RAILROAD WEEK IN REVIEW
September 20, 2024

"US refinery utilization remains elevated, a consequence of significant post-COVID turnarounds that have supported several management commitments to improved mechanical availability. Watch the gap between miles driven and implied gasoline demand as an underlying trend that might support the idea that US gasoline demand has peaked." — OPEC Turns 64, Wolfe Research, September 15

"D.R. Horton's stock surged on July 18 after the homebuilder released its fiscal third-quarter financial results. With the average 30-year fixed mortgage rate around seven percent, affordability remains challenging for many prospective homebuyers. Horton continues to benefit from its relatively affordable price point compared with other builders." — Morningstar, July 19

"We believe that the industry is increasingly focused on profitable growth moving forward. It's also worth noting that the two rails with the worst operating ratios currently – BNSF and NSC – have actually lagged CSX and UNP on volumes over the past five years. There's no evidence based on data that better margins are coming at the expense of volumes." — Scott Group, Wolfe Research, before the STB, September 16

When writing a newsletter like this, you always run the risk that the input for your output is wrong. Last week I wrote, "Looks like UP, alone among Class Is, has re-started its shortline meetings." I had hardly hit send when ASLRRA President Chuck Baker sent an email correcting my error in saying, "UP alone Class Is…"

Chuck writes, "NS had a large shortline conference in May 2024. I was there. It was in Atlanta at their HQ. It was very similar to the UP Conference that I was at in Omaha earlier this month. CSX has theirs every September in Ponte Vedra. I was there last year and am going again next week. It's also essentially the same thing as the UP one. CN did their first one in many years last October 2023 in Homewood. Their next one is tentatively scheduled for spring 2025 in Montreal. They are not regional."

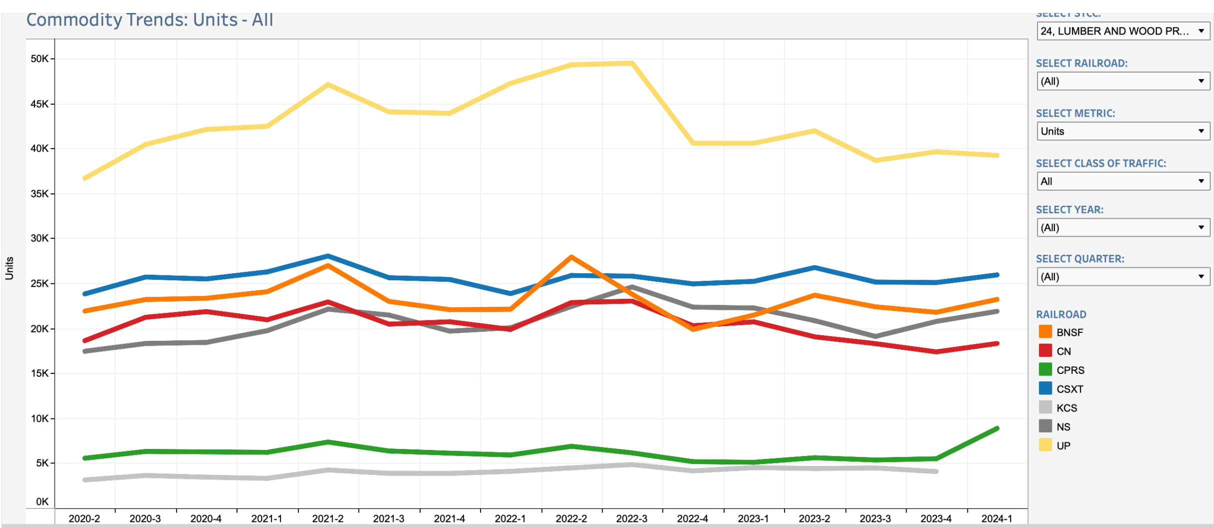
This comes as a very welcome correction. At a time when railroads are being chastised for poor service, the short lines' strength in creating sticky customers is well known. These meetings give the Class Is a chance to outline their goals and short lines/regionals a chance to show how they can support these goals. The STB discovered a couple of years ago that Class I first-mile/last-mile performance was lacking, and it is in this very area that the non-Class I roads excel.

I think the ability to include shortline placements and pick-ups in the trip plans is essential. That way a trip plan is initiated when the local hauler's customer releases a car. The short line/regional transit time and the dwell at the Class I interchange becomes part of the trip plan and door-to-door compliance is measured accurately.

So I'm heartened to be reassured the Class Is' annual shortline get togethers are alive and well. I'm sure that crisp first-mile/last-mile performance numbers will go far to improve rail industry service to a proper level.

From Seeking Alpha: "J.P. Morgan analysts continue to be positive about homebuilding stocks although less constructive towards building products. Shares for homebuilders are up an average of seven percent in J.P. Morgan's universe. 'We believe the homebuilding stocks should continue to benefit from solid fundamentals, including a still-favorable demand/supply backdrop, in particular driven by fairly tight supply across the broader housing market,' wrote JPM analyst Michael Rehaut in a note."

