RAILROAD WEEK IN REVIEW

January 15, 2021

"We've heard rumblings that a lack of last-mile trucks has caused some delays in moving frac sand to well pads from mines and/or transload facilities — sounds like this has been occurring since roughly New Year's day as qualified owner operators with CDLs have exited the oil patch for (seemingly) greener pastures that hold steadier (paying) jobs." — Tudor, Pickering & Holt, Morning Note, January 11

"While first-half 2021 freight demand should be terrific with easy comps and inventory re-stocking, the second half could be challenging with tougher comps as inventory restocking eventually fades and consumer spending shifts back to services. Thus we generally prefer industrial over consumer exposure in the transport space." — Scott Group, Wolfe Research, January 10

"Staring into the 2021 abyss, the outlook for rail-hauled chemical traffic looks like a mixed weather forecast: Early morning fog, changing to overcast skies, with a high-pressure system moving in later for sunny skies. The fundamental assumption is that the COVID-19 pandemic will gradually abate as immunization shots take hold." — Jim Blaze for Railway Age Newswire, January 11

I firmly believe Class III railroads are responsible for much of the merchandise carload growth the Class I railroads are reporting. The Big Six are down seven percent for the year and yet my small samples of short lines and regional railroads are seeing carloads increase.

One of my favorites in this regard is Pennsylvania's Reading & Northern. They did 34,000 carloads in 2021, up slightly, yet saw revenues increase four percent. Among Class III carriers the R&N is unique in that it has eschewed the handling line settlement process, opting to be an ISS road so it can control its own destiny rate-wise. Doing so is a definite benefit when you're out there trying to increase carloads from existing customers and simultaneously create new customers.

Owning your own car fleet can facilitate customer shifts in traffic mix, increasing the tonnage moved and upping the revenue base another notch. For example, anthracite carloads had taken a hit partly due to foreign exchange rates, making imported Russian anthracite cheaper. Yet R&N cut delivered costs for its anthracite by developing rail-truck facilities throughout the Midwest and southeast to handle anthracite for area steel mills. [WIR Nov 6] That business is expected to increase significantly in 2021 as additional steel-making capacity comes on line.

Another area of growth was R&N's transloading and warehouse business. The year 2020 saw greater demand for warehousing raw materials, resulting in a 54 percent increase in carloads moving to a railroad-owned and operated warehousing facility. Last year was also also the first full year of operation for the purpose-built steel coil transload at West Hazleton. Here is yet another instance where shortline ingenuity and flexibility turns truckloads into carloads — my estimate is 2-3000 new carloads for R&N.

Two significant industrial development projects were completed in 2020. *Iris USA* is now up and running in the Humboldt Industrial Park and *Crossroads Beverage* outside of Reading began new rail service last June. Both are expected to continue ramping up production and their inbound plastics by rail over the course of 2021.

Doing all this takes money. R&N purchased 143 rail cars for anthracite coal service, 17 locomotives, a welded-rail train, and more than 34,000 new ties. Most impressively, R&N completed its investment in its Nesquehoning Bridge project, which opened for business on February 4th. R&N spent more than $4 million of its own capital to build this critical track structure enhancement and improvement.

The key to this kind of success is **going to see the customers** and asking how the railroad can make their supply chains work better. Sometimes it's building transloads either locally or at distant customer sites to extend the railroad service reach beyond trackside. Sometimes it's adding owned-equipment to make sure car supply is sufficient to meet demand. Sometimes it's reconfiguring the railroad to eliminate reverse moves and add capacity. As BNSF's Katie Farmer says, do whatever is needed to help the customer say YES when you ask for the order.,

The fourth quarter truckload carrier survey from Cowen equity research is revealing, and I think railroad marketeers can learn something about the competition from it. Private trucking carriers in the survey averaged rate increases of three percent on contracts that they renegotiated in the last month, on average, up from two percent in the 3Q20 survey.

Carriers expect to capture a 3.5 percent increase on rates that they will be renegotiating in the next six months, up from the 3.0 percent increase from a quarter ago. That said, the 3.5 percent mark is the highest mark noted since 2Q19. While above historical averages, it appears the consensus viewpoint is well north of the 3.5 percent the survey suggests.

To raise rates or not to raise rates is always the question, and the answer depends largely on one's perception of the economy going forward. The Cowen survey shows a significant step down in economic confidence, with 48 percent of the survey having less confidence in the direction of the economy today than they did three months ago. This negative confidence increased when compared to 31 percent a quarter ago, signaling a less positive outlook for the overall economy.

Finally, given all the chatter out there about autonomous trucks, Cowen asked around. Asked whether they are open to testing autonomous trucks. 33 percent of participants said yes, about what it was three months ago. Five percent are not only open to testing autonomous trucks but have already done so, roughly one percent below last quarter. Finally, the remaining responders said they are not open to testing autonomous trucks, in line with last quarter. From this I would conclude the autonomous truck is not an immediate railroad threat. However, though, mandating two crew members in the locomotive cab on a private right-of-way vs. nobody in the cab for trucks on the open public highway is not only anti-competitive but also downright dangerous.

In sum, then, I think it is safe to say the truckers expect a middling year where they can make a living but not make a killing in new business truckloads or rate expansion. This could very well have an effect on the supply of truck bottoms, creating new business opportunities for railroads with adequate equipment, reasonable prices, and connections beyond that offer a durable competitive advantage.

The chemicals business that the non-Class I railroads participate in lies mainly in STCC 28, which includes both fertilizers and industrial chemicals. With respect to the former, Morningstar expects that potash demand will increase over the next several years.

As the fertilizer helps plants grow in stressed weather conditions, including mild drought and flooding, farmers globally should continue to apply potash in greater quantities to maximize crop yields. Although demand was up vs. supply in the 2020 crop year, new supply ought to keep prices under control: Morningstar forecasts that demand growth in 2021 will sop up excess supply, leading to higher prices.

With respect to the latter, industrial chemicals producers saw demand begin to recover sequentially after falling sharply during the second quarter because of pandemic-driven plant closures. It would appear there has been a continued sequential volume recovery in the fourth quarter that ought to extend into 2021. This should bode well for specialty chemicals producers, whose differentiated products command premium pricing, driving profit recovery as volumes return.

Jim Blaze reports in *Railway Age, "*Plastic resins movement was a growth chemical segment overall in 2020 due to the role it plays in producing COVID-19 protective materials. Some chemical products that support automobile manufacturing are also recovering strongly as plastics are a big input to automotive. From 2015 through 2019, automotive units averaged nearly 17 million per year. Sales during 2020 are expected to have come in at only 14.4 million units. The outlook for 2021 is perhaps 16 million units."