Is the Railways "Great Experiment" Over Before it Even Begins?

After Renaissance, Retreat – Now What?

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Can Rails Change the Narrative After the *3 Big Blows*?

- Rails suffer # (3, at least) Big Body-blows over the last 18-24 months (some wounds self-inflicted but not all)
    - Supply Chain Crisis/STB Hearings
    - <u>**Regular**</u> labor round goes the distance
    - East Palestine and ramifications
  - So - Are Rails Inept, Greedy & Dangerous?
- NSC Investor Conference (joined by CSX new CEO) – **"The Great Experiment",** change in incentives, furlough policy, investment
- CNI Investor Conference – Growth through Investment
- CPKC Debutant's Ball – Growth through Competition
- Slow but **steady** progress on Service Consistency & Resiliency

Rail Strike – "Crisis Averted"
(Or, "When you're right, you're right!")

- <u>This was business-as-usual – the every 5 year three years-plus-back pay negotiations</u>
- The system (The RLA) was designed to go slow, cool off, mediate, PEB, etc; also remember rail contracts run in perpetuity and although nationally negotiated (in the US) actually fall down to small historic groups (think NS = N&W, Southern, CRR, etc etc)
- The only unusual item was how the face cards all fell labor's way – the Democrats in power, the labor shortage, the Supply Chain "crisis", rail record earnings, inflation
- So rail labor played their cards out – as expected – to the (almost) very last minute – AND WON!
- Got 24% (including back pay), which was a PEB split-the-baby slight lean Labor; got no real change in benefits, some work rule (attendance, doctor trips) changes
- The PEB recommendations were ALWAYS going to be the template!
- Rails did not get consist or other automation productivity reform (as we might have hoped back in 2019); FRA might supersede whatever they achieve in "local negotiations" anyway
- Worry – with back pay coming so might another bump in attrition
- Hope – with labor issues resolved for 3+2 years, hiring and retaining thereafter goes back towards normal – shareholder aligned here with labor
- What was truly unusual was media reaction to the ***"Impending Economic Crisis***" – see Time Magazine (??)
- From transport to business to the Front Page!
- Fallacious issue of "paid sick leave"
- And the issue of crews, retention, scheduling all trace their roots to H2/20 – and The Pandemic
- <u>Rails don't look so bad after other labor outcomes</u> – UPS, ILWU – and coming: UAW)

NSC, East Palestine & the (over?) reaction – Existential Threat?

- NS accident couldn't have been worse timed - or to a more unfortunate carrier
- NS safety history, efforts at Common Carriage, originator of TGE
- Rails are not allowed to carry haz-mat, they are compelled to do so
- ASCE Grade of B; Big & Consistent Capex

- Everyone on the attack:
  - Train length??
  - Crew size???
  - **ECB Brakes (car-based!) – your thoughts??**
  - Corp Greed/share buybacks??
  - Don't trust the EPA
  - Fix <u>everything</u> but the problem!
  - Doubling hot-box detectors price tag $1-2B
  - Etc
- ~$900mm* spent, excluding reputational and political hits

*Not sure of the current number! Much bigger!

Union Pacific's Sunday Surprise

- Soroban forces a change of leadership (in February)
- Suggests Vena (again)
- Another "existential fight for the soul of the rails"? (from growth to margin focus?)
- Many gaffes - Capex at 15% or less; G55; STB issues
- Chronic under-performance (of *potential*)
- Still the best job in the business
- KC remained "otherwise occupied"

Tale of the Two Jims

- Vena in at UP
  - Lots of vetting
  - Why not right away?
  - How long (Beth)?
  - H2, K2 or J2?
- Jamie out at CSX
  - “Culture change”
  - Similar pattern as at CN
  - Orr? Cory? Reilly? Sanborn? Other? <u>It’s Mike!</u>
  - Where will JB show up? UP?

Brand New Baby Railroad

- CPKC “Last Spike” April 14
- Never (NEVER) in doubt – just listen to the STB (and to me)
- Congrats to the STB for filtering out the noise (DOJ, Warren)
- New Growth Opportunities can help to turn around perception of rail
- Rail/Rail Competition
- Rail/Truck/Competition
- 80% Synergies – i.e; revenues
- Can the Unicorn bring it home – yes. In 3 years? (A: No – they pushed out the really big numbers to ’28)

3 Railroad Investor Conferences Push Growth

- NSC December 2022 – the initiation of the Great Experiment
- CNI in May – growth (but it will cost!)
- CPKC “Debutant’s Ball” in June – bigger growth then the applic ation, more time needed to achieve it (and three sets of numbers!)
- Flurry of deals and alliances – Falcon, CSX-Meridian, etc
- Next up: CSX?
- Waiting for direction: UNP
- Beginnings to talk: BNSF (with their renewed marriage partner)

Recurring and Accelerating Rail Trends

(Not to be confused with RailTrends November 2023!)

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 & 3	**Fuel Advantage (2A)** (4:1 ton/mile; AAR)[2] – So 2B is ***EMISSIONS***/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)

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

- Short Lines & Regionals still hot properties
  - Multiples have doubled in the last 5 years
  - No public companies left (GWR)
- Many small recent deals (by OmniTRAX, RJ Corman, etc.)
- Watco-Dow and CN deals a new prototype?
- On the market: At least four? Lake State Railway just completed
- Off Market & Smaller Deals (ex. SLGW)
- Financial Partnerships (RDC, Watco, etc)

- Spanner in the works? Problematic STB?
  - Massena Line & lawsuits - Withdrawn
  - WC-Watco, Pan Am finally finished!
  - KSU? A Slam Dunk? Views from my trip to DC
- Buyers (all with different WACC, timeframes, ROI expectations):
  - Strategic (above)
  - PE (and PE/partner)
  - Infrastructure Firms
  - Class Ones as sellers (CN?) and/or Buyers (CP-CMQ, CSX-PAR, BNSF-MRL)?

Short Lines To the Rescue of Class Ones?

