



SWARS 2021: Railroads – and the Nation - in The Age of Disruption

(Still) Lockdown/NYC

But I think '21 is going to be a
good year....March



Wash Your Hands!

- Stay safe
- Stay healthy
- Stay at home if you can
- Railroads are Essential (of course)
- Thanks to Clients & Subscribers!
- See report on Rails & Covid-19 – Long Term Impacts
(A Virtual “Discussion” with RR Leaders & Strategists”)
- This is big, but....
- ... *This Too Shall Pass!*

Rails Top 10 2020-21

1. Covid (duh)
2. The Shark's Tooth
3. Uncertainty/Visibility/(Lack of) Guidance
4. Accelerated (Not Altered) Trends
5. Intermodal!
6. Zooms and (Rail) Trends (MARS21)
7. Technology – from Portals to Pulses: Tu Simple!
8. ESG
9. Ag
10. Globalization/Slowballization/De-Globalization
11. (one good thing about 2020



Recurring and Accelerating Rail Trends

(Not to be confused with RailTrends November 19-20!)

- > The Mix Shift Towards Higher Levels of Service

- > The Parallel Faster Decline of Coal

- > The Continuation and Success of PSR

- > The Continuing “Cult of the OR”

- > The Continuing Fight over FCF – Share Buybacks “vs” Capex

- > The Consistent “Hype” of EV & AV Highway Competition (response?)

- > The Remaining Importance of Trade (and Tariffs Remain)

- > Solid Financial Results/Good Cash Flow & Capital Access

- > The Continued Lure of M&A in short lines/regionals

- > The Continued “Hype” on the Value-Trap of Rail Consolidation

5 Enduring (?) Railroad Competitive Advantages

1 Labor Advantage

(ex: Double-stack LA-Chi – or Rupert-Toronto)¹

2 Fuel Advantage

(4:1 ton/mile; AAR)²

So 2A is Environmental Advantage (see....WMRT, Unilever, etc.)

3 Infrastructure Advantage

(after the IHS buildout; user-pay and capex to support changing logistics patterns – ex: transcon)³

4 Railroads' Excellent Financial Condition, Liquidity, Free Cash flow

5 Railroads' Historic Ability to Reduce Expenses in a Known Slowdown (2009, 2020)⁴

1. AV trucking?; 2. EV Trucking?; 3. Infrastructure Bill? (LOL); 4. Newly Added (in response to C19)

Critical Rail Discussion Points/Lessons: RailTrends 20

Trends accelerated by C19	Energy	Technology	Intermediate Term	Off Network Issues
Ecommerce		Threat & Opportunity	What comes after "Inventory Re-Stocking"? What is Secular vs. Cyclical vs. Pandemic?	Regulation, M&A, Short Lines, Succession, Post-Election (Trade), etc.

2020 - What a Year of Change!

Percentage Change in 2020 Class I Railroad Traffic				
Railroad	Total	Intermodal	Carload	Coal
Canadian Pacific	-2.2	0.3	-3.7	-14.5
CSX Transportation	-5.7	1.5	-6.8	-25.8
Canadian National	-6.1	-1.5	-9.2	-13.6
Union Pacific	-7.0	-4.0	-7.3	-22.0
BNSF Railway	-7.6	-1.4	-9.5	-22.0
Norfolk Southern	-11.9	-5.9	-13.3	-37.0
Average	-6.8	-1.8	-8.3	-22.5

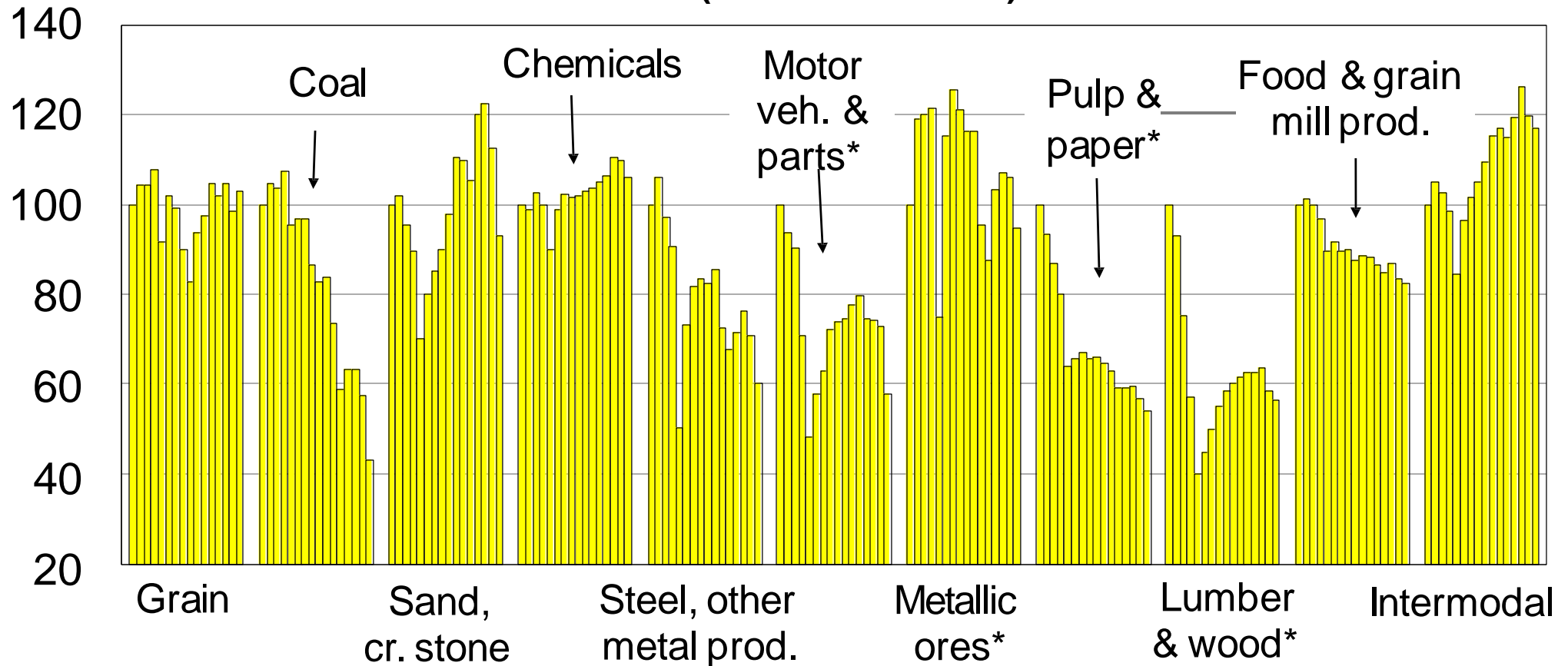
Source: Weekly AAR carload reports. Carload includes everything except coal and intermodal.

