR has had a great run as a Listed company and that I expect results to improve still more as a private company. BNSF is a good example of what can happen when you shift to private ownership.

Now that all the results are in, it's time to tally how the Class Is scored in percentage changes in my key financial and operating measures. CP ranked first seven of the nine — total revenue increase, gain in revenue units, RTM increase, merchandise carload revenue and numbers, operating income and OR point change. CN posted the best percentage RPU increase and UP took operating expense down by the largest percentage.

Investors have noticed, too. CP shares are up 20 percent over the trailing twelve months. I'm looking at a screen of price charts for all seven Class Is (BRK-B is a placeholder for BNSF) and they all lag CP in percentage change for the period. I think it's a matter for focus and leadership that has everybody from the president to the spike driver thinking the same way. That's how it should be.

The 2019 CP Shortline Meeting will be in Calgary October 27-28. The format will be much as last year — a reception Sunday and formal remarks Monday morning with breakout sessions in the afternoon. Like last year, the event will be held in the Royal Canadian Pacific pavilion, surrounded by CP's business car fleet, including some fully restored cars dating from the 1920s, and the beautifully kept Royal Hudson number 2816.

As I remarked last year, CP is the only railroad to have its short lines gather on railroad property and surrounded by host-railroad equipment. Also last year, what set the CP meeting apart from other short line/Class I meetings is that they left out everything that didn't really apply to short lines and stressed those things that do.

A major accomplishment last year was putting individual shortline leaders together with their CP counterparts to explore specific opportunities in all disciplines — marketing, operating and financial. Feedback over the past 12 months tells me the ideas fleshed out in Calgary have resulted in marketing, operating, and financial benefits for all parties. I fully expect that such will be the case again this year. Further news as events warrant.