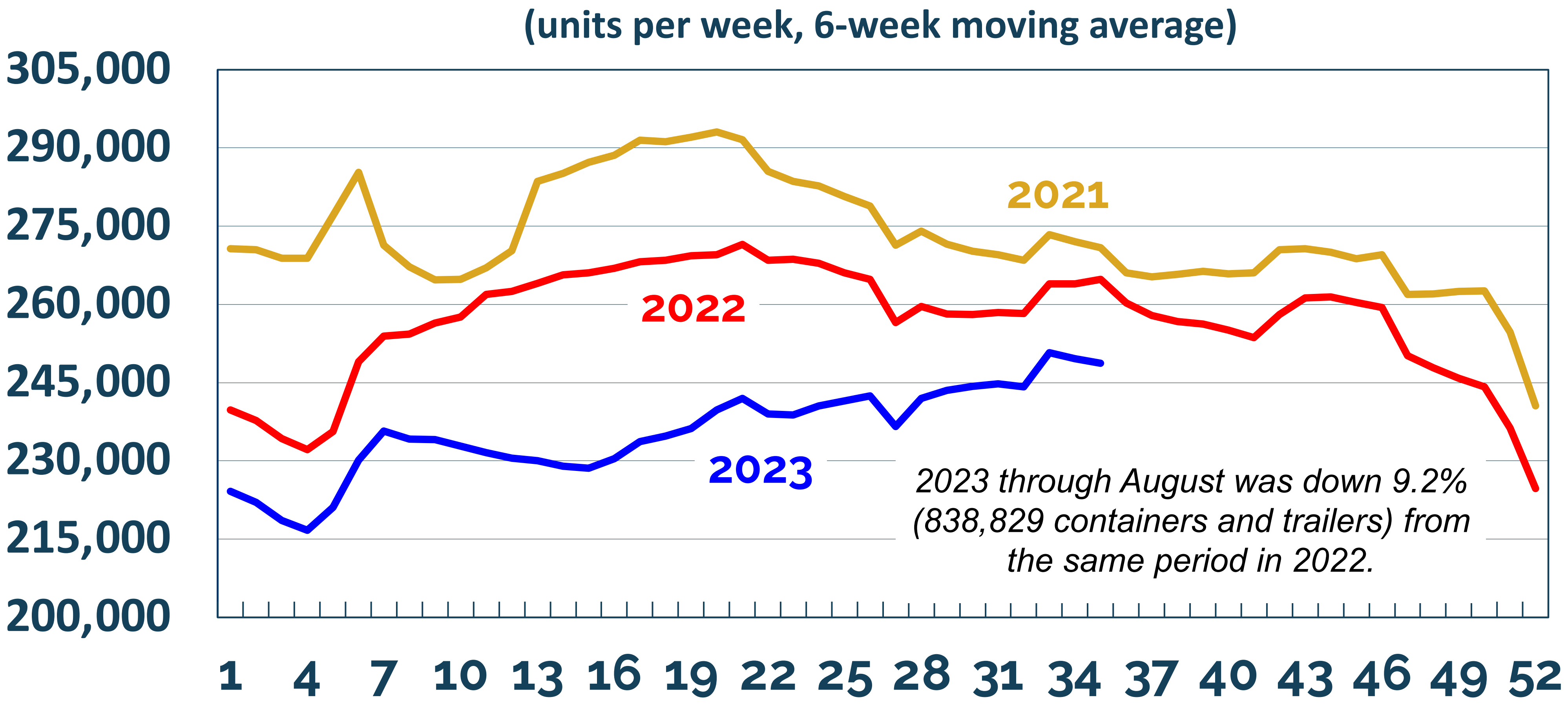
- ***Class One service crisis and the impact on/of regulators (STB/FRA) and Legislators***
  - New focus, data on First Mile/Last Mile (and it ain't pretty!)
  - Service failures are manna to STB concerned about rail market power (price)
  - Reciprocal Switching (which is about pricing power!) is coming, in modified form
  - STB use of *common carrier obligations* as a lever (UP/Foster Farms), focused on weekly switches
  - Declining Class One carload growth since the 2008-9 Financial Crisis
- **SOLUTION? Increased use/creation of Short Lines!!**
  - Short lines have consistently out-grown C1 in carloads
  - Short lines offer tailored, customizable switching services
  - Short Lines have better work rules, less severe labor shortages
  - Short Lines are looked upon quite favorably by regulators and legislators!
  - Watco's Dow and especially Dutchtown Southern (Louisiana/CN) increased weekly switching from 3-5 to 7+ and grew carloads by over *one third* in the first *year* of operations – win (customer switches)/*win* (Watco new business)/win for C1 partner CN (more cars for its long-haul business)
  - All SLHCs have logistics/switching arms etc
- ***So why is the momentum of C1 strategy seemingly to buy or retake SLs*** (see DMQ/Pan Am/MRL)??
  - I support a "feed the beast" strategy (looking to extend a C1 market reach – ex CN 2018-21
  - However that should not preclude thoughtful C1-SL partnerships (that solve customer problems!) – ex RailPulse
  - *Nonetheless, I see no evidence of C! leadership taking these steps (yet?)*

Regulators, Luddites & Data – DC in tha House

- Peak STB post merger?
- Reciprocal switching – a “nasty curveball”, but good for analysts – and?
  - Canada sticks to a larger milage-based plan
  - Standardized (and more) data will be useful in the US
  - A tailwind for service recovery?
- Will the Hatfield (UP) & McCoy (STB) feud finally end?
- The FRA takes the Trident – anti-technology in favor of jobs

U.S. Rail Intermodal

ASSOCIATION OF AMERICAN RAILROADS



Data are originations, are not seasonally adjusted, and do not include the U.S. operations of CN, CPKC, and GMXT. Source: AAR *Rail Time Indicators*

