Roads in the Fork: Railroads 2019 & Beyond

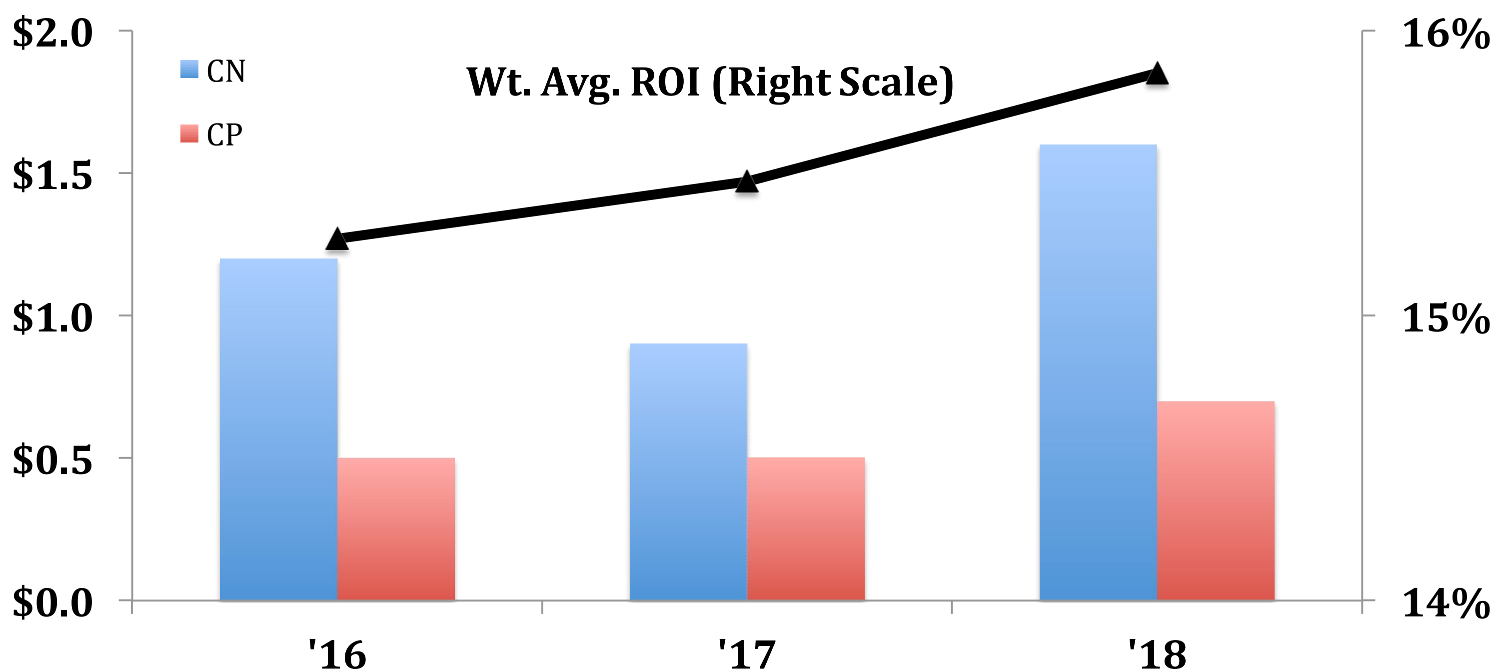
abh consulting

RAC

Ottawa!

September, 2019

Canadian Railroads Capital Spending and ROI



Source: Company Reports

Enduring (?) Railroad Competitive Advantages

1. Labor Advantage (ex: Double-stack LA-Chi – or Rupert-Toronto)*
2. Fuel Advantage (4:1 ton/mile; AAR)**
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- *AV trucking?
- ** EV Trucking?
- *** Infrastucture Bill? (LOL)

2019 Will Be Calm & Simple – *Not!* *RISK*

- Rail Operating *Risk* – Service Metrics* must improve! (and not just be “re-stated”) – see weather, PSR
- PSR *Risk* (operational, regulatory)
- Earnings *Risk*? Not initially (starting next week….)
- Economic *Risk* – slowdown, at long last?
- Political *Risk* (boom in Gondolas for The Wall?)
- Weather *Risk* (Polar Vortex, Mid West flooding – so far….)
- Trade *Risk* (soybeans, autos – etc) now *Border Shutdown Risk*
- Oil Price *Risk* – Now, cheap oil is a *bad* thing
- Technological *Risk*
- Markets *Risk* – and potential impact on Capex
- Management *Risk* – Activists, Succession, Big Transition Years (UP, BNSF, NSC, CSX….) – ability to capture *Big Canadian Game*….

