RAILROAD WEEK IN REVIEW

September 11, 2020

"We don't need more minimally viable products. We need more maximally viable organizations attacking big problems with a tinkerer's mindset and a capitalist's goals. Let's call it Entrepreneurship 1.0 — a society of tinkerers who embrace entrepreneurship with meaning." — Luis Perez-Breva, faculty director at MIT Innovation Teams, epsilontheory.com, Sep 4, 2020

" The railroad focus has changed from growth to profitability. This is all part of the precision schedule railroading mantra…The railroads are not willing to follow trucking rates because doing so will affect the operating ratio, and the operating ratio is important in today's scheme of things." — Larry Gross, Trains Magazine, October 2020

"The railroad operating ratio measures efficiency and profitability and is worshiped by the railroad industry. Wall Street demands continued lowering of the OR for ever greater profit margins. But this has strangled volume growth by forcing railroads to focus solely on the most profitable traffic." — Bill Stephens, Trains, October 2020.

In the 1950s, the railroad trends toward wide-scale retrenchment culminated in infrastructure consolidation as a result of merger and abandonment. It was all done in the name of greater productivity by eliminating perceived route redundancy, concentrating traffic on fewer routes, while higher horsepower diesel's enabled operation of even longer trends. Yet, route retrenchment limited the railroads' reach." — Brian Solomon, Trains, October 2020

Peter Drucker has famously said, "The purpose of any business is to create customers." Not always, it appears to me. The US class Is are doing more to run off customers than to create new ones, not only in my humble opinion, but also that of the *Trains* contributors cited above.

Wall Street has glommed onto the themes of "operating ratio" and "precision scheduled railroading," yet rather than using these themes to create new customers and build franchises with older customers, managements are using them as an excuse to cut costs, thereby improving the operating ratio without improving the core business.

Happily, there is a cadre of smaller railroad operators who have glommed onto the Entrepreneurship 1.0 theme. That's where we're seeing the growth; that's where we're seeing more customers coming to the railroad than running away from it.

The present "financialization" model of increasing earnings per share by cutting costs and buying back shares isn't doing the customer any good. The chief beneficiaries are the executives with their stock options and – for the moment – shareholders who are buying the OR/PSR/share buyback program story.

The employees, the suppliers, and the customers see no benefit whatsoever and are increasingly leaving and looking away from the Class Is. Time to bring on Entrepreneurship 1.0 on a Class I scale in order to benefit all stakeholders.

Shortline operator RJ Corman is buying three properties — two in Pennsylvania's northeast quadrant, and one in the New York southern tier — plus TranZ, an area transloader. The seller is Steve May, a shortline presence in the area for many years. Altogether the three lines operate 143 miles of railroad, doing some 14,000 carloads annually, right at 100 cars per mile. NS is the principal Class I connection for all three.

In Pennsylvania, the Lehigh Railway operates 56 miles of the original Lehigh Valley main line between Athens and Mehoopany. The Luzerne & Susquehanna Railway runs about 60 miles of the one-time Lackawanna in the Wilkes-Barre area, now leased from the Luzerne County Redevelopment Corporation. The sole New York operation is the Owego & Harford Railway, a 27-mile railroad in New York that operates on a long-term lease from Tioga County Industrial Development Agency (TCIDA).

Though just skirting the eastern edge of the Marcellus natural gas fields, the Lehigh line is in position to aid in the tapping of significant amounts of liquified natural gas. New Fortress Energy, a division of New York's Fortress Investment Group (former owner of the FEC and most recently the CMQ) is developing plans for two facilities that would liquefy locally-produced natural gas in the Marcellus.

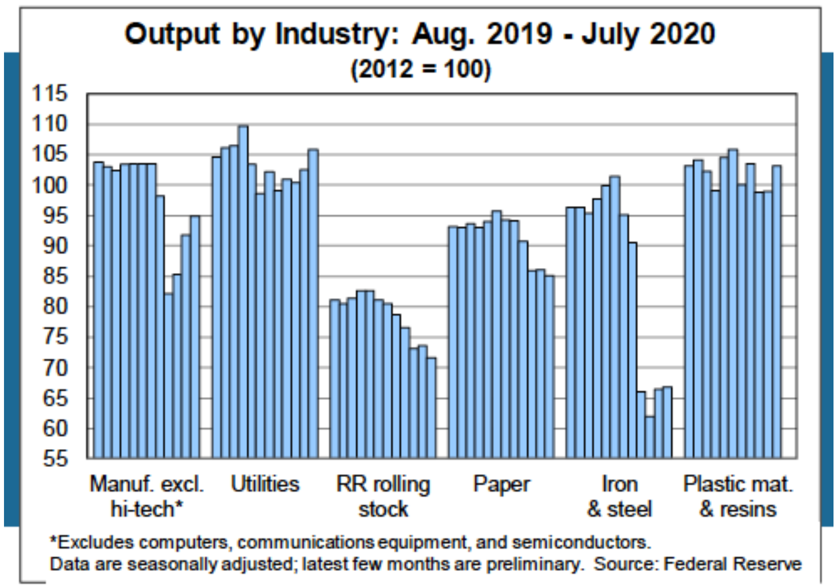
New Fortress Energy already operates a liquefaction facility near Miami, so is not new to the game. A year ago the company won a special permit to move up to 100 LNG cars a day to a to-be-permitted terminal in Gibbstown, New Jersey, served by Conrail Shared Assets. The FRA is fussy about what tank cars can carry LNG; there are now fewer than 100 of them in existence.

Then there's routing. New Fortress Energy will be in Wyalusing, about a third of the way from Mehoopany to Athens. Reading & Northern will take the cars at Mahoopany, forwarding to NS en route to Philadelphia, operating on along Amtrak's Northeast Corridor from the Schuylkill River to Frankfort Jct., and across the Delair Bridge. Shared gets the cars at Pavonia and runs through the middle of Camden and ultimately to Gibbstown. The local activists will have a field day with this, and I'm not holding my breath.

Kansas City Southern has rejected a roughly $20 billion takeover offer from a group of investors, per the WSJ after the close Wednesday. KCS maintains that the $208 per share bid undervalues the railroad. Allison Landry of Credit Suisse agrees, writing that a 40-50 percent premium would likely be required. Moreover, she continues, "We maintain our view that the success of a deal will come down to the value that KCS believes it can create over time by operating independently and how much an infra fund is willing to pay and lever up." She's right.

The September 4 *Rail Time Indicators* from the AAR notes that August average weekly carloads of primary metals products and iron/steel scrap is the highest in 5 months. Ned Davis Research in Venice, Florida says "materials are rallying" and the Schwab Materials Sector analysis confirms that materials do better when "stocks are up and the dollar is falling," like now.

This RTI chart shows steel is repairing the output damage done in the recent drop — slowly. This fits with the upward trend in manufacturing, which in turn supports the plastics increase.



I should also add that the inventory of existing homes for sale is down, prompting a surge in new home construction; COVID-related exit from big cities is a factor. A research note on Owens-Corning from Loop Capital Markets cites such new home construction as behind the O-C "staffing up of plants." Roofers are known as good railroad customers, so others in the space — GAF, for example — are no doubt participating.