U.S. Rail Intermodal

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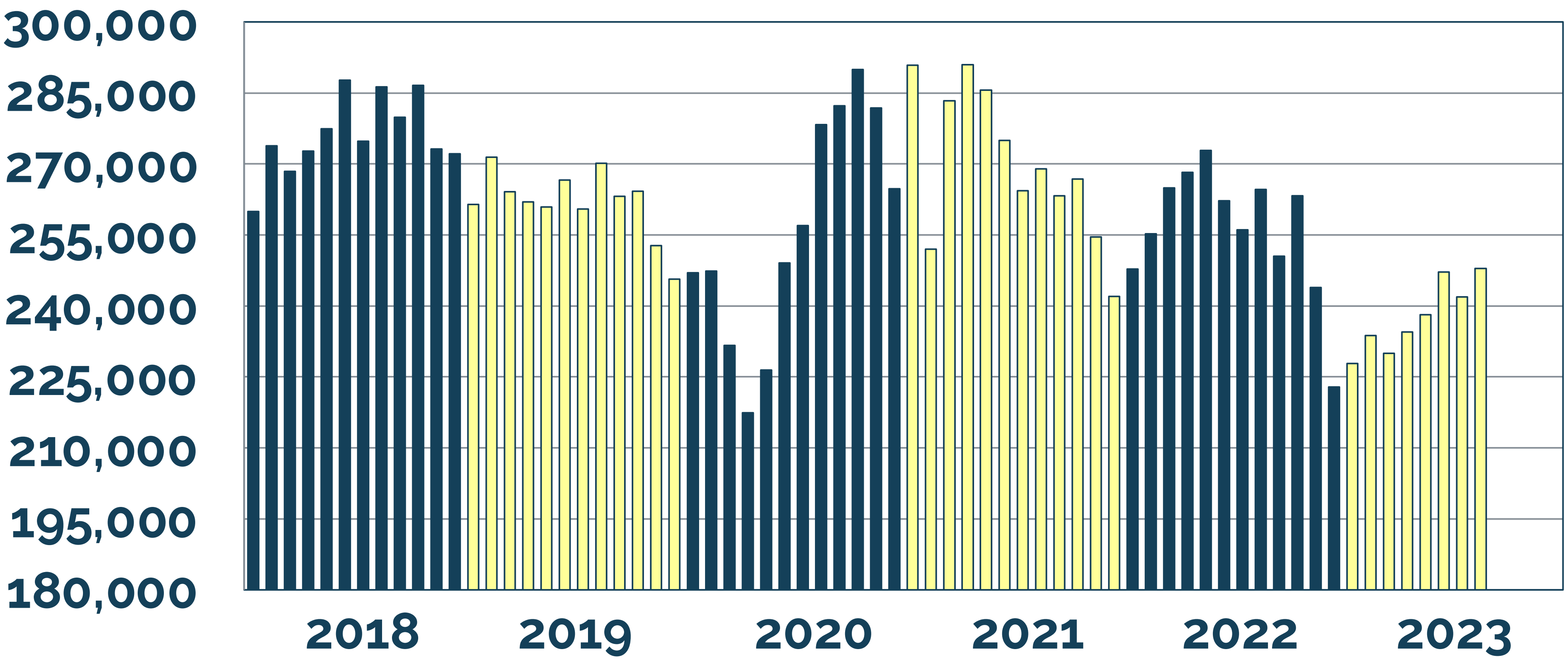
(average weekly originations by month)



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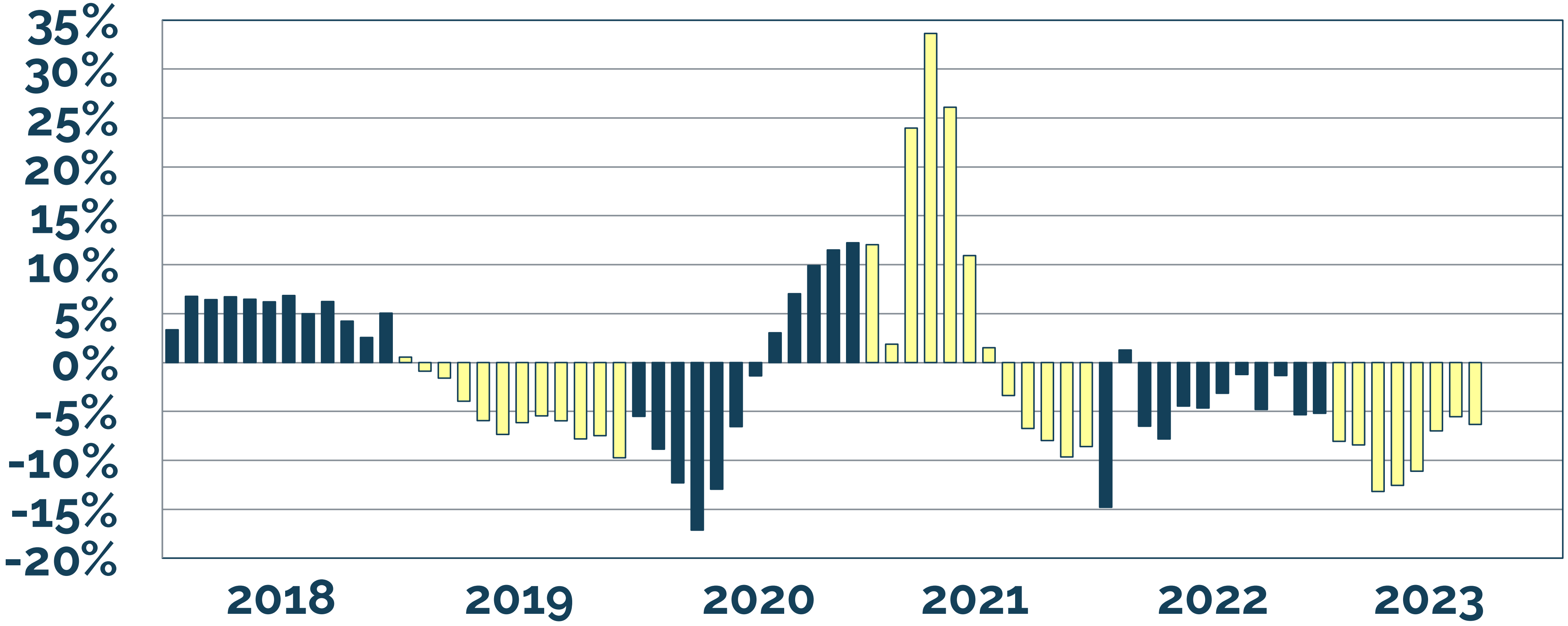
(% change from same month previous year)