New Administration: A Return to “Normalcy”?

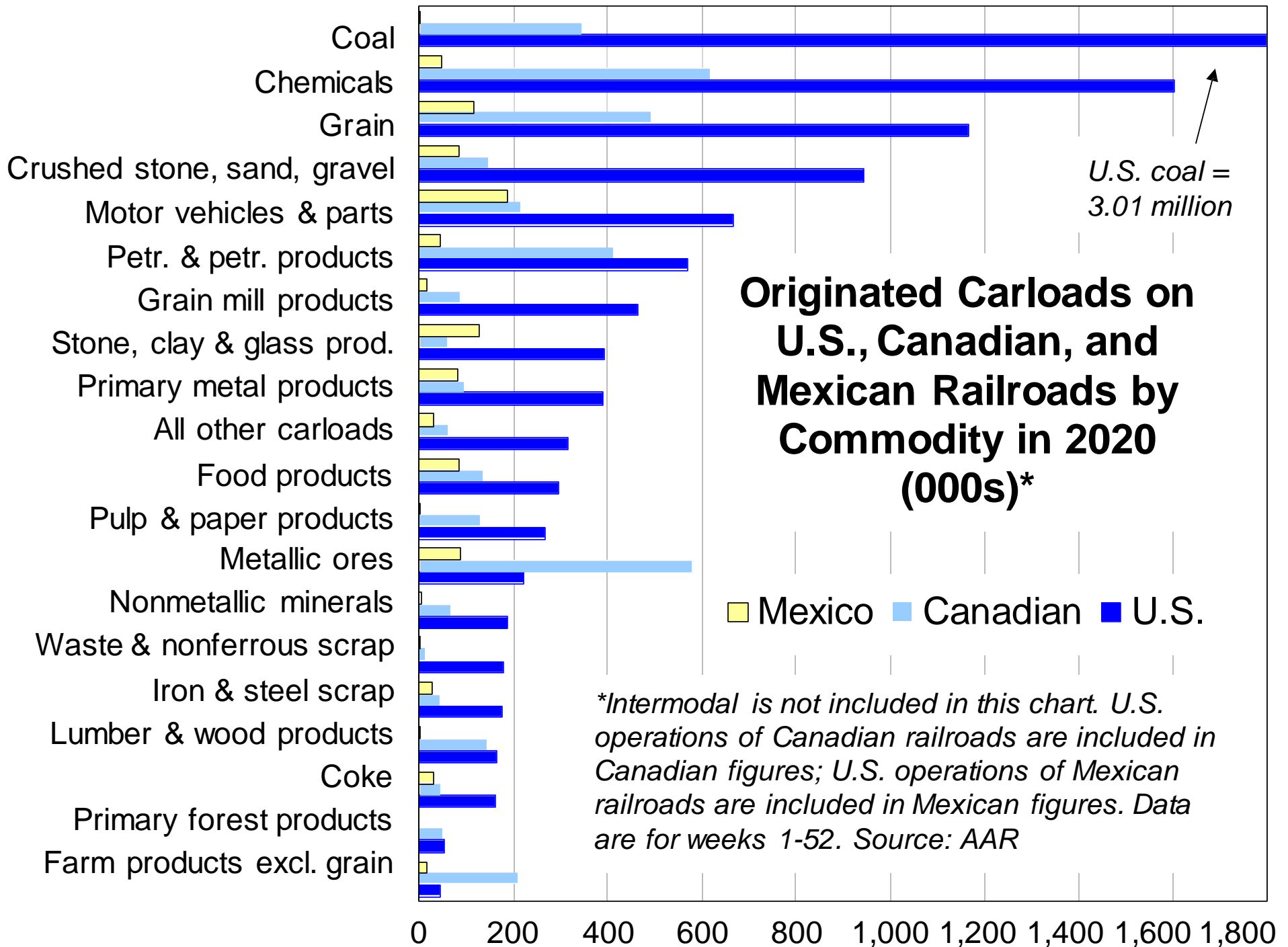
- STB Impact?
- Infrastructure?
- Crew Size!!
- Emissions, etc.?
- Ethanol?
- Amtrak & Passenger?
- Trade!!

Commodity Fluctuations

Annual Rail Carloads by Commodity: 2005-2020
(index 2005 = 100)



