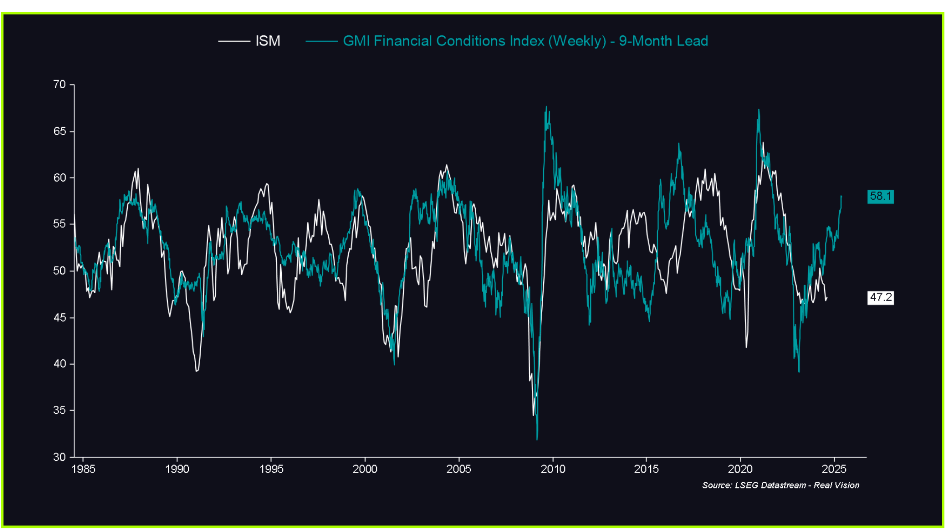
RAILROAD WEEK IN REVIEW
September 27, 2024

“It’s time to start to move away from the 20-year strategy of price-driven operating ratio reduction, given the pricing story has faded. A consequence of this strategy has been negative volume growth and the declining relevance of the railroads in the US economy.” — Rick Paterson, Loop Capital, September 20

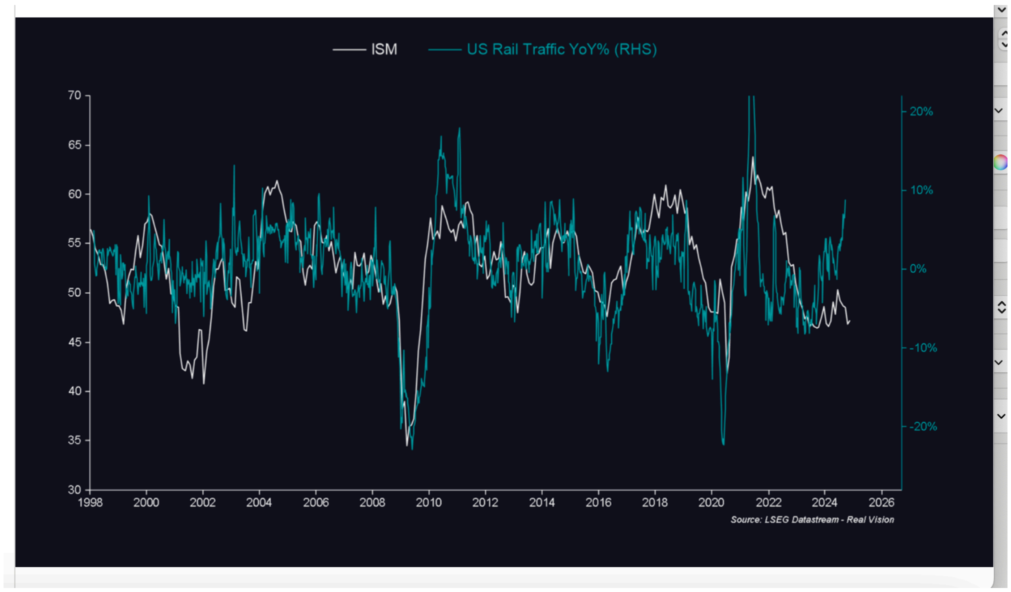
“Will Wall Street change its focus from profits to growth? That is not the right question. Can railroads and their managements implement strategies that provide the kind of service that increases volumes, takes trucks off the highways, and increases profits? If the answer is ‘yes,’ then Wall Street will follow.” — Dr. William Huneke, former STB Director and Chief Economist, railwayage.com, September 23

“Shippers focus on the total cost of doing business with a carrier or transport mode. Freight rates are still important, but shippers now factor many other considerations into their choice of a carrier or mode, such as safety stock, warehouse productivity, inventory turns, billing accuracy, problem resolution speed, shipment visibility, and timely and accurate data reporting.” — Adriene Bailey, Oliver Wyman Partner, September 20

