RAILROAD WEEK IN REVIEW
June 18, 2021

" @Economics this morning estimates that 52 percent of the May CPI increase was from used cars, rental cars, car insurance, lodging, airfares, and food away from home—continuing to support the idea that latest impulse largely due to short-term factors." — Liz Ann Sonders tweet, June 15

"You need to have a passionate interest in why things are happening. That cast of mind, kept over long periods, gradually improves your ability to focus on reality. If you don't have that cast of mind, you're destined for failure even if you have a high IQ." — Whitney Tilson

"Elliott Springs, President; Lucius Beebe, VP in charge of the Internal Audit; W. F. Halsey, VP in charge of White Horse Supply; Gypsy Rose Lee, VP in charge of Unveiling." — Lancaster & Chester Railway, Official Guide, June, 1953

"The combination of CN/KCS would make a big railroad even bigger, creating the third-largest of the North American railroad systems, and one that would be three times larger than CP (which would become the new smallest) in the U.S. But more important, in my judgement, it would eliminate some critical competition that now exists between CN and KCS, reducing the options for America's shippers and communities." — Former U.S. Sen. Byron L. Dorgan was a Democratic congressman and senator for North Dakota, Railway Age, June 16

How much is that railroad really worth and what are its prospects? The shortline or regional railroad operator has a vested interest in the future health of his interchange railroads. That future represents, if not a lifetime interest, one that looks out for more than five years. With that in mind, the feeder line owner needs to know his connections' prospects because their outlook for tomorrow will color the way they behave today. And how to position himself for bad behavior.

Accurately guessing traffic levels out just five years, let alone ten or 20 years, is well nigh impossible. On the other hand, the Class Is are emphasizing near-term shareholder returns over the long-term viability of the franchise, and from that we can measure and predict. Then one can approximate five-year returns assuming the railroad continues to behave as it has.

Start with "owner earnings." It's measure of how much a company earns in terms of what it takes to keep the franchise running profitably. Start with net income, add back depreciation, and subtract capex. The capex-depreciation relationship is especially important with railroads because every time a wheel turns something wears out a little more — railheads, ties, locomotives, cars, and so on. Depreciation is really a savings account to make sure one has funds available to replace what's worn out.

Class I owner earnings 2016-2020 increased in a CAGR range from a high of 38 percent (CSX) to a low of three percent (CN). Included are share-counts to account for the buy-back programs; BNSF just uses net income because there are no shares as such. By applying the five year CAGR to the Dec 31, 2020, share price, one can see where it might be in five years.

Finally, there is the “margin of safety” — how much one pays today for a dollar of owner earnings five years out. The best buy at the moment is CSX at $0.72; CN brings up the markers at $0.97. (FWIW, that dollar in owner earnings at CP will cost you 90 cents and at KCS 81 cents). Which says loudly that none of the railroads are screaming buys, though CSX gets closest at 72 cents. The question then becomes can the present momentum be sustained for five years?

The best way to improve earnings is to cut expenses and raise prices, both of which impact regional railroad customers. We see daily examples of customers moving to trucks because the cost-benefit ratio of Class I “service” goes against their supply-chain goals. And since the local railroad service product is only as good as that of the connections, it behooves the local operator to keep close tabs on Class I trip-plan and pricing performance, being ready to nip in the bud any trends working against the local customers’ best interests.

The most successful feeder line owners think beyond trackside. Think of a steel fabricator located a short distance from the regional rail head and hundreds of miles from his sources of rolled steel coils. Extending an existing industry track was not an option, so truck all the way was the obvious solution for the fabricator. Happily, the railroad’s nearby shortline business development team had other thoughts.

First, they determined with the customer exactly what they should need to unload steel coils from a gondola. Using their network of MHE (materials handling equipment) suppliers, they found a power-shovel type device that could be outfitted with hooks to transfer the coils from the car to a waiting flatbed truck.

Then they needed to create a 600x40 transload pad as there was nothing like it on the railroad. Once a suitable site was identified, they put down 850 feet of new rail and a switch off the main to complete the transfer site. The site worked so well that in a couple of years they added 400 feet of track and paved transload space to accommodate this growing customer. Bottom line: this railroad investment of time and money (no outside funds, thank you) is generating upwards of 200 carloads of new business for this regional railroad.

South Carolina’s Lancaster & Chester Railway has a come a long way since the days of Elliott Springs and his “Springmaid Line.” Now part of the Gulf & Ohio family of short lines, the L&C has become a local logistical powerhouse with some 62 route-miles of track, serving customers in agricultural products, steel fabricating, chemicals, and forest products, and others. In addition, the railroad boasts more than 3,000 acres of industrial-zones property and is just an hour’s drive due south from the Charlotte, NC airport.

This week L&C announced plans for a $423 million Gallo production and distribution facility. Construction on the new facility is set to begin almost immediately, with the first phase of the project on track to be completed in October of 2022.

According to the Gallo press release, "Providing bottling and canning capacity as well as warehousing and distribution for the company's growing portfolio of wine and spirit brands, the new South Carolina facility will allow Gallo to better meet customer demand on the East Coast, and, given [this location's] proximity to the Port of Charleston, this new facility will also serve as a hub for Gallo's import and export business."

When ultimately completed, perhaps 15 years from now, the facility will have over 7 million square feet under roof. When Phase 1 is completed in October 2022, the facility will see between 3,500 and 5,000 new carloads annually. Gallo's site requirements included being on a short line with dual access so they could get the kind of service that cannot be provided by a Class 1. Kudos to the L&C for landing this significant piece of new business.

Lumber prices are returning to some degree of sanity, according to a recent story in the *Wall Street Journal*. The standard 1000 board-feet unit has dropped to a mere thousand dollars vs. $1,700 last month. Says the paper, "The rapid decline suggests a bubble that has burst and the question is how low lumber prices will fall… During the run-up, wood was hoarded by builders, retailers and others worried about running out of material during a construction season set into overdrive by low mortgage rates and federal stimulus payments."

As supply and demand resume somewhat of a normal relationship, lumber producers foresee prices per MBF in the $700-800 range through next year. From a railroad point of view, it appeared the extremely high lumber prices could slow growth in carloads, so I asked shortline clients what they were seeing, and where this week's news was making a difference.

A west coast shortline owner writes, "Now that the prices are softening, builders are continuing to buy for projects two to three months out, trying to lock in on prices. Lumber carloads were slowing down over the past two weeks and now is picking back up." And from an eastern short liner comes a note that confirms my suspicions: "Some drop in volume. No one wants to buy a carload of lumber and then see the price drop before it's sold."