RAILROAD WEEK IN REVIEW

August 14, 2020

"As efforts to contain the spread of the COVID-19 pandemic accelerated in the second half of March and continued through the second quarter, most of our businesses were negatively affected, with the effects to date ranging from relatively minor to severe. Several of our businesses deemed essential have continued to operate, including our railroad, utilities and energy, insurance and certain of our manufacturing, distribution and service businesses." — Berkshire Hathaway 10-Q, June 30, 2020

"Pink slip announcements came in at 262,649 in July, a 576 percent year-over-year surge (and +54 percent MoM).The biggest increases in layoff announcements were in apparel, autos, energy, entertainment/leisure, financials, industrial goods, media, mining, retail and transports (accounting alone for one-quarter of the overall layoff tally). The areas that are seeing declining layoff trends are construction, aerospace/defense, pharma, telecom, utilities, consumer products and electronics." — Breakfast with Dave (Rosenberg) Aug 7

"The new Port of Saint John service offers shippers a compelling value: a congestion-free port with a world-class operator, matched with CP's precision scheduled railroading model. CP has been without access to a deep-water Atlantic Ocean port for a quarter-century, and today I'm pleased to deliver a simple message: We're back." — Keith Creel, CP President and Chief Executive Officer, August 11

BNSF reported $4.6 billion in second quarter revenue, down 22 percent year-over-year. The railroad handled 2.1 million revenue units[1], down 18 percent; merchandise carloads (industrial products and agricultural) were down 18 percent.Within the merchandise and agricultural carload groups, most categories were down double digits. The agriculture group fared best of all, down only 4 percent, representing 9.7 percent of all BNSF revenue units including auto and intermodal.

Consumer products (auto and intermodal) were down 13 percent and represent 56 percent total revenue units. Second quarter operating income fell 14 percent, with the 26 percent cut in operating expense being a considerable help. The operating ratio came down 3 1/2 points to a more respectable 62.4. Below the line, net income fell 15.5 percent to $1.1 billion. Free cash flow after capex was down a mere eight percent.

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[1] Quarterly carloads are from the BNSF Week 26 (July 27) AAR carload report. BNSF does not report quarterly carloads in the 10-Q, however, since the year-to-date BNSF 10-Q carloads are not even a rounding error from the week 26 AAR report, I feel it is safe to use the AAR Week 26 numbers as a proxy for the actual second-quarter numbers for BNSF.

Revenue for the six months was $10 billion, down 14 percent, though the revenue unit per decline improved to minus three percent. As for the individual commodity groups, Jan-June, industrial products fell 14 percent on pandemic-related production shortfalls and reduced demand in the energy sector particularly in frac sand and petroleum. Ag products dropped just two percent, though fewer ethanol carloads and lower net exports were the drag. Coal carloads dropped 21 percent on mild winter weather, low natural gas prices, and plant retirements.

Among its pure Class I railroad peers, BNSF fared fairly well in comparing key Q2 metrics. Revenue units were off 18.1 percent, trailing only CN ad CP. Merch carload revenue slipped 20.2 percent, again trailing only the Canadians. Merch carloads were off 18.0 percent, bested by UP at minus 14.4 percent. Operating income slid 13.8 percent, second to KCS, minus 1.3 percent.

Union Pacific is upping their customer-contact game. The railroad's *SmartETA* technology collects multiple data points, including GPS signals on locomotives, to locate shipments. With the help of machine learning and predictive analytics, the velocity data and GPS coordinates are then used to determine arrival times that are more accurate than ever before.

Over time, the data will "get smarter" and predict even more precise ETAs based on the historical data gathered. The result is more accurate and dependable shipment location data and estimated delivery times for customers. Timely "Local Service Scheduled Today" notifications let customers know when they will receive service at their facility and "You Are Next" notifications provide guidance on the timing of local service.

I don't see anything on the UP website about trip plan compliance or transit times that would help customers take days out of supply chain planning. As it happens, Union Pacific inherited such a car management system when they bought the Missouri Pacific in 1982. Known as the Transportation Controls System (TCS), it was the MoPac Service Design group — the very group that would use it — that designed it.

TCS was a major step toward eliminating Unplanned Events. It directed every event for every car on the MoP, tracked same so every car could hit the right schedule, and fed empty cars to the system to meet movement orders. As a result, TCS not only satisfied car tracing, traffic reporting, demurrage, and car accounting functions, but also improved communications between the MoP and its customers.

I know it works because I used it for a client in the steel fabrication business. He was slitting the steel coils into narrow bands at his IHB-served plant in Hammond, Indiana, to be further shaped at five UP-served field locations from Texas to California. Our objective was to insure cars would arrive at the destination dock when wanted by the customer. It worked.

Susquehanna's Bascome Majors reports that several useful themes emerged from their recent transport and industrial conference. UP, NS, CP, KCS, and CSX were in attendance. Majors cites "a slightly more constructive" discussion of demand than he had picked up just a few weeks ago. Intermodal volumes are set to improve, and there were words of "incremental improvement" for the merchandise carload sector.

A continuing theme was the need to balance putting more assets in service (crews, power, freight cars), more freight coming on line, and how long it will stay. Because both Pan Am Railway and KCS may be in play, there was some discussion of mergers, though not much came if it, writes Majors. I suspect such a thread is a non-starter, if only because of the potential STB role, which I mentioned in my KCS remarks last week.

There are still "cyclical challenges" for capital equipment vendors and lessors but the outlook is "less dire" than it was a few months ago. Customer demand is indeed slacking off, but "interest hasn't gone to zero." Equipment lessors are zeroing in on utilization rates and are adjusting fees accordingly, so not turning cars promptly could push up lease rates and hurt the customer's competitive advantage.

Truckers talked about their excellent July results (not falling off vs. June), though there reports of "particular tightness" on the west coast for both truckload and intermodal. Truckload and intermodal pricing power appears to be on the mend, though brokers could find themselves scrambling to "cover contract freight in elevated spot market."

Canadian Pacific has returned to Maine, re-establishing its traditional international service through the Port of Saint John, N.B. The inaugural train carried containers from Hapag-Lloyd's *Detroit Express* bound for intermodal terminals on the CP network in Canada and the U.S. The train moved to CP at Brownsville Jct., Maine, via a connection with the New Brunswick Southern (NBSR) and Eastern Maine (EMRY) Railways. Containers are ultimately destined for destinations that include Toronto, Winnipeg, Calgary, Edmonton, Vancouver, Chicago and Minneapolis.

CP regained access to the Port of Saint John through the acquisition of the Central Maine & Quebec Railway (CMQ), completed in June. CP's route is the shortest between Atlantic Canada and key North American markets. By year's end, CP anticipates it will be able to offer 24-hour service between Saint John and Montreal.