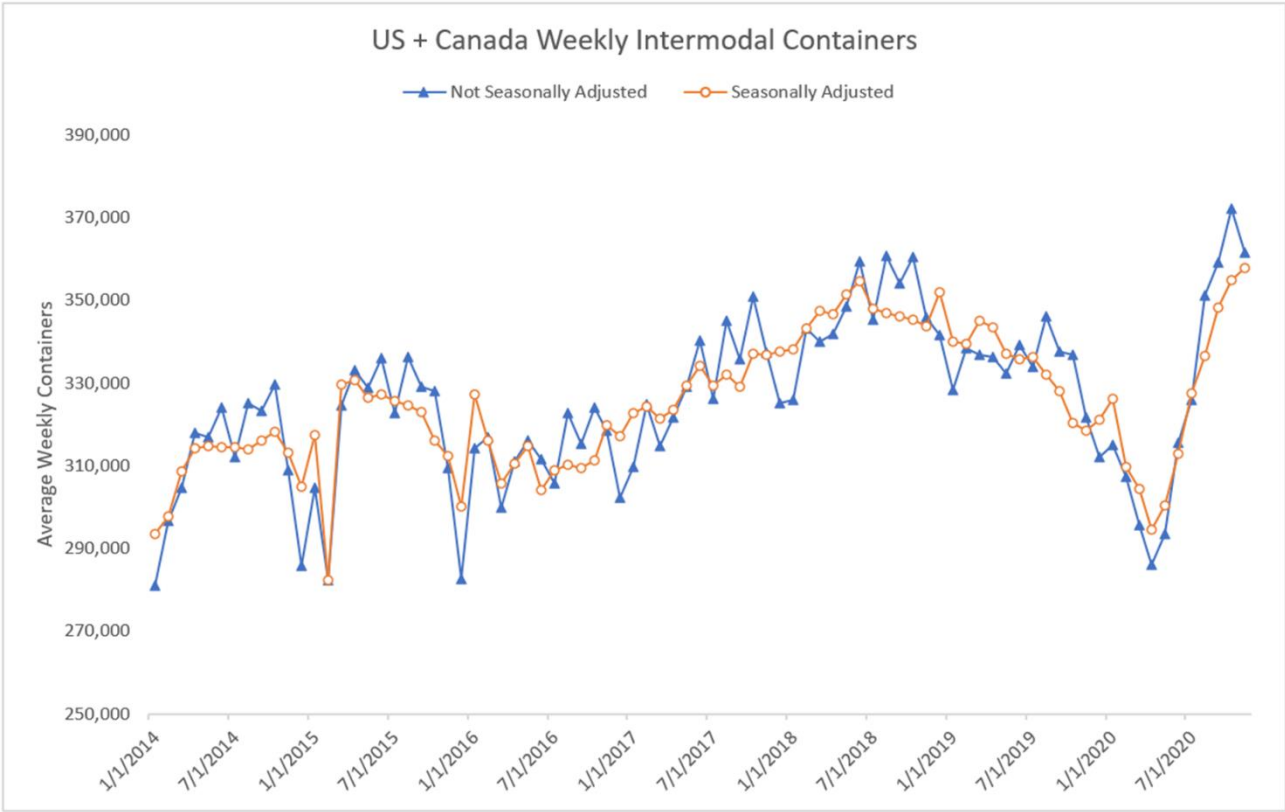
*Combined U.S. + Canadian carloads. If petroleum products were shown on this chart, its index would rise from 108.1 in 2010 to 259.4 in 2014 down to 161.9 in 2017 and up to 214.73 in 2019. Source: AAR *Rail Time Indicators*



Emerging Themes for Rail Investors

- ESG (see TCI and CP, CNI, UNP)
- Technology
- Growth (really!)
- STB?
- Re-mapping the east
- Short Line Boom continues
- Great to see the back of 2020
- But rails handled it decently well, from both an *Operating* and *Financial* perspective
- *Avg FY20 OR 60.4%; -150bps*
- Q4/20 was *solid*; Guidance re-established

From the AAR and MSU: Intermodal!



2019 Volumes Were Scary

**What's the cause (beyond "tough comparisons")?
How to allocate into the 6 buckets?**

1. *Economic Slowdown – in USA/Mexico (only?)*
2. *Continued Trade Distortions* and Market losses (from soybeans to electronics)
3. *Trucking overcapacity* (what a difference a year makes!) – Investors are questioning the very nature of the IM Value Proposition!
4. *PSR* – inadvertent or planned share loss (ex. CSX – and now, UP - IM)
5. *Lingering weather impacts* on operations (and on crops!)
6. So – 2020 will be the new "base year" - RIGHT?



Coal Continues to Slide



% Share U.S. Electricity Generation

	2000	2005	2010	2015	2019	2020*
Coal	52%	50%	45%	33%	23%	19%
Natural Gas	16%	19%	24%	33%	38%	41%
Nuclear	20%	19%	20%	20%	20%	20%
Renewables	2%	2%	4%	7%	11%	12%
Hydro	7%	7%	6%	6%	7%	7%

*Jan-Oct Source: EIA

Dealers' Choice? Deal-Fever in Short Lines (Still)

- Many small recent deals (by OmniTRAX, RJ Corman, etc.)
- Watco-Dow deal a new prototype?
- On the market: US Steel lines, Pan Am Railway
- Off Market & Smaller Deals (ex. SLGW)
- Spanner in the works? Problematic CSX-CN "Massena Lines"/STB
- Buyers (all with different CoC, timeframes, ROI expectations):
 - Strategic (above)
 - PE (and PE/partner)
 - Infrastructure Firms
- KSU and Infra? KSU and Class One?
- Class Ones as sellers (CN?) and/or Buyers (CP-CMQ, CSX-PAR?)

KSU Shows Up on the Rumor Mill (Again)