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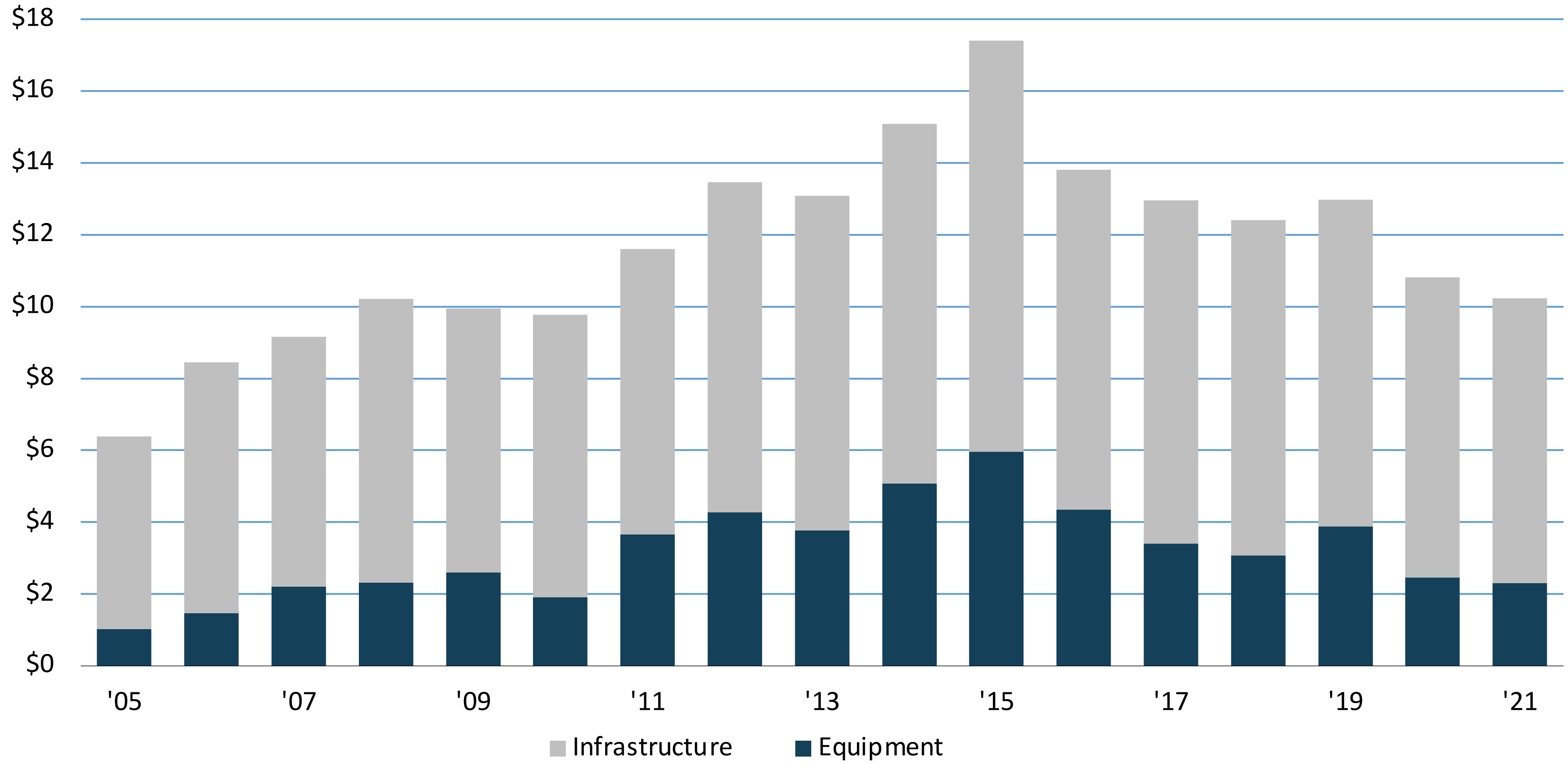
To meet coming "existential threats", Rail *Tech* / Innovation is Accelerating (T10) – 2023 Budgets will be critical

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, CP!)
4. Rail Pulse – a game-changer (and other EODB efforts)
5. Moving Blocks/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); Innovation; LOS to the CEO?
8. Simulation (UP's "Train Builder")
9. Remote meetings, virtual crew offices, zoom (sigh)
10. AVR – the "Holy Grail", change the RR strategy? Terminals…..

