RAILROAD WEEK IN REVIEW
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"We need to educate a new generation of shippers how to use rail. It must be our responsibility to explain terminology and make simple the process for rate-making, car ordering, and so forth." — Peter Gilbertson, Chairman, Anacostia Rail Holdings

"OmniTRAX takes a hyper-localized approach. Our operations are an integral part of the community. We don't just pass through. Our team members live locally and have a vested interest in the improvement of that community." — Dean Piacente, CEO, OmniTRAX

"We learned long ago that you should listen to your customer, ask questions, and learn how to solve their problems in a value-creating manner. We like to say Yes to a customer who asks us to take on a new service, even something we hadn't provided before." — Dan Smith, CEO, Watco

"By enabling real-time access to shipping data, CN can unlock critical supply-chain information to give our customers better visibility of their shipments, both while on CN and beyond." — JJ Ruest, CEO, Canadian National

"The CP family is ready to continue producing for our customers, the communities we serve, our shareholders, and each other. We need to talk with our customers regularly to determine how their needs are changing and how CP can best meet them." — Keith Creel, President and CEO, Canadian Pacific

The common thread between and among the above quotes is creating customers. They all appear in the March *Railway Age* "CEO Perspectives" feature and go straight to the question of making railroads "more relevant," in the words of one NEARS shipper panelist.

Customers don't really care about lower operating ratios, "sustainability," artificial intelligence, or advanced technologies. They care about finding transportation providers that are easy to do business with, add value to their supply chain initiatives, and are consistent, reliable, and dependable. Not a tall order.

The way I see it, the railroads began to lose their "relevance" when management's focus moved from providing a service with a durable competitive advantage to enhancing financial results. The term "financialization" comes to mind. As I wrote in *Week in Review* for November 30, 2018, there are dangers to putting investors ahead of everybody else:

> The financial manager's incentive is completely different than the entrepreneur's. He doesn't have three generations invested into his factory. He needs to make his stock options work over the next three to five years. The ownership of business becomes financialized and you end up with a company that's run by people who are interested in the next 24 months. The

> former operating-owner who used to have something that was robust and potentially multi-generational becomes a speculator.

The italic quotes at the open above are all about putting the customer first, where management thinks like that operator-owner. The short lines and regionals are the true leaders in this regard, as you can see from the likes of Piacente, Gilbertson, and Smith. But I think that the leadership styles of Ruest and Creel are bringing that entrepreneurial bent back to the Class Is.

The railroad customer and equipment builder surveys from Cowen & Co are always very insightful and useful. This week's reports are no exception:

Railroad customers view business generally as back to pre-covid levels. Shippers are saying railroad moves are 25 percent cheaper than truck, but we don't know if that's just rates or rates plus the inventory cost of slower transit times. There are some signs of truck to rail conversion — improved rail service is a factor. Equipment availability is a concern, particularly for box cars and center-beams. NS gets the worst marks in service satisfaction.

As to equipment, almost half those surveyed say they "may" order additional cars, a "slight decrease in the level of certainty." Incremental equipment needs are coming down. The increased demand for box cars and center-beams is reiterated. There is some growing concern about railroad capacity, with equipment concerns the highest -- box cars and center-beams again. Overall, builders see the highest levels of business growth expectations since 2016.

The several boxcar and center-beam observations reinforce what I've been reading about lumber/panel supply and demand. Lumber prices per thousand board-feet have tripled in the last year. The 4x8 sheet of 5/8 inch plywood that cost ten bucks not that long ago now fetches something north of $80. Prices per thousand-board feet of dimensional lumber are pushing a cool grand. There are a number of factors at work.

Housing demand is at record levels as people flee the dense-population urban zones and tiny apartments for more *lebensraum* in the community and more living space as work-from home and home-schooling continue. Trouble is, the for-sale lists of existing properties get shorter as the influx continues and exurbanites already there stay put. The increased demand for a now-lessened supply of new single-family units drives prices skyward.

To be sure, the pandemic slowed the rate of new construction as the available labor pool shrank. It also made the mills short-staffed. All of which makes the materials costs of a new home rise quickly. Yet millennials are looking for smaller starter houses and retiring baby-boomers are downsizing, putting still more demand for more smaller houses.

So now you have a pull for newer, smaller houses on the demand side against a lumber and labor shortage on the supply side. Thus the spike in dimensional lumber and panel prices. Put all these things together and see why lumber carloads are in the doldrums. And slow transit times mill to lumber yard don't help.

The AAR *Rail Time Indicators* for Feb 5 says the Census Bureau reports 2020 had the most housing starts since 2006 yet railroad lumber and wood carloads in 2020 were the lowest since 2012 and the correlation between housing starts and carloads gets weaker and weaker. Tells me such lumber as is reaching the market is coming in by other means. Just look at the inventory risk: a thousand board feet bought for $1000 last fall could be sold onlyfor $500 in a matter of weeks.

Here's why that matters. The lane analysis tool at Rail Impact shows transit time, for example, Spokane to central Penna is roughly two weeks. A truck taking half that time certainly reduces inventory risk. And that's got to be part of the reason railroads are losing share in this fast-moving lumber and panel market.

Kansas City Southern's first quarter revenue units decreased only one percent to 555,400; merchandise carloads — total ex-intermodal and coal/coke — decreased 3.8 percent to 272,200 and represent 49 percent of total revenue units. Freight revenue decreased 2.7 percent to $672.6 million; merchandise carload revenue dropped 3.2 percent to $549.2 million. Average RPU dipped a point to $1,211. Total revenue fell 3.5 percent to $706.0 million.

Operating expense increased 2.3 percent to $453.0 million including $19.3 million in merger-related expense this year and $6.0 million in restructuring charges last year. On the call and in the presentation material, KCS backs these out to arrive at more favorable non-GAAP numbers. I don't do non-GAAP because everything in the income statement is a cost of doing business, merger or no. Thus I'm sticking with the GAAP operating income of $253.0 million, down 12.4 percent, net income up 0.8 percent to $153.0 million on lower taxes, and a 64.2 OR, 3.63 points worse.

As for the merger, KCS presents a time-line of its merger path from the first announcement last month to expected completion in mid-2022. They have received nearly 400 letters of support from customers, elected officials, transload operations, and short lines and expect a decision from the STB on the merger rules waiver request in a couple of months.

My conversations with other industry observers lead me to believe there is wide support of the transaction and very little opposition. I wish them well.