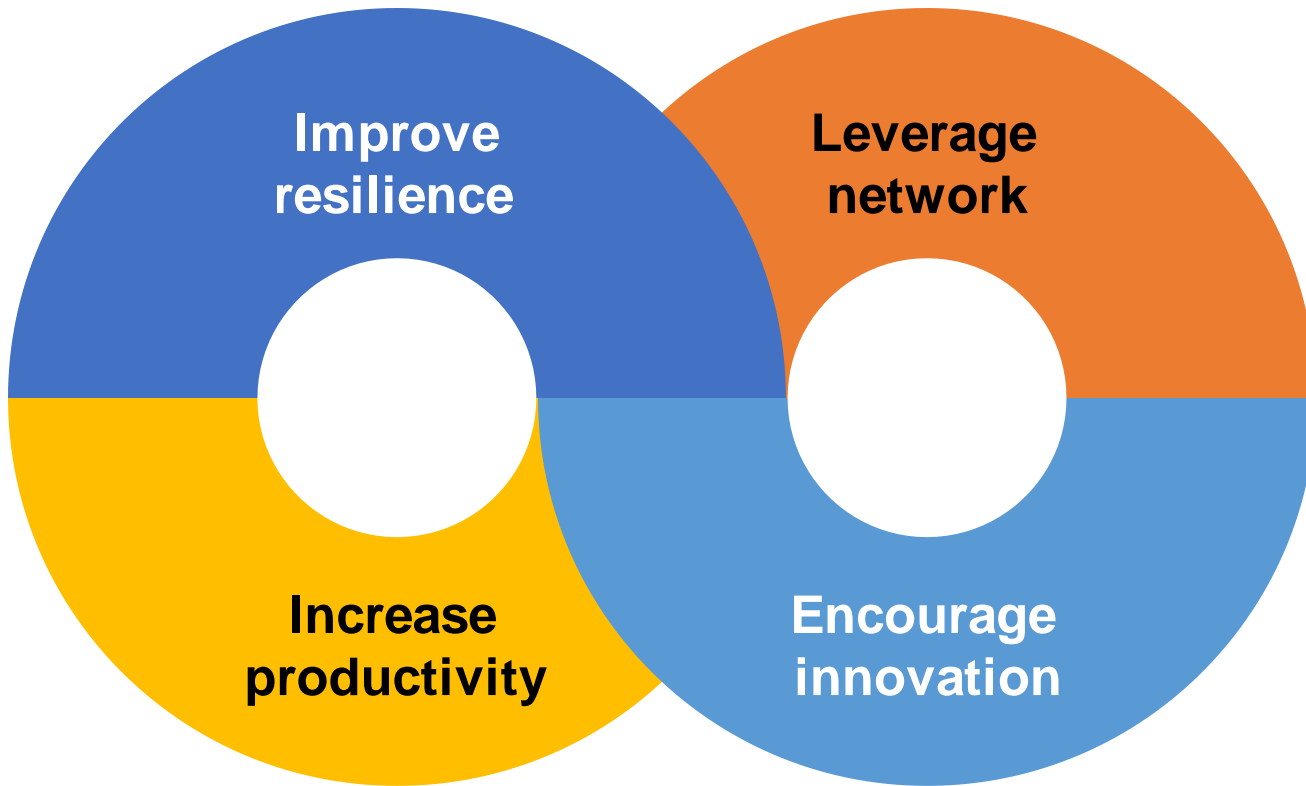
- Sized right for Infra (other C1s too big – so *this, if true*, would NOT be the start of a trend (rather, the culmination of a trend in regional rails))
- A financial deal doesn't require STB approval, nor change the competitive landscape much, if at all
- Infra funds can provide capital (“velocity of capital” – KSU *generates* plenty of capital)
- Infra Funds remove companies from the Q-to-Q –
 - Despite “Cult of the OR”, rail investors are actually patient
 - But advantages of LT strategy are apparent in dealing with opportunities & existential threats
- The rumors this time were *specific*: Blackstone & GIP (so who leaked?)
- And then the old-C1 rumors re-emerged....

Some Railroad and KSU Consolidation Thoughts

- RR Consolidation isn't simple (see IT/operational/cultural integration)
- RR Consolidation history isn't pretty
- RR Consolidation will be opposed – shippers, unions, regulators
 - See the aborted CP-NSC effort
 - See active STB on CSX-CN “Massena Lines”
 - See Newly-Active Mexican regulator; AMLO
 - Doesn't meet the “Matt Rose” provisions – failing/flailing railway, shipper need for capacity
- Risks – Access, other deal-breaking provisions
- Mexican Risks – AMLO, PEMEX, near-shoring “hype”

Coming Highway Challenges

- Attack on Fuel Efficiency – EV, Platooning
- Attack on Labor Efficiency – easier driving to full AV
- Oliver Wyman – (worst case) 1/3 of the rail/IM base at risk
- Momentum – EV and AV “in the news” on the daily
- Matt Rose’ advice – Rails have to do it on their own; Silicon Valley is working for the largest (i.e. truck) market
- Momentum lost – C19, short term shareholders, loss of key rail advocates
- Legislative Challenges (helping AV-Highway; hindering AV-railway)