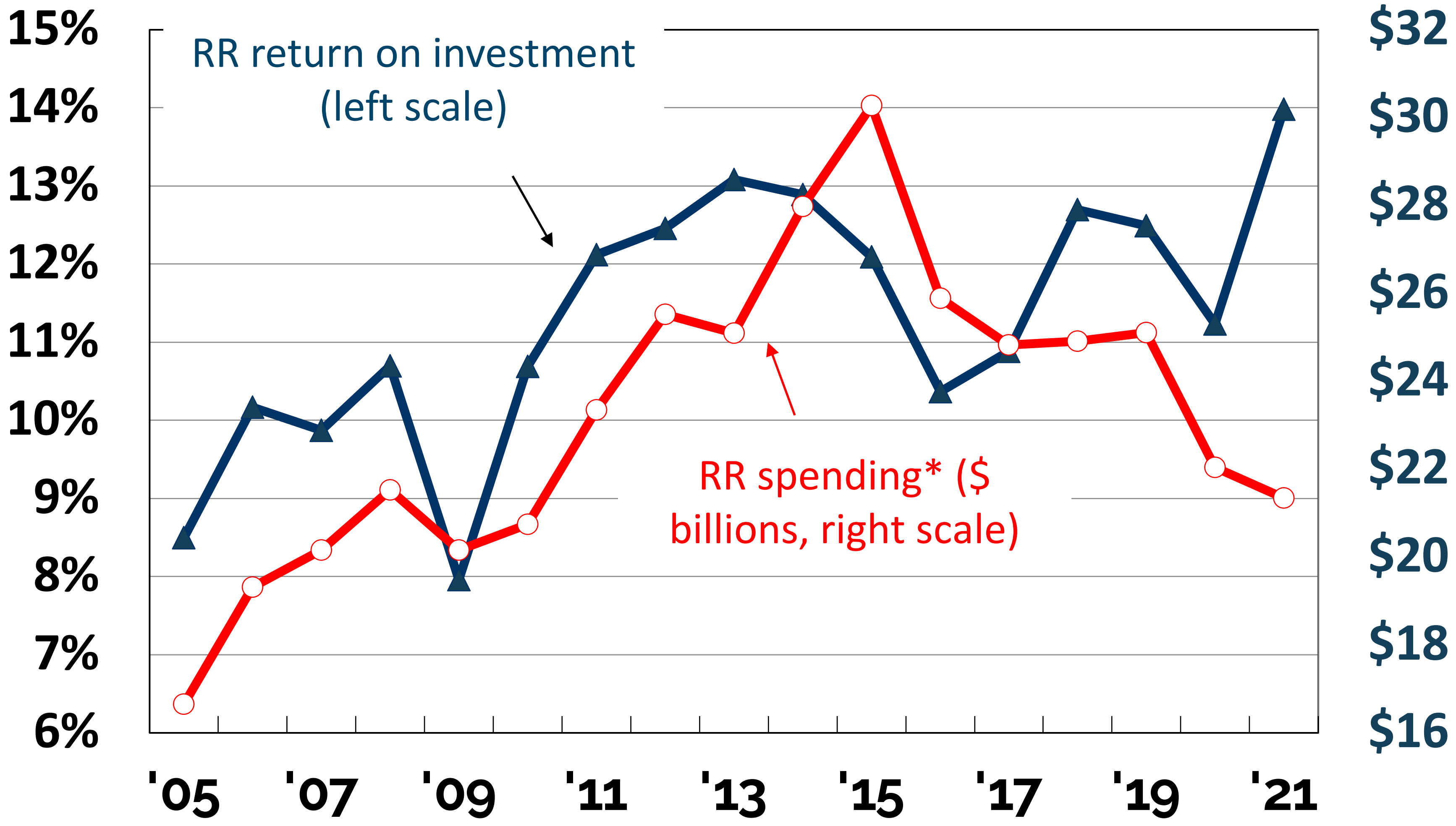
Railroad Capital Spending

($ billions, current dollars)



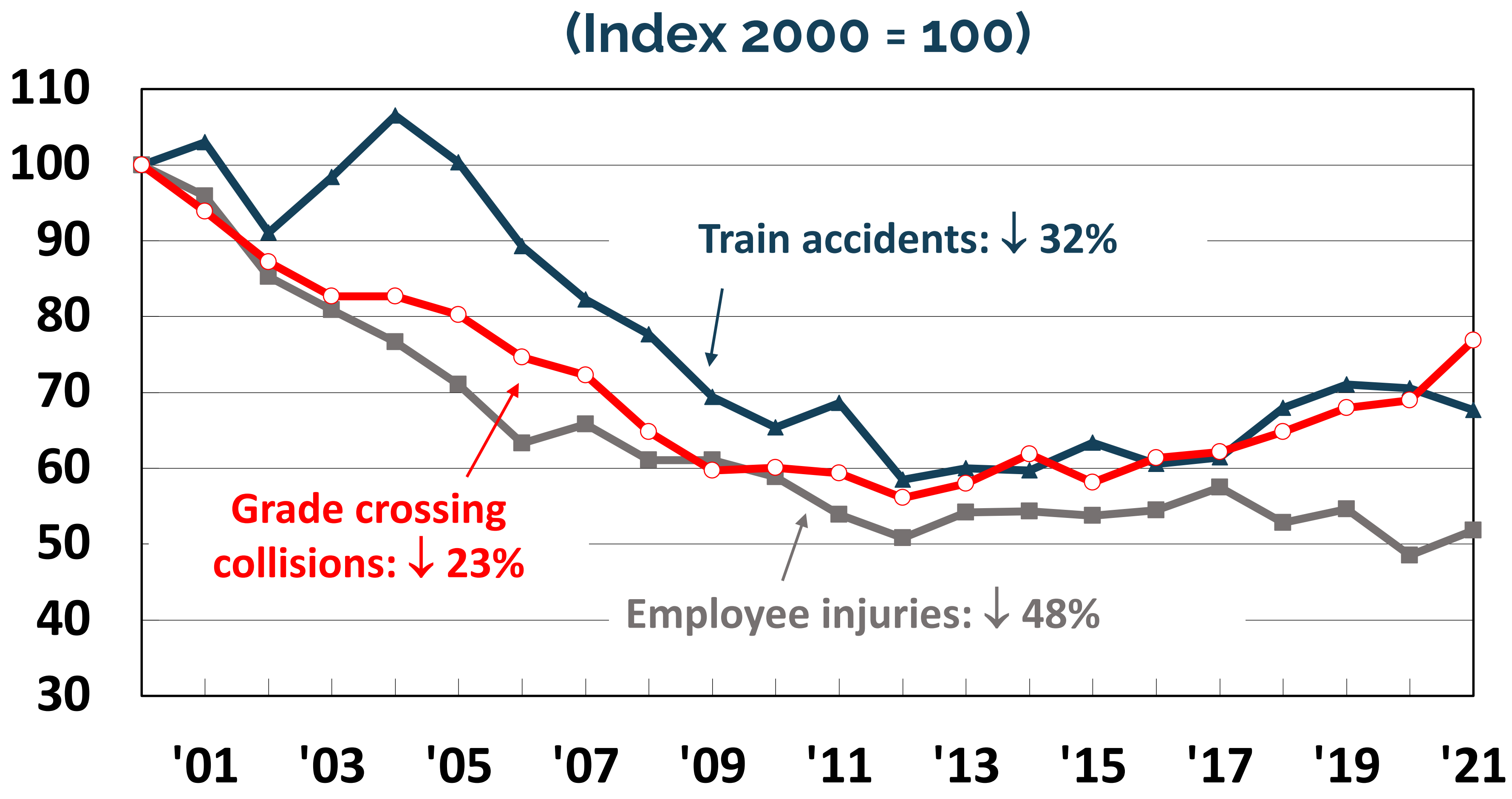
Data are for Class I railroads. Source: AAR

