RAILROAD WEEK IN REVIEW

September 13, 2019

"I'll tell you that the thing that's surprised me is the pace and the way we work with our customers. I think most people thought the approach would be to break a lot of glass and then build the backup. And what we've done is, we worked proactively with our customers and it's really helped us out." — Kenny Rocker, UP Executive Vice President, Marketing & Sales, Cowen Conference, September, 2019

"NS is allocating resources to opportunities with the greatest return and reducing network complexity to develop a valued service product we execute every day… Volume decreases were offset by the continued implementation of our strategy to price to the value of our improving service product, generating a 5% increase in revenue per unit" — Alan Shaw, NS Chief Marketing Officer, Q1 and Q2 earnings calls, 2019

"Between 1993 (the year before NAFTA's implementation) and 2018, U.S. agricultural exports to Mexico expanded at a compound annual rate of 6.9%, while agricultural imports from Mexico grew at a rate of 9.4%." KCS Cowen Presentation, September, 2019

Last week's Cowen Transportation Conference (the 12th if you're keeping score at home) brought us three very eye-opening and informative railroad presentations. I'll start with Union Pacific. Five slides in the accompanying presentation were particularly useful. Slide 3 shows strong commodity carload performance and the fact that these groups comprise 69 percent of UP revenues — good news for its shoreline connections

Of the four main commodity groups, only the industrial carload sector showed gains, terminal dwell was down, and trip plan compliance was up — again, all positives for the carload sector. And even though UP measures shortline trip plan compliance from the interchange, not the shortline customer, one can, assuming shortline dwells are minimal, use this to promote UP commodity lanes for shortline customers.

Third quarter volume is currently down 7% year-over-year, driven by excess truck capacity and weaker coal demand related to lower natural gas pricing as well as global trade uncertainty. Energy carloads are down 14 percent in the quarter as strength in petroleum products is more than offset by a 17% decrease in coal volumes and 42% fewer sand carloads.

Agricultural product carloads are down 2% compared to last year, driven primarily by a 6% decrease in food and beverage shipments and 5% fewer fertilizer carloadings, partially offset by a 1% increase in grain products volumes. On a more positive note, industrial shipments are up 2% quarter-to-date. The drivers in this category are 17% increase in construction volumes and a 5% increase in plastics shipments, partially offset by lower forest products and metals carloadings.

Looking ahead, third quarter volumes have been softer than anticipated. As a result, UP's current thinking is that volume for the second half will now be down mid-single digits versus 2018. That said, UP pricing strategy remains unchanged as the railroad continues to price the service product to the value it represents in the marketplace, while ensuring it generates an appropriate return.

Norfolk Southern's Alan Shaw, EVP and Chief Commercial, presented one of the shortest slide sets I've ever seen at an investor conference. That said, the meat of what we care about is on slide 3. The four lines of most interest to short lines are ag, chems, forest, met/con. Though Alan's side shows no gains anyplace, you can drill down into the NS Week 35 (Aug 31) AAR carload report to see exactly where the ups and downs occur and the relative importance of each commodity line.

Exclusive of auto, of which short lines comprise a minuscule percentage, the three biggest merch categories are chems, metals, and aggregates. These amount to roughly 39 percent of the merchandise carload franchise. Of these, chems (includes crude oil) and metals were down; aggregates ("crushed stone, sand, gravel" to the AAR) was up.

Re slide 4, they've been talking for some time about productivity and service supporting margin growth, not volume growth. This is in line with what Shaw said on the Q2 earnings call: "Volume decreases were offset by the continued implementation of our strategy to price to the value of our improving service product, generating a 5% increase in revenue per unit." What's implied is that where they can't get the price they want they'll let the volume go.

We knew this was coming when Shaw said on the Q1 earnings call, NS is "allocating resources to opportunities with the greatest return and reducing network complexity to develop a valued service product we execute every day." And yet, of the three biggest commodities as a percentage merch carloads, only low-value aggregates posted a gain. Perhaps the ag and chems guys don't see the value/service proposition the same way Shaw does.

The investor community may be waking up, too. Moody's rates NSC paper Baa1, just above junk, thanks in part to their debt/equity ratio of 75%. MarketEdge has them as a short and Recognia shows intermediate term -- 9-6 months -- projected price trends with five bearish chart patterns to zero bullish chart patterns. Ned Davis gives them a Neutral. Attention must be paid.

The KCS slide set from the Cowen conference is the most customer-focused set I've seen. Ever. It combines what investors need to know to evaluate KCS as an investment at the same time relaying to investors AND customers how KCS creates more customers in the pipeline and adds value to shareholdings.

Starting with slide 3, note the word "customer" appears in each of the three panels: customer-focus, customer expectations, customer orientation. Slide 4 shows how the KCS network can add value to customer supply chain performance, and slide 6 shows how KCS can help open Mexico so customers can meet their objectives there. Slide 7 outlines service offerings and slide 9 shows how the ag sector works to benefit players on both sides of the border. Finally, slide 10 addresses both customer and investor goals.

The message seems to be working for investors. Share prices had been in a $115-125 groove May-Aug, yet have marched steadily upward to $133 since Labor Day. KCS Mexico revenue units YTD are up 5% whereas KCS all-in revenue units are up slightly but essentially unchanged. I'm going to credit customer creation for the increase and suggest that others take note.

RailTrends 2019 once again comes to the NYC Times Square Marriott Nov 21, 22. The Thursday session kicks off as usual with the State of the Industry panel with the NRC, AAR, ASRRA, RSI, and the Railway Assn of Canada. Also on Thurs we get UP's Kenny Rocker, Norfolk's John Scheib, Mark Wallace from CSX, and Patrick Fuchs of the STB.

The shortline panel returns with Eric Jacobowski, Mike Bostwick, Stefan Loeb, Michael Miller, and Justin Broyles. Tony Hatch and Don Broughton will do a reprise of their investor tag team match and we'll get to meet the new AAR head, Ian Jeffries. Cocktail hour follows and I've got a nearby French restaurant I've been going to for 50 years that is quite charming.

On Friday, KCS President and CEO Pat Ottensmeyer receives the Railroad Innovator 2019 award and we hear from the FRA's Ron Batory plus Wabtec President and CEO Rafael Santana. Dick Kloster brings up the markers with his review railcar trends and rates of change.

Every year I come away with a few tidbits that remain front of mind for the ensuing year and beyond. Current railroad trends bring to mind such questions as…

* How can railroads create customers in today's economic environment?
* What works best for railroads to create a competitive supply chain tool for customers?
* How does one go about establishing specific at-dock times for customers?
* How are current economic trends affecting business planning and service design?
* What can customers do to have the railroad add value to their supply chains?

So put on your thinking cap and bring an attentive ear. You'll be glad you did.

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