According to Railinc's carload survey of non-Class I railroads (WIR Sep 6), STCC 24 lumber and related wood products account for roughly three percent of total revenue units in this universe and are up seven percent year-to-date. Among Class Is, BNSF is the leader by far with some 40,000 annual loads.



As you know, the rate of housing starts is greatest in the US southeast and southwest, so it follows that CSX and NS have a place at this table.

Shares of the XHB Home builders ETF have been on a roll as well. This is an index of major homebuilder share prices — Horton, Pulte, KB Home, Toll, etc. Naturally, they are major consumers of everything from studs to shingles, so the level of activity here is a likely mirror of the lumber business.

The chart (—>) starts in April. The blue line immediately below the chart is the RSI, now approaching over-sold levels. Not shown is the On Balance Volume, also on a nice uptrend.

In their 2Q2024 earnings release CSX reported an increase in forest products carloads due in part to “higher shipments of building products.” (BNSF did not provide that level of commodity data in their 2Q2024 reports.)

In short, it appears to me there will be places where STCC 24 will do well. Knowing how well in advance depends on how well you know your customers.

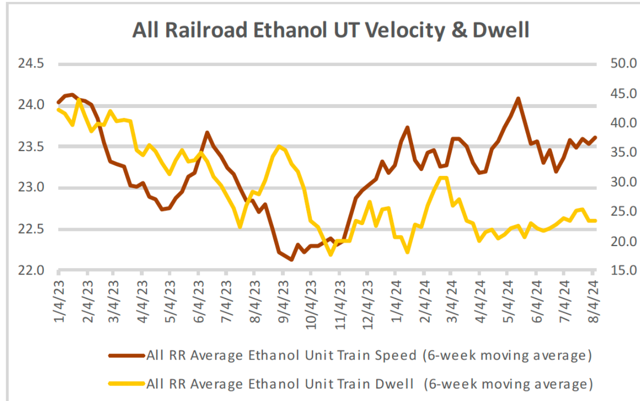
The STB on September 5 issued its Decision EP 775, “Growth in the Rail Industry,” scheduling a September 16-17 hearing on “recent trends and strategies for growth in the freight rail industry.” I thought the testimony of the the country’s largest biofuel producers, Growth Energy, by their SVP of Regulatory Affairs was telling. Excerpts:

“Growth Energy represents nearly 60 percent of all U.S. ethanol production, including 98 bio-refineries plus 121 other businesses that support biofuels production and the supply chain… [The US has] 210 bio-refineries in 27 states with the capacity to produce more than 18 billion gallons of ethanol, now ten percent of our nation’s fuel supply.

“We depend on timely and efficient rail service. About 70 percent of our production moves by rail — the largest hazmat commodity shipped by rail, with an average of more than 100,000 carloads a year using a fleet of about 34,000 cars. We ship more than 200,000 annual loads of distillers dried grains and more than 10,000 cars of corn oil.

“In 2022, average dwell time for ethanol unit trains increased, average rail speed decreased, and average number of ethanol-loaded cars not moved increased — all negative trends that contribute to added costs and other negative consequences throughout the entire biofuel supply chain.

“Given that inconsistency, many in our industry have sought to add additional rail cars, if available, at considerable cost. One day of lost service in a month would require the addition of 1,200 tank cars and 550 hoppers to replace that lost volume of ethanol and distiller dried grains.



“Solubles [are] another 36,000 tank cars; DDGs add 200,000 covered hoppers. To purchase 1,200 railcars at a conservative cost estimate of $170,000 per car—if they could even be found in a timely manner — would require our industry to spend $180 million a year for rail cars that, in normal operating circumstances, will sit idle as under-utilized assets.

“Rail rates have continued to increase, and service continues to be inconsistent… If our plants do not meet the railroads’ needs in a timely manner, a railroad can and will assess demurrage fees. Conversely, if power or labor from the railroad are delayed, our plants do not have the same ability to assess fees or receive any sort of discount or other remedy.

“These growth opportunities for biofuels and American agriculture can also offer tremendous growth opportunities for freight rail as well. However, that is all dependent on timely and efficient rail service being able to deliver significant increases in rail traffic. For example, if we moved current ethanol levels of E10 fuel to E15, we would add nearly 7 billion additional gallons of ethanol and nearly 2.5 billion additional bushels of corn – essentially a 50 percent increase in total volume.

“Taking recent trends in carload data into consideration, we would need the ability to move an additional 200,000 carloads of ethanol beyond what our industry is shipping today.” And there’s more. The testimony texts are on the STB website.

Industry averages suggest a carload of ethanol moves 800 miles on average at a freight rate of $3,000-plus. That additional 200,000 ethanol loads would then be worth perhaps $600 million in new revenue. Given that all this moves in unit trains of leased equipment, margins would be quite handsome. So why aren’t the Class Is doing it?