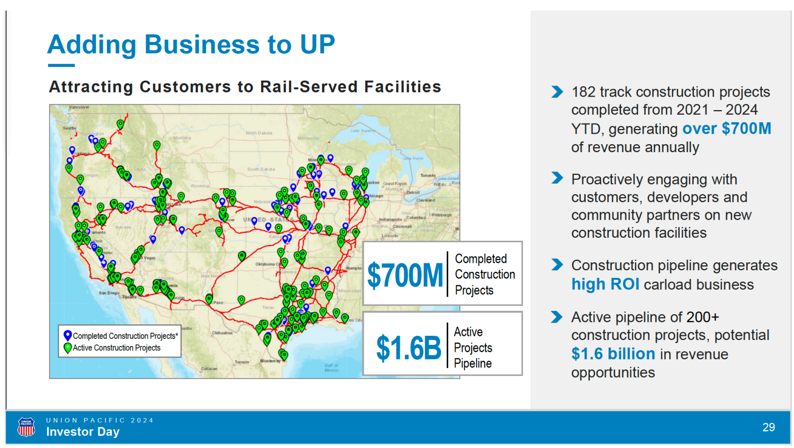
I’ve written before about the ISM having to be >50 to indicate more favorable business conditions. My friends at Global Macro Investors (GMI) publish charts like this every couple of weeks, keeping one well ahead of where rail traffic volumes are probably heading. Here, GMI is saying the ISM could hit 60 by mid-2025, clearly in expansion territory. From this one might conclude a survey of customers re their goods movement outlook is in order. Take this chart with you as a talking point.



And another thing: the Dow Theory says changes in rail traffic are leading economic indicators of economic activity. The rationale is that as the economy heats up so does the need to have goods in place to feed the improving economy. See how the blue line pattern below matches the blue line in the above ISM chart.



From this one can conclude we ought to be coming out of the present traffic volume soft patch starting in 4Q2024. At UP's Investor Day last week, the theme was "The Pursuit of What's Possible." I found the remarks of Kenny Rocker, Chief Marketing Officer, most encouraging. Building the business means creating customers, and Rocker really nails this one.



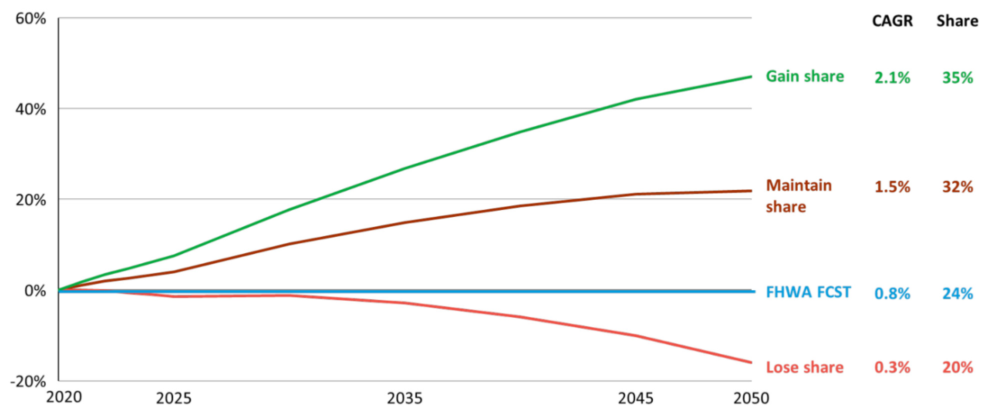
Yes, it looks good, but… says Loop Capital's Rick Paterson, "Compared to prior UP strategies, it felt like more of the same and the result is probably going to be the same — a lower volume business by the time we get to the next Investor Day. We can basically write up Jim Vena's legacy as UP CEO right now: 'Improved service a bit but didn't change Union Pacific's poor volume growth trajectory.'

"Sorry, but that's how we see it. We like how Mr. Vena speaks about growth and his 'coal is no excuse' mantra, but from our vantage point the strategy looks underwhelming relative to the problem. Prove us wrong."

It's just possible UP can do exactly that. Some years ago working with UP on behalf of shortline clients, we created new customers and carloads by planning everything from loading dock times to intermediate dwell. The secret sauce was trip plan compliance. If it was in their genes then, it must still be there.

Speaking before the recent STB rail traffic hearings, Oliver Wyman Partner Adriene Bailey noted that "Class I rail volumes have not materially grown over the past decade. Indeed, rail is the only freight transportation mode that has lost overall net tons since 2017. Rail moved eight percent fewer total net tons between 2017 and 2023, while truck increased net tons moved by three percent."

Exhibit 1: Possible Growth Trajectories for Rail Market Share to 2050
Percent deviation from US DOT forecast of revenue net-ton miles



Source: US DOT forecast of rail revenue net-ton miles as per FAF 5.4, Oliver Wyman analysis to calculate deviation based on rail market share scenarios

She cites a DOT study that projects that rail will have the slowest growth among freight transportation modes through 2050 – which means that railroads are predicted to lose share to other freight modes over that timeframe. She concludes, "Shippers we surveyed found truck to be superior to rail on all attributes of customer experience. They want to do more with rail because of its advantages, but the product and usage experience simply are not meeting their supply chain needs." QED.

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