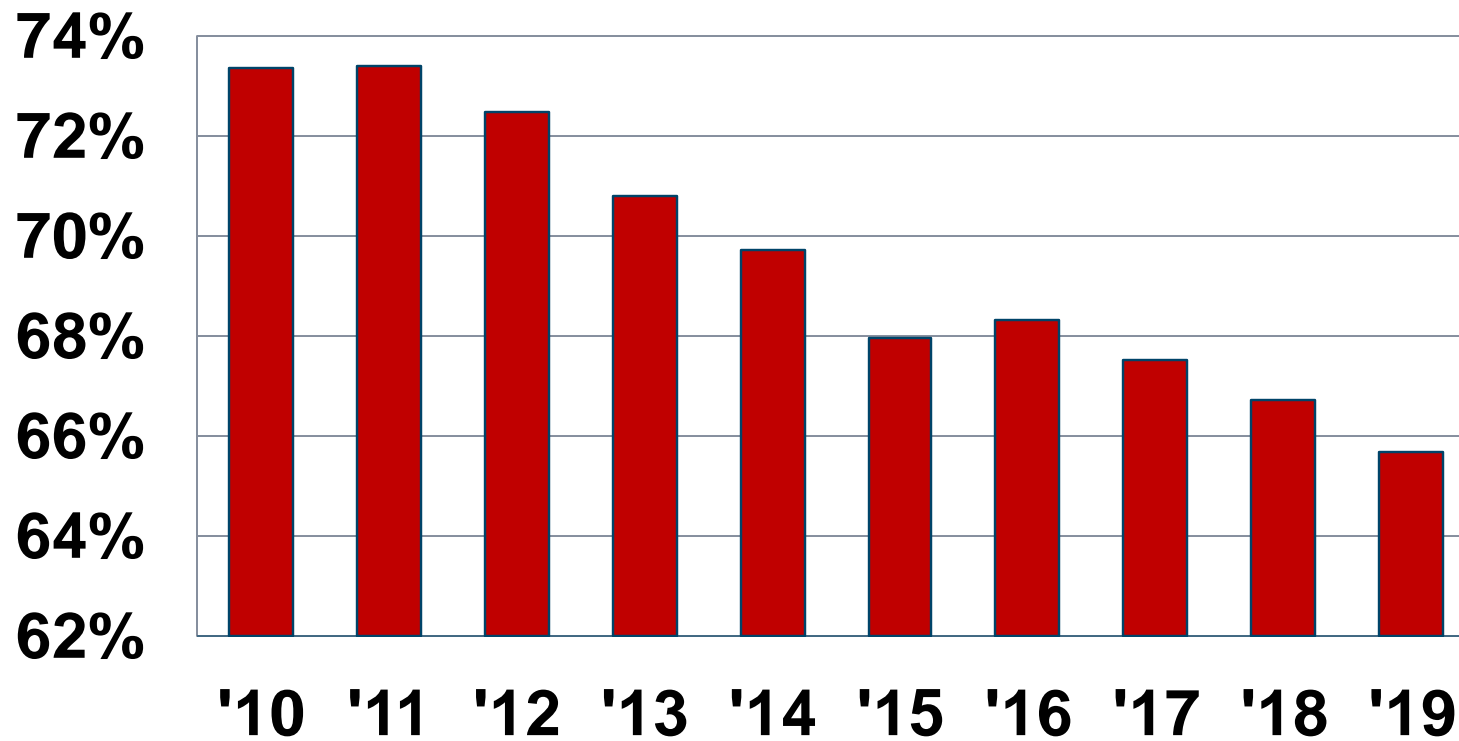
Response Has Been Muted – At First

- PTC completed (almost) – provides the potential “backbone for the digital railway”
- Offense or Defense?
- Many successes on the Operations side – *defensive* measures like Car/Track inspection
 - which does lead to lower costs/greater consistency/more capacity – all of which can be sold “offensively”
 - Most CIOs report to the COO
- Chief *Innovation* Officer – KSU
- Efforts on Fuel (thus Emissions) Efficiency (ESG tactics)

But Rail Tech/Innovation is Accelerating (T10)

1. Inspection Portals (from CN to the world)
2. Track Inspection Cars (at speed) and other preventive MoW)
3. New loco power (BN-WAB, PHL, **CPI!**)
4. Rail Pulse – a game-changer (and other EODB efforts)
5. Moving Blacks/Quasi-moving Blocks (BNSF) – unlocking PTC
6. Outside Investments – CN/UP+Tu Simple; KSU (etc?)
7. Big New Hires at CN (WAB) and UNP (WMRT)
8. Simulation (UP's "Train Builder")
9. Remote meetings, virtual crew offices, zoom (sigh)
10. AVR – the "Holy Grail", change the RR strategy? Terminals.....

