RAILROAD WEEK IN REVIEW

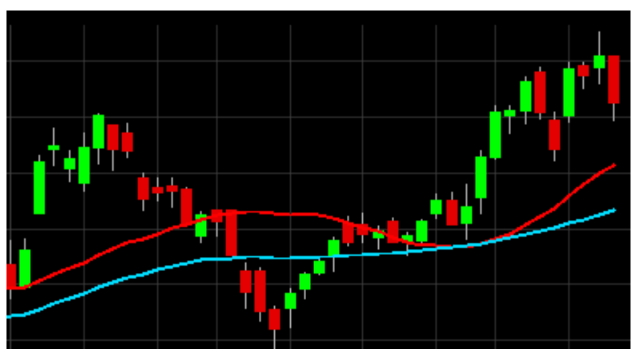
March 12, 2021

"It is an unfortunate fact that great and foolish excess can come into prices of common stocks in the aggregate. They are valued partly like bonds, based on roughly rational projections of use value in producing future cash. But they are also valued partly like Rembrandt paintings, purchased mostly because their prices have gone up so far." — Tao of Charlie Munger, page 61

"[Hunter] was determined to grab back share with a better product that included precise schedules and better pricing, underpinned by a more efficient operation. Satisfied customers could then lower their inventories and get rid of excess boxcars, saving costs." — Railroader: The Unfiltered Genius of Hunter Harrison, page 79

"We aim to provide our customers excellent service, anticipating the customer' needs so that they can focus on what they do well, knowing that we will provide the freight transportation piece that's time efficient, cost-efficient, and safe." — Kate Luce, President and CEO, Mississippi Export Railroad, promotional video

There's life in the single-carload sector. BNSF has reported a surge in scrap metal carloads. That might be a good sign for steel with scrap being feed-stock for minimills. With that in mind I reviewed stock price performance for a number of steel producers. This chart of Reliance Steel share prices YTD (the red line is the 20-day moving average) is indicative.



By way of review, Reliance Steel & Aluminum Co. is a metals service center company in North America (the United States and Canada). As of December 31, 2018, the Company's network of metals service centers operated over 300 locations in 39 states in the United States and in 12 other countries (Australia, Belgium, Canada, China, France, Malaysia, Mexico, Singapore, South Korea, Turkey, the United Arab Emirates and the United Kingdom).

As of December 31, 2018, it provided metals processing services and distributes a range of more than 100,000 metal products, including alloy, aluminum, brass, copper, carbon steel, stainless steel, titanium and specialty steel products in a range of industries. Its various metals service centers process and distribute only specialty metals. It delivers a range of products from facilities located across the United States and Canada. It provides a range of processing services for its customers' and delivers products to fabricators, manufacturers and other end users [from Schwab.com]. I'd say that's a pretty good prognosis for more railroad carloads.