Historically, a Strong Positive Correlation Between RR ROI and Spending



*Capital spending + maintenance expenses. Source: AAR

Recent Decade Was Safest Ever



% = change in rate from 2000-2021. 2021 is preliminary. Source: FRA

Rail Industry ROI vs. Cost of Capital

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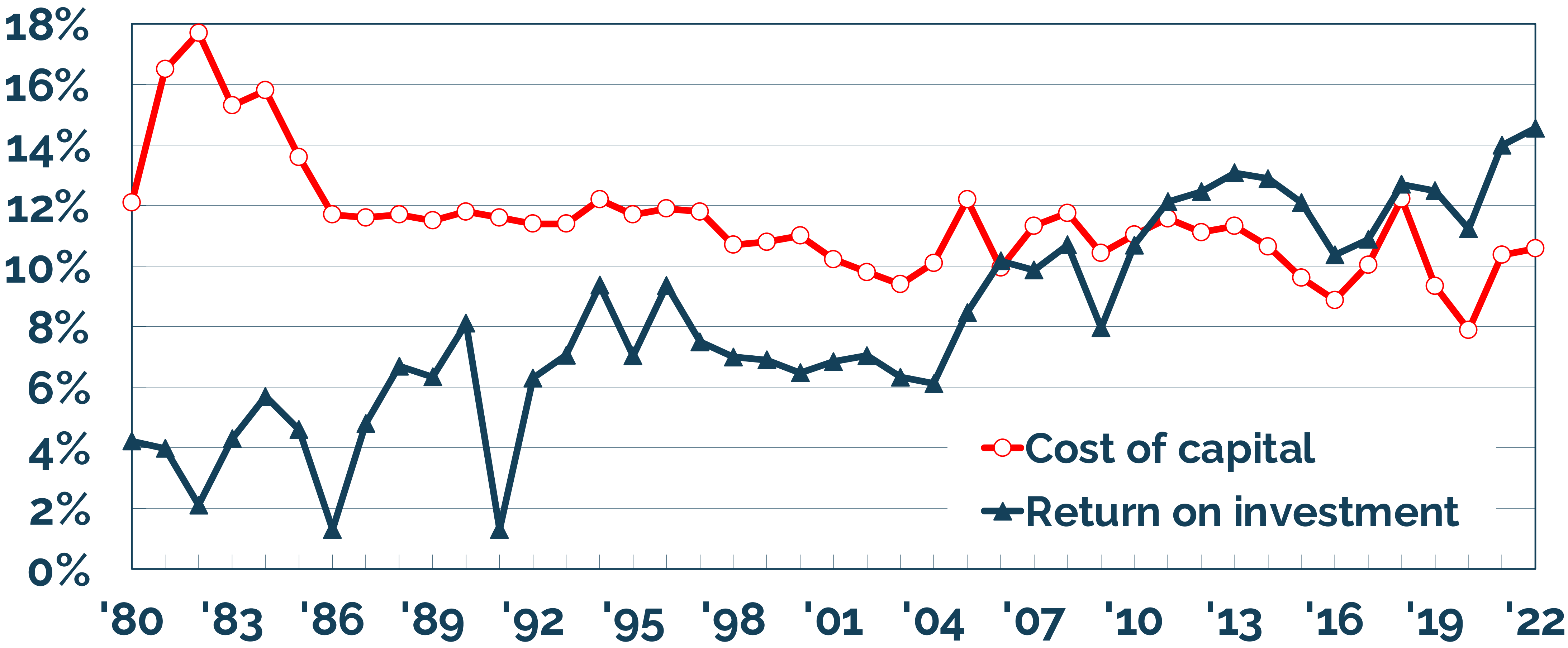
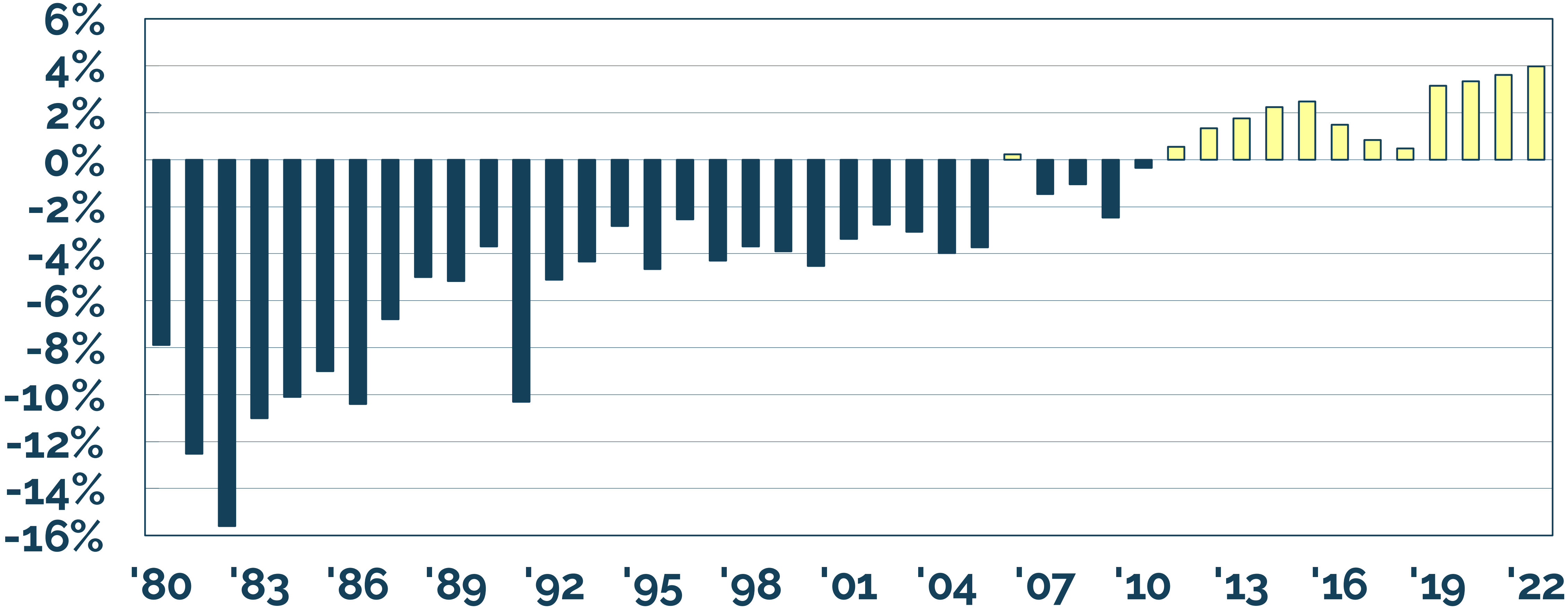