Class I Railroad Aggregate Operation Ratio*

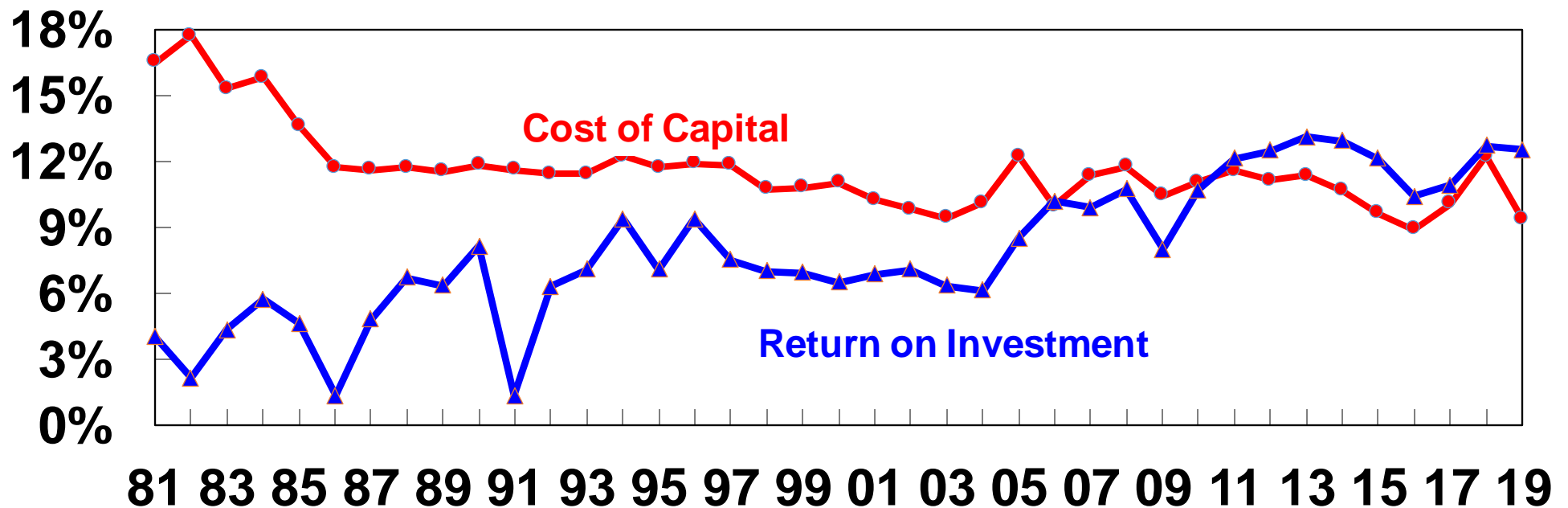


*Operating expenses as a percentage of operating revenue. Source: AAR

Rail Industry as a Whole, Now Earns Its Cost of Capital

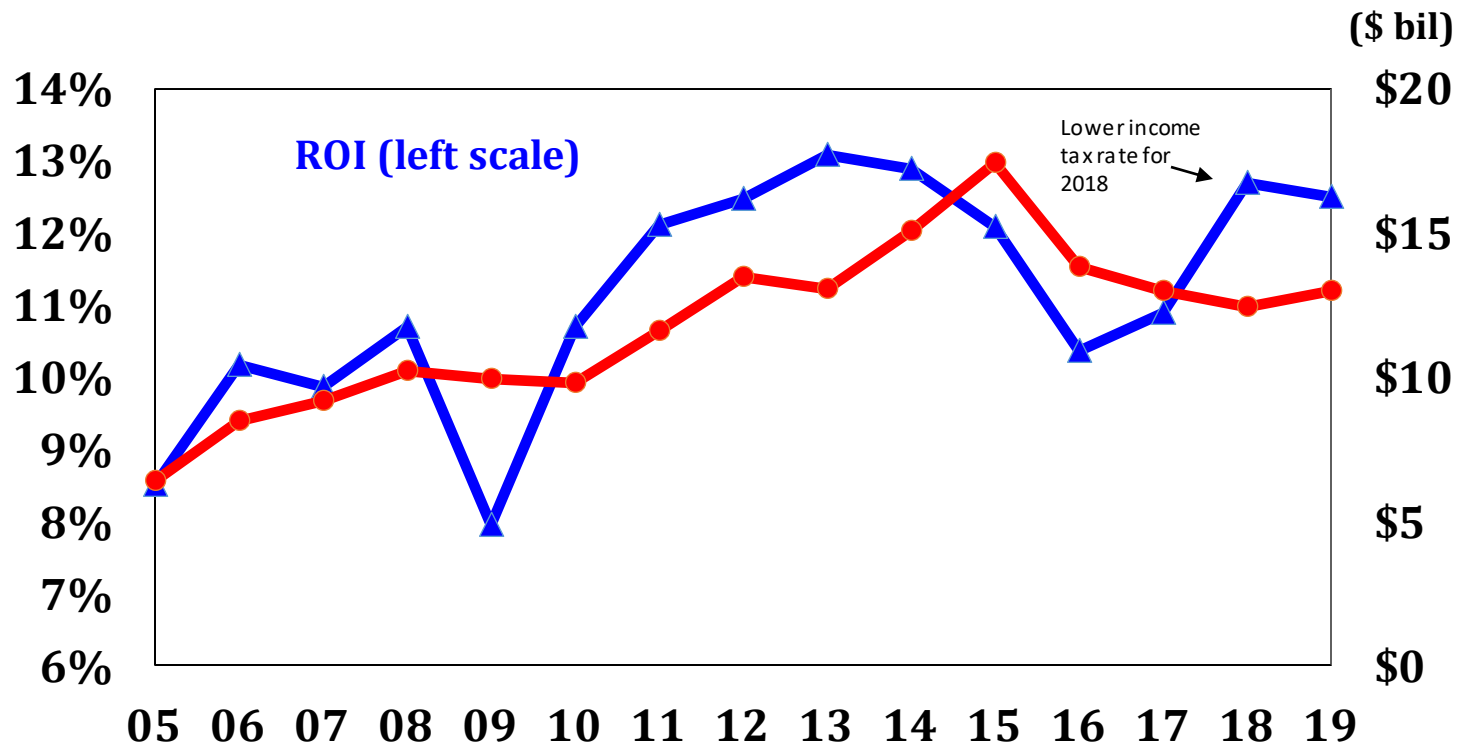


Class I RR Cost of Capital* vs. Return on Investment



*In 2006, the Surface Transportation Board significantly changed its cost of equity model.
ROI excludes accumulated deferred income tax credits.
Source: STB

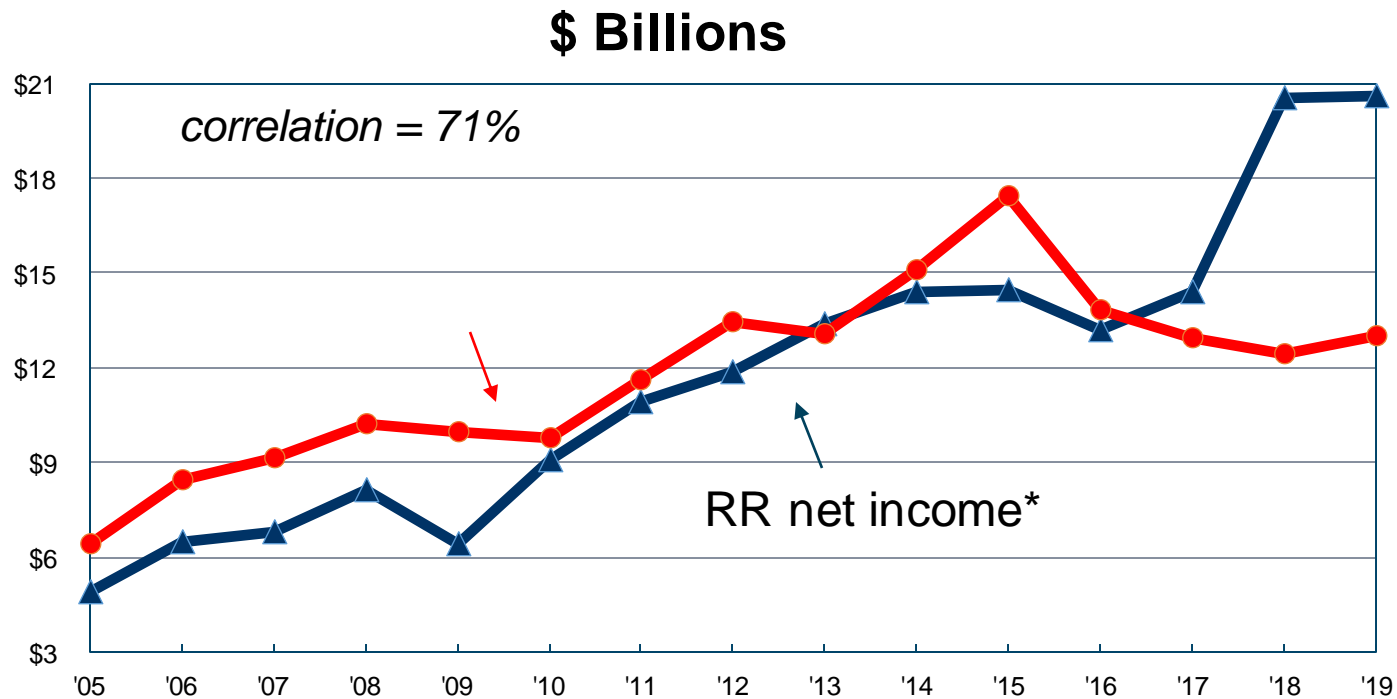
Close Correlation Between Railroad ROI & Capital Spending



