RAILROAD WEEK IN REVIEW

September 20, 2019

"Negative interest rates is one of the worst ideas I have ever heard. We are a capitalist economy. Our banking system has created credit to help grow businesses, help families buy homes. Banks would not be able lend as they do today." — Danielle DiMartino Booth

"Days supply is the absolute best indicator for the automobile industry: how many days it would take for a car dealer to run out of inventory based on the amount of inventory on hand. When you see a spike in day supply, you know that there's an imbalance between production and sales, that supply is outweighing demand and vice versa." Daniel Ruiz, blindersoffresearch.com

The UAW strike against GM that started this week will have a much wider effect on the railroads than just parts via intermodal and new vehicles in auto-racks, together accounting for about eight percent of total 2018 annual railroad revenue units, according to the AAR. Scott Group of Wolfe Research writes, "The strike will initially only impact GM's U.S. plants, but production at GM's Mexican and Canadian plants will likely be impacted as well in the event of a more prolonged strike."

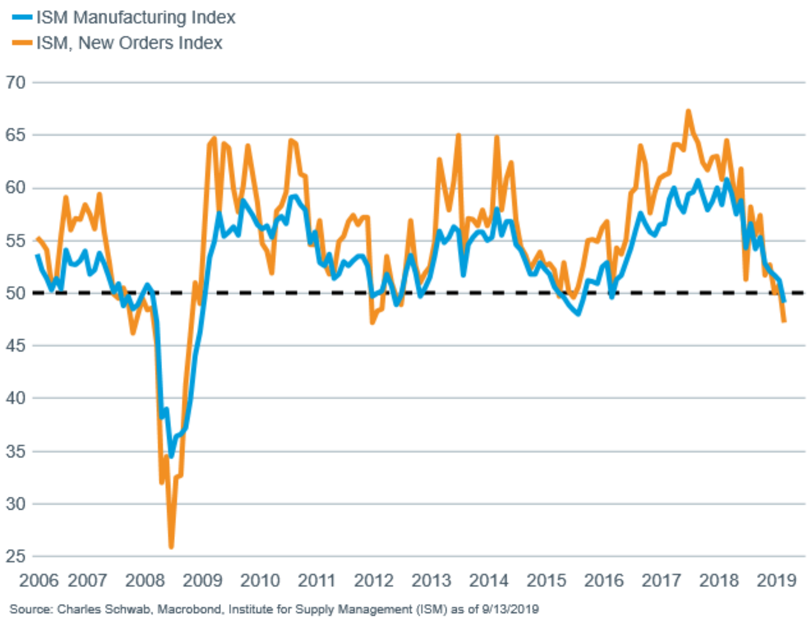
Putting things in perspective, GM is the largest auto maker in North America, accounting for about 19 percent of total production. Total new light vehicle sales in August ran at an annual seasonally-adjusted rate 17 million units, with light trucks dominating. For the first nine months of 2019, sedan sales fell eight percent while light truck (pickups and SUVs) sales increased four percent.

But there's downside here. Part of the labor grievance is about sedan plant closures as less-expensive sedans are replaced by higher-priced SUVs. Consequently, says auto guru Dan Ruiz, "As the average transaction price increases, the average loan term extends, and amortizing that loan is taking longer, even with lower interest rates. Compare the vehicle value of the car in question and you can see it's taking longer to reach the breakeven point in consumer loans."

Carload participation in the automotive market comes mainly from raw materials from glass to steel to plastics. Group again: "Total exposure to autos including inbound raw materials (e.g. plastics) and some auto parts is even higher. Among the rails, CSX and UNP have the most direct auto exposure at around ten percent of revenue with GM a third of that."

According to the AP, the strike will mostly affect GM plants in Michigan, Ohio, Tennessee, Kentucky, New York (all big CSX states) as some 50,000 union workers stay home. Though this is the first work stoppage in the US auto industry in 12 years, and isn't expected to be especially protracted (GM reportedly has enough inventory on dealer lots to last 77 days at the current rate of sales), raw material supply chains are bound to be affected, and commodity carloads that feed the auto industry will see some declines.

Manufacturing continues to weaken, says Charles Schwab research:



Earlier in the week, I received a note from Stifel showing how retail inventory levels have come down faster than have raw materials and finished goods inventories for manufacturers. It's the latter that ought most to concern the non-class I railroads. Retail finished goods travel mostly by truckload and intermodal, so smaller inventories suggest greater demand for replenishment.

On the other hand, manufacturers of capital and other industrial goods are seeing a slowing of demand thanks to tariffs and a general uncertainty about the direction of the demand for their products. Take the railroads themselves, for instance. Demand for their services is slowing as industrial customers retrench and so capex budgets are coming down, freeing up more free cash flow for share buy-backs. And since the preference for share buybacks over capex is across all industries, continued high manufacturing inventory levels is a railroad concern.

There has been series of very thoughtful and well-informed articles about Precision Scheduled Railroading of late. The common thread is that PSR can be good for the railroads but customers are slow to see the supply chain benefits.

I'm reminded of the story about how Steve Jobs revolutionized the music streaming business with the iPod. Previous efforts had failed because musicians didn't understand technology and technicians didn't understand music. Jobs' uncanny understanding of the needs of both interests led to the iPod and, as it grew in popularity, more Macintosh computer sales.

The railroad technicians -- the operating side -- know what it takes to make trains go and control costs but they're not so good at understanding what creates sticky customers. The marketing (music) side knows what goods owners need from transportation suppliers but are less savvy on the technical side. As a results, you have railroad silos talking past each other, just as you had the streaming music silos talking past each other.

Hunter Harrison was the closest the railroads ever came to having their own Steve Jobs. Hunter Camps brought all disciplines together in one room and consensus was reached through mutual understanding. The PSR experience with Hunter Harrison, Keith Creel, and JJ Ruest is a function of focus and leadership, I think. Ops and sales now speak the same language and customers benefit, thereby increasing revenue unit sales.

All we need do to replicate the Jobs/Harrison magic is to create a seamless service and sell more product as a result. Call it the iRailroad.

RailTrends is returning for its 15th year November 21-22 and once again the venue is the Times Square Marriott. Also, once again, RailTrends is bringing back its short-line chief commercial officer panel in its entirety. Panelists are Eric Jacobowski of Anacostia Holdings; Watco's Stefan Loeb; R. J. Corman's Justin Broyles; PanAm Railways' Mike Bostwick; and Genesee & Wyoming's Michael Miller.

This is certainly an appropriate reunion. The year 2019 has really has been a remarkable year for short lines, in terms of growing importance through the PSR process, through more Class I segment sales (see CSX) as well as other short-line sales (the huge demand creating its own supply) — and the privatization mega-deal for Genesee & Wyoming. The shortline panel is up Thursday afternoon at quarter to four. See you there.