

RAILROAD WEEK IN REVIEW

December 2, 2022

“The Fertilizer Institute attributes the erosion of cycle times to implementation of PSR, which has had several consequences, including eliminating too much rail carrier personnel, idling of locomotives, and closures of service yards, all of which has compromised rail carrier operational elasticity and the ability to handle unexpected issues.” — Justin Louchheim, The Fertilizer Institute, STB hearings, April 26

The message never changes. Oliver Wyman’s Rail Practice Partner Adriene Bailey opened her *RailTrends 2022* presentation, “The Growth Story: Rounding the Bend,” with upbeat quotes from three Class I CEOs: Alan Shaw of NS, Joe Hendricks from CSX, and CN’s Tracy Robinson.

We’ve been hearing these comfortable words for years yet the railroad transportation product hasn’t improved that much if measured by carloads and shipper testimony at the STB’s April 2022 *Urgent Issues* hearings (WIR May 6). Bailey gets right to the point in her slide 8:



01 Rail CEOs/COOs are not articulating how fundamentally different the required end state must be or outlining credible plans to get there	02 Softening demand will create additional cost cutting pressure, potentially setting back the transformation to a truly customer-centric offering	03 Rail CEOs have not yet convinced investors that growth is the way to maximize the value of rail franchises	04 Regulators are failing to support important initiatives for the industry – which is an epic failure of public policy
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All four items relate to regaining railroad relevancy, a term a used in a NEARS shipper panel years ago. I’d put items 1 and 3 at the top of the list. And I’d like to see the CEO sound bites in slides 2-4 gain more traction so the walk matches the talk.

Re item 3, I first introduced the subject of “financialization” in 3Q2018: “When a company gets financialized, the owner is replaced with a management team, and the management team’s job is to get this thing prepped for float on the stock exchange, which is how they're going to make money... The Cult of the Operating Ratio, which I wrote about here August 3, is one manifestation.”

Based on figures from the railroads’ 10-Qs, CAGRs for revenue units over the past five years have declined five percent, and total revenue is essentially unchanged. Operating income is up a few basis points and net income did somewhat better. Long term debt as a percent of shareholder equity has increased by half. Not a picture of health.

Bailey notes in her Slide 18 that the current US DOT forecast “grows rail net ton-miles by 0.8 percent CAGR through 2050 and is likely overstated.” She cites four particular challenges to deliver growth. Run forward comps off the present downturn, convince investors of the value of growth, foster a supportive regulatory environment, and acknowledge the need to improve the rail transportation product.

I think the STB’s Oberman et al can provide that supportive regulatory environment where rail service metrics are outward rather than inward looking. Wall Street can help by putting less emphasis on quarterly EPS gains by any means and more on growing the customer base. Railroad boards of directors need to shift the focus from growing the value of stock options to increasing operating income by other means than rate hikes, fuel surcharges, and reducing headcount.

Then at next year’s RailTrends perhaps we can hear Adriane Bailey talk about how the railroads have made themselves relevant once again.

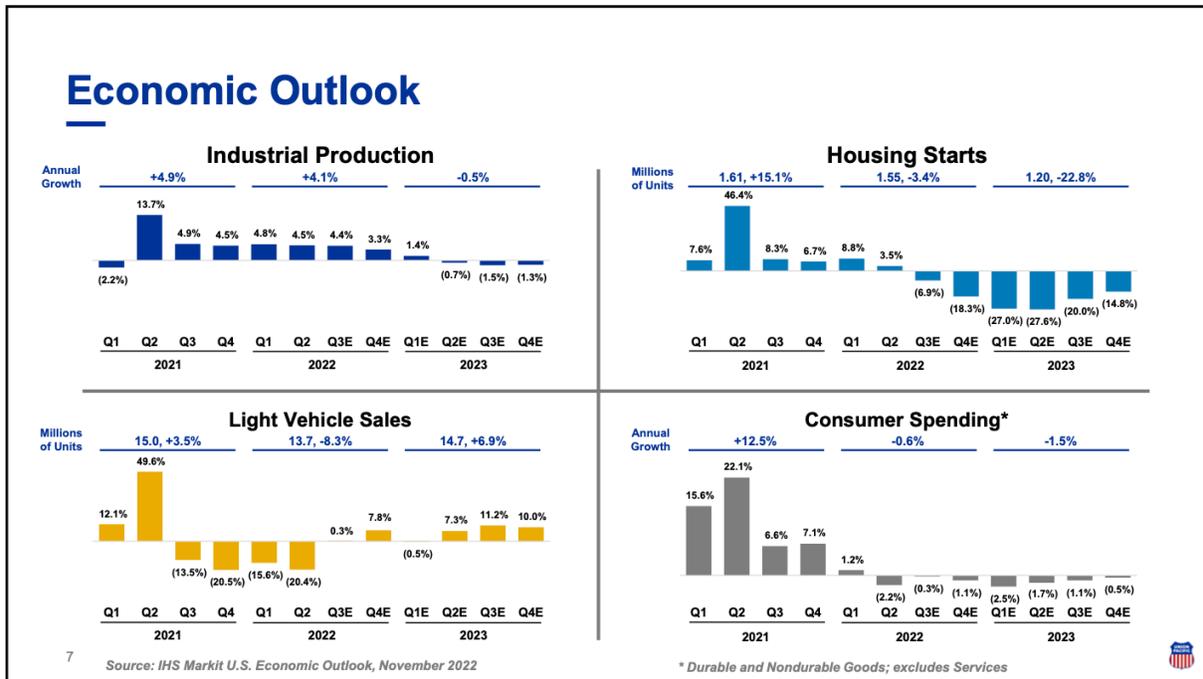
As for the unpleasantness regarding a railroad strike, non-Class Is can always do three things to minimize the impact of interchange irregularities on themselves and their customers -- with or without a strike.

(1) Get inbound loads emptied ASAP so you can get car hire for those empties back on the the Class I clock. (2) Advise customers to advance-order inbound material to keep supply chains full. (3) Encourage customers to get empties or outbound loads off your line promptly by releasing them back to you when their work is done.

Last Monday’s stock market sell-off can be attributed partly to recession fears. Any railroad shutdown would have only made matters worse. You saw the pix of Black Friday shoppers with carts loaded to the gunwales with goods. A rail stoppage would no doubt

have lessened shoppers' options and exacerbated recession effects. So it's imperative short lines keep their own houses in order and give customers the tools to minimize the double whammy of wobbles at the interchange and a recession.

Union Pacific CFO Jennifer Hamann told attendees at Wednesday's Credit Suisse Global Industrials Conference that even as the railroad is operating better, the outlook for carload freight isn't all that exciting. This chart says it all.



The merchandise carload sector depends heavily on both housing starts and industrial production. You've read elsewhere about too many houses being started a year ago and the painful increases in mortgage rates this year. So much for STCC 24 and related.

The latest Purchasing Managers Index (PMI) is hovering right around 50, the break between good times and bad. Add to that the just-resolved strike threat that had already caused customers to seek alternatives, and the Fed's saying we're not yet out of the recession woods, it's time to prepare for slim pickings in carload freight.

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