Source: AAR

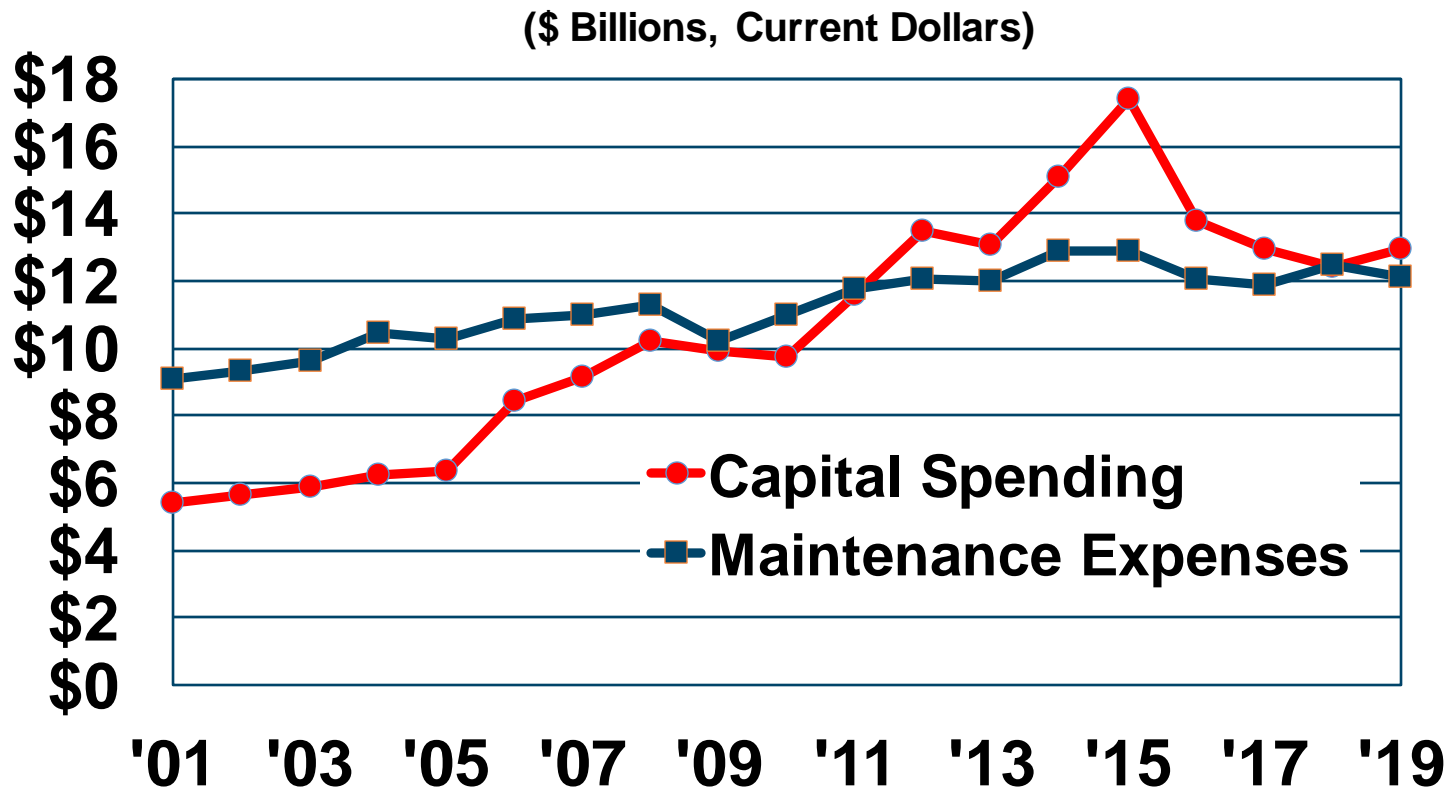
Note: ROI excludes accumulated deferred income tax credits.

Higher Rail Profitability & Higher Capital Spending



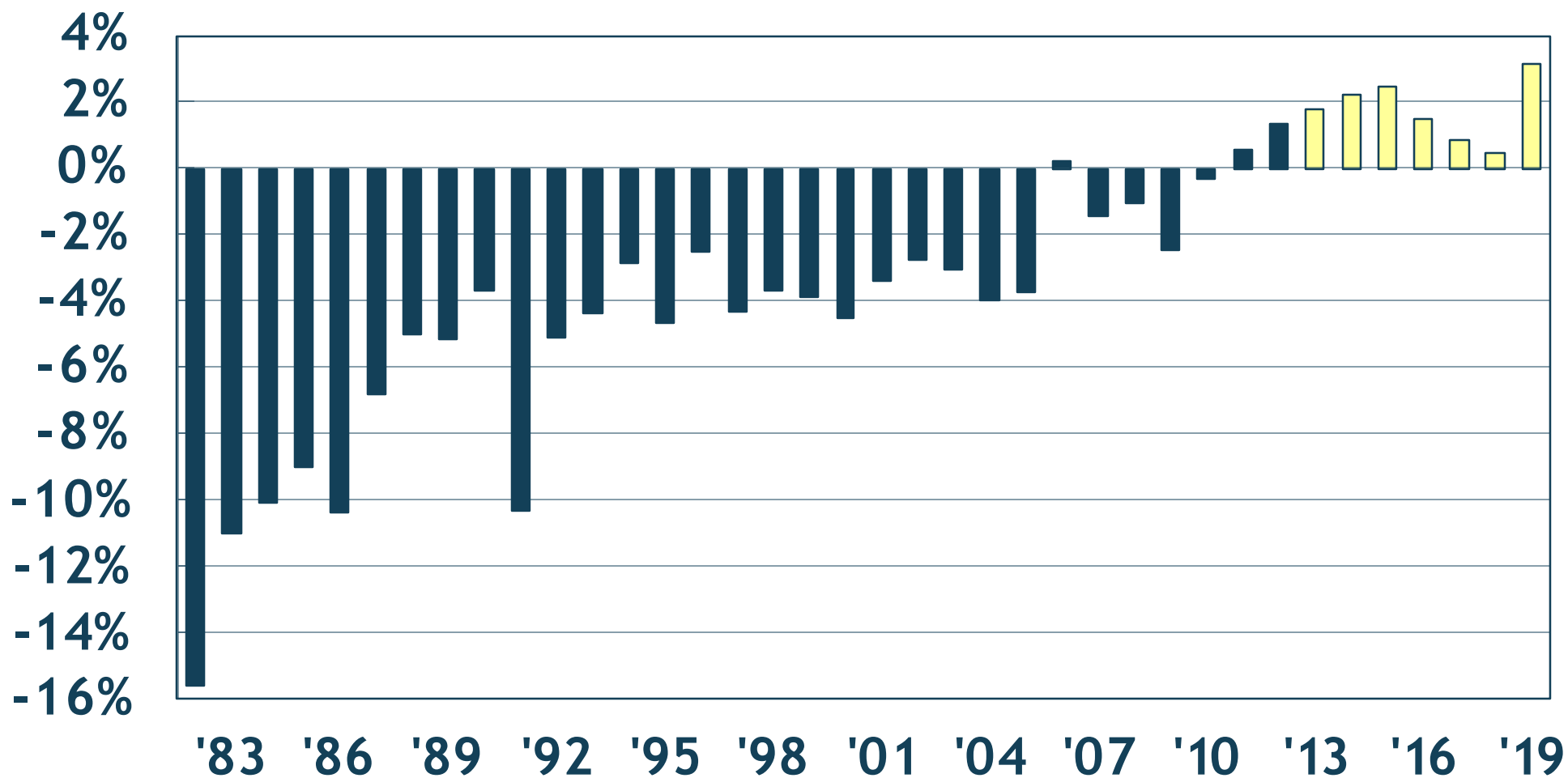
*Net income for 2017 has been adjusted to account for tax effects from the Tax Cuts and Jobs Act of 2017. Data are current dollars and are for U.S. Class I railroads. Source: AAR