*In 2006, the Surface Transportation Board significantly changed the method by which it calculates the rail industry cost of capital. Source: STB

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



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Return on Investment is Crucial

If ROI > cost of capital:

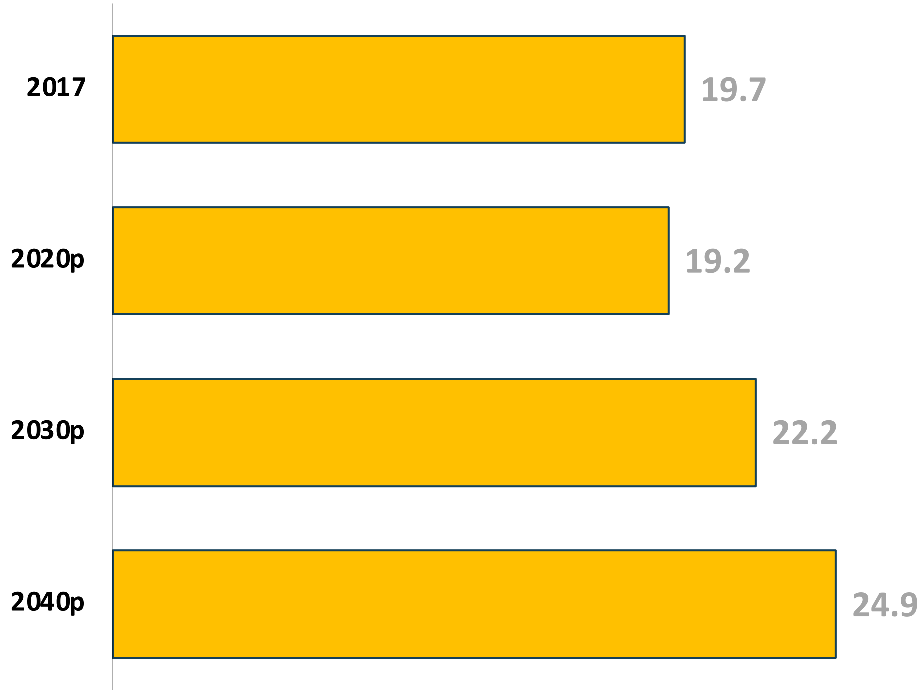
- Capital spending expands
- Stronger physical plant; more and better equipment.
- Faster, more reliable service
- Sustainability

If ROI < cost of capital:

- Lower capital spending
- Weaker physical plant, equipment
- Slower, less reliable service
- Disinvestment

Long-Term Demand for Freight Transportation Will Grow

Billions of Tons of Freight Transported in the U.S.