Earnings Risk?
Reiteration (Q1) vs. Capitulation (Q2)

- CSX spooked the markets (reported "near-miss" & simply stating the <u>obvious</u> about YTD volumes – which are reported *weekly!)*
- UNP (and KSU) restored sanity (but what happened to *"Service begets Growth"?!?)*
- CP's excellent quarter was forgotten; CNI showed that Canada is the future ("*We the North!")*
- NSC reported a "miss" but Top21 is "flawless" so far….
- *Scorecard so far: 4-3; Q2/19 rail earnings of high single digit range will compare nicely, once again, to the loss by S&P500*
- *Remember Rails' historic "outperformance" in a recession*

But Volumes are Scary

What's the cause (beyond "tough comparisons")? How to allocate into the 5 buckets?

1. *Economic Slowdown – in USA/Mexico (only?)*
2. *Continued Trade Distortions* and Market losses (from soybeans to electronics)
3. *Lingering weather impacts* on operations (and on crops!)
4. *PSR* – inadvertent or planned share loss (ex. CSX IM)
5. *Trucking overcapcity* (what a difference a year makes!) – Investors are questioning the very nature of the IM Value Propisition!

Renaissance 2?

- New Operating Plans!! PSR vs Other? PSR vs PHH?
- Intermodal? Opportunity or Missed Opportunity?
- Merchandise: Plastics? Housing? Perishables? ? Infrastructure? (??)
- *Paper! Cardboard! Boxcars!*
- CBR back from the dead? For how long??
- Sand back *to* the dead?
- Trade?? 42% <u>*US*</u> RR units (in 2014….)
- IT spend? Versus….
- IT Threat? (AV/Tesla/Amazon/etc)?
- Capex vs. FCF in the era of the Activist?
- *New "Golden Age" of/for Short Lines!*

Boom in Short Line Valuations

- Infrastucture Funds - low cost of capital and long term (moderate) return expectationbs
- One major SLHC is going private– deal at ~14X – up from 7-9X!

  - they had perhaps outgrown ability to remain publicly-traded (difficulties of the small deal)
- CSX Lines….?
- Demand *creating* supply – sellers’ market!

Challenges/*Opportunities* to/*for* SLs

- SLs lack true pricing power (and Fuel Surcharge coverage)
- SLHCs –may - lose local focus; tough central/decentralized strategic mix
- SLs do not participate in the hotter markets:
  – IM to any degree
  – nor in Mexico
- *C1s more focused on car-load (SL sweet-spot)*
- *C1s more focused on ROI (create more SLs?)*

PSR Spectrum
Precision Scheduled Railroading

- Hunter: IC to CN to CP to CSX
- PHH: CN, CP, soon CSX?
- PSR without EHH+: “Measured”, “Lite” or “2.0”?
- PSR as part of G55+0/Unified Plan 2020
- PSR tenets informing new Operating Plan: NSC
- PSR-by-Neighbor: KSU (
- PSR-by-Connection: GWR
- PSR? BNSF

So – What *is* PSR?

- Is it new? (car-focus vs train, etc) – “Railroading 101”
- Is it a playbook or an *attitude?*
- Is it “just” cost cutting? Or does “Service Beget Growth”
- Is it closing humps?
- Is it point to point?
- Can intermodal survive PSR?
- Is it key-man driven? (Change agent)
- Does it work? PSR and PHR!
- Is it too short term oriented? PSR & PHR!!
- Three Camps: Canada/USA/Norfolk Southern (& maybe KCS)?

RRs and NAFTA

- •	U.S. to Canada: intermodal, motor vehicles, chemicals, coal, food
- U.S. to Mexico: motor vehicles, intermodal, food, grain, chemicals
- Mexico to U.S.: motor vehicles & parts, food, electrical machinery
- Canada to U.S.: intermodal, chemicals, lumber & paper, motor vehicles, grains
- ***One Continental Market – in freight and in equities (CP & UP)***

Service is Even More Critical

Continuing (& Continuous) <u>Traffic Mix Shifts</u> Toward Service-Sensitive Freight; Growth drivers shifting to optimized service