Railroad Spending on Infrastructure & Equipment



Data are for Class I railroads. Source: AAR

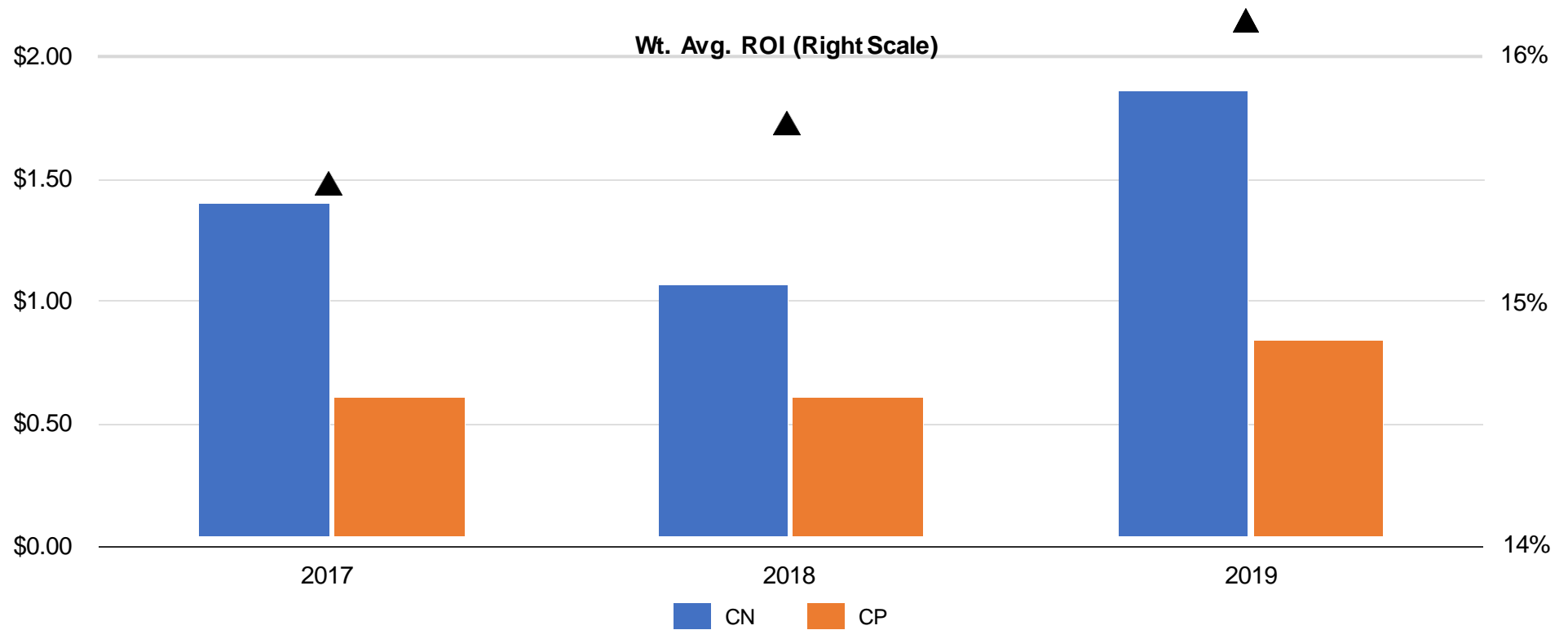
Spread Between Rail Industry's Return on Investment and Cost of Capital



*In 2006, the Surface Transportation Board significantly changed the method by which it calculates the rail industry cost of capital. Source: STB

Canadian Railroads Capital Spending & ROI

Capex (in \$B) & ROIC (%)



Source: Company Reports

Prepare for Rail World Post C-19

- Capex can *change* (lighter network, less rolling stock) but not be decimated
- PSR efforts should be maintained
- IT Spend should, if anything, *increase*
- Premium and high-service business mix share accelerating; coals decline also accelerated
- Railroads should spend to prepare for the recovery (ex. Xtra Boards)
- Will trade flows shift?
- This too shall pass

Person of the Year

NARS recognizes
Tony Hatch
with the
NARS 2019 Person of the Year Award
for his steadfast support of NARS and its regional associations.

*Thank you Tony for your guidance, dedication and service
to NARS and its regional association!*





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