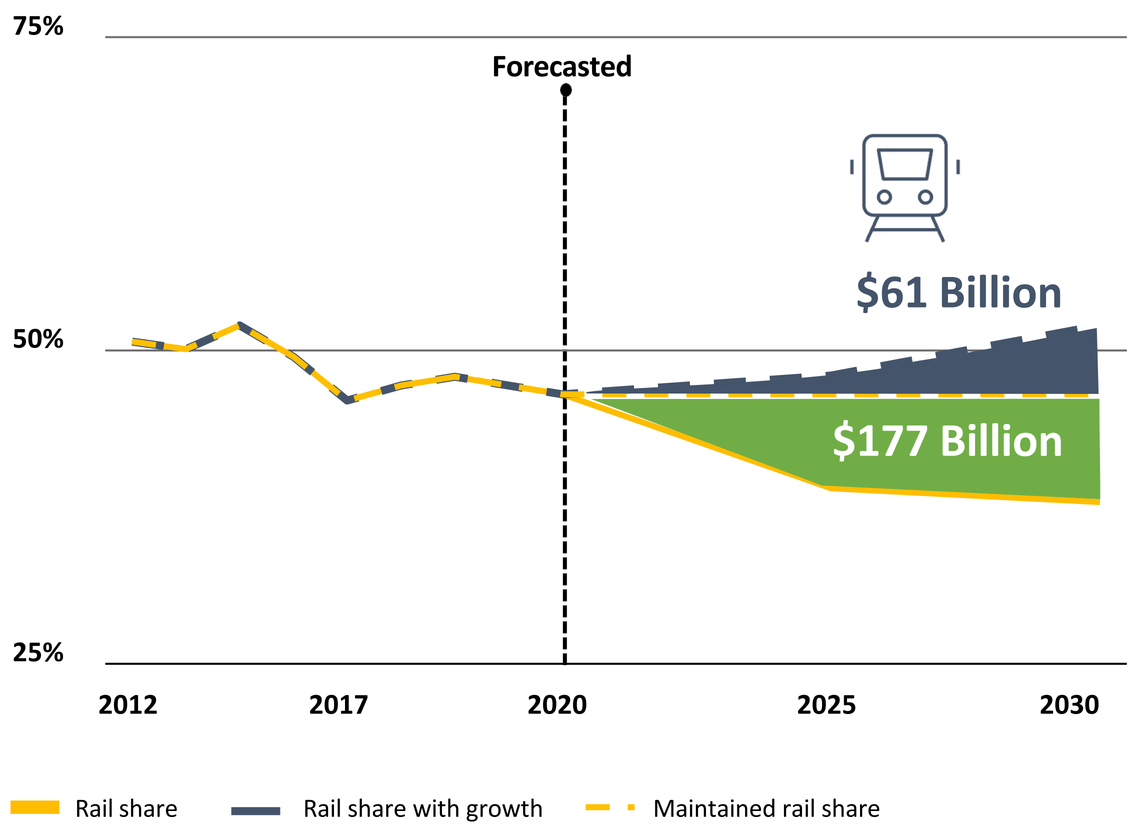


U.S. DOT estimates that total U.S. freight movements **will rise from around 19.2 billion tons in 2020 to around 2.49 billion tons in 2040** – a 30% increase.

p – projected
Source: FHWA - Freight Analysis Framework, version 5.0

By using available capacity, railroads could add $61BN more in growth revenue – with limited capex

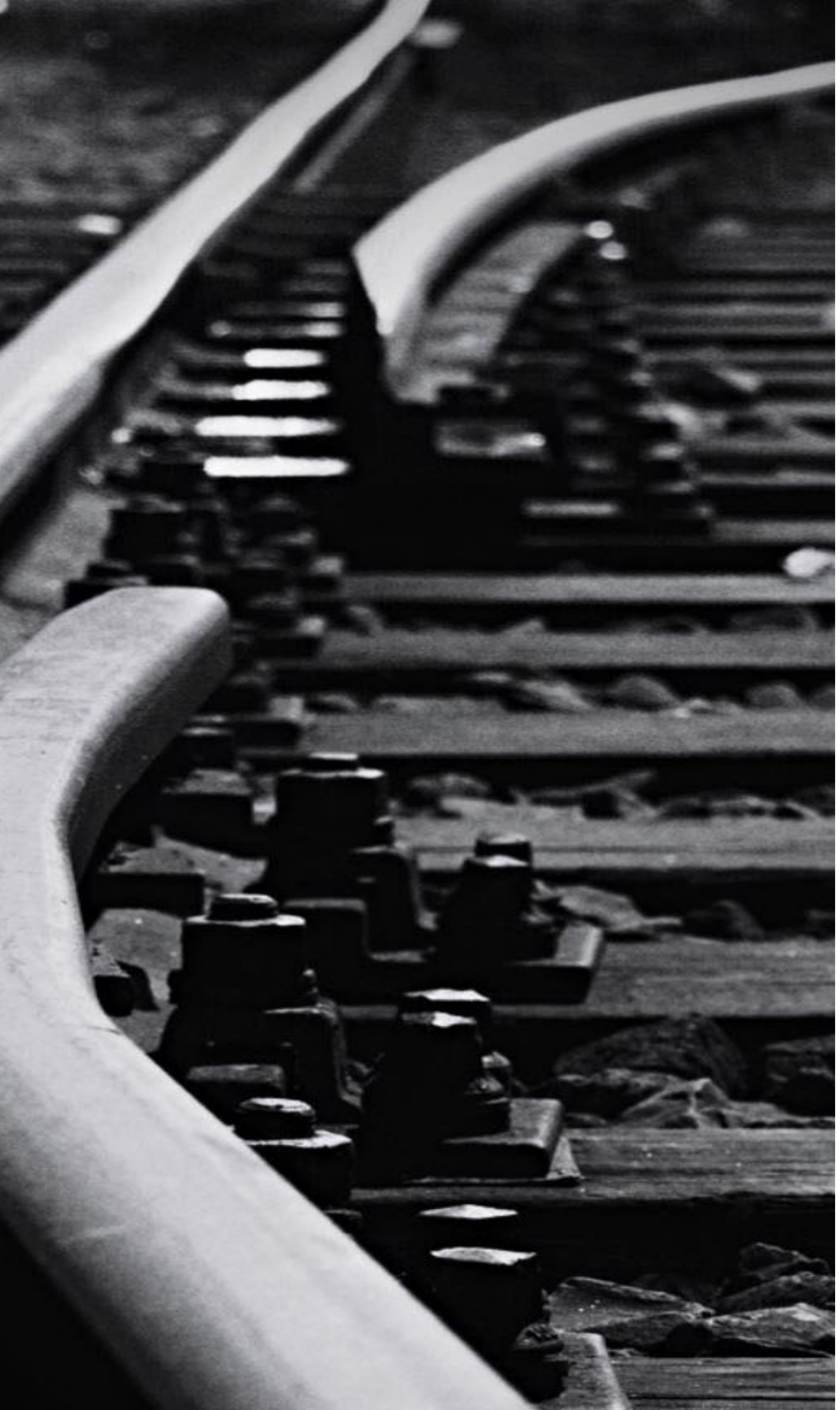
Freight market share analysis and forecast by ton-mile



Gaining a half point of share per year delivers growth that by year ten fills current available capacity

Assumes no material technology advancements

Source: © Oliver Wyman



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!

Anthony B. Hatch
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