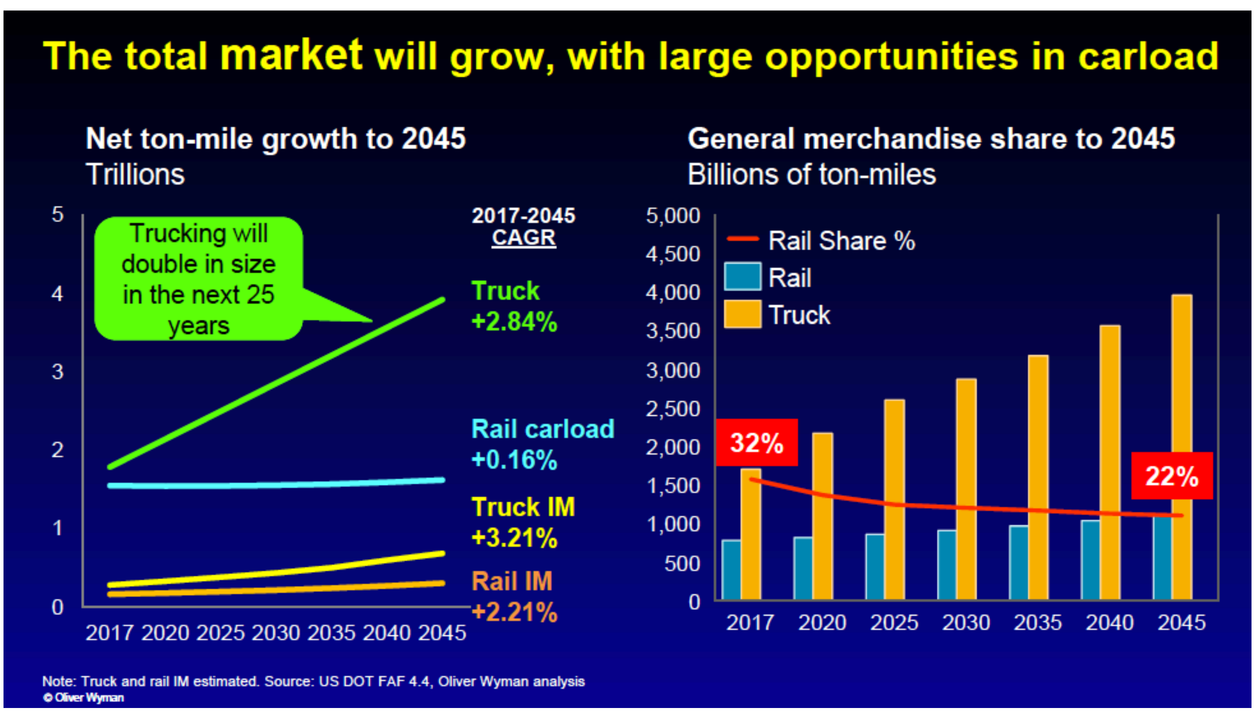
The same things are happening in the energy sector. On a recent day when the Dow was down more than 300 points, I brought up a list of 20 or so petroleum-related companies. All were showing share price gains for the day, led by the Exploration & Production sub-sector — where all the frac sand and piping goes.

Later in the day I read about truckload concerns with two companies in the manufacturing sector. The first talks about a "backlog of freight" and the second cites "industrial distributors with low inventory levels." Both would seem to support the recent increases in share prices in the materials, energy, and metals spaces. On the other hand, a railroad customer in the chemicals sector comments on "deteriorated rail service, missed switches, and a shortage of rail cars." Worse yet, he's being hit with rate increases in the plus or minus five percent range.

Clearly there's carload business to be had if the railroads would only go get it. Fact is, short lines and regionals are growing their business by paying attention to the customer (see Kate Luce, above), and there are places where short-lining Class I light density branches would yield significant carload volumes.

The big railroads complain about high operating costs and low cost-benefit ratios, yet they hang onto properties that could bring in more revenue at lower incremental variable AND fixed cost. One reason they don't could be that the internal Class I silos are worse than ever, according to one 40-year RR veteran.

This Rod Case slide from the 2019 RailTrends drives home my point.



Moreover, as we see in the CSX Massena Line case, paper barriers are alive and well. The way I see it, in transactions like this, the language wants to make sure every move stays in the Class I account from start to finish. If it can't, well, maybe we won't sell the branch. And the Rod Case case holds true.

The number of 20 percent is bandied about as the short line/regional railroad portion of total AAR carloads. For the month of December, 2019 it was close to 17 percent all-in, 31 percent excluding intermodal but including coal and auto.[1] Total Class I units decreased nine percent year-over-year; shortline carloads also decreased nine percent year-over-year. Over the past five years, the Class Is averaged a negative 0.4 percent CAGR, with a revenue CAGR of 0.9 percent, an operating income CAGR of 2.7 percent, and the average net income CAGR is 4.6 percent.

Here's my concern where the non-Class Is are concerned. The revenue CAGR increased more than the CAGR for carloads, largely thanks to rate increases and fuel surcharges. Yet over the past year or so Class I share prices have increased to a point where they are running about a third ahead of DCF intrinsic value, based largely on OR, PSR hype, and share repos. Volumes rarely enter the discussion. As a result, the Street has to view railroads as in better shape than they really are.

Shortline revenues are volume-dependent and don't participate in either rate increases or fuel surcharges, so as the connecting Class Is' car-count goes, so goes the non-class Is' revenue base. If car counts have a one percent CAGR and shortline operating expense has a two percent CAGR, the value proposition begins to look shaky.

[1] AAR Rail Time Indicators, January 3, 2020; Railinc Short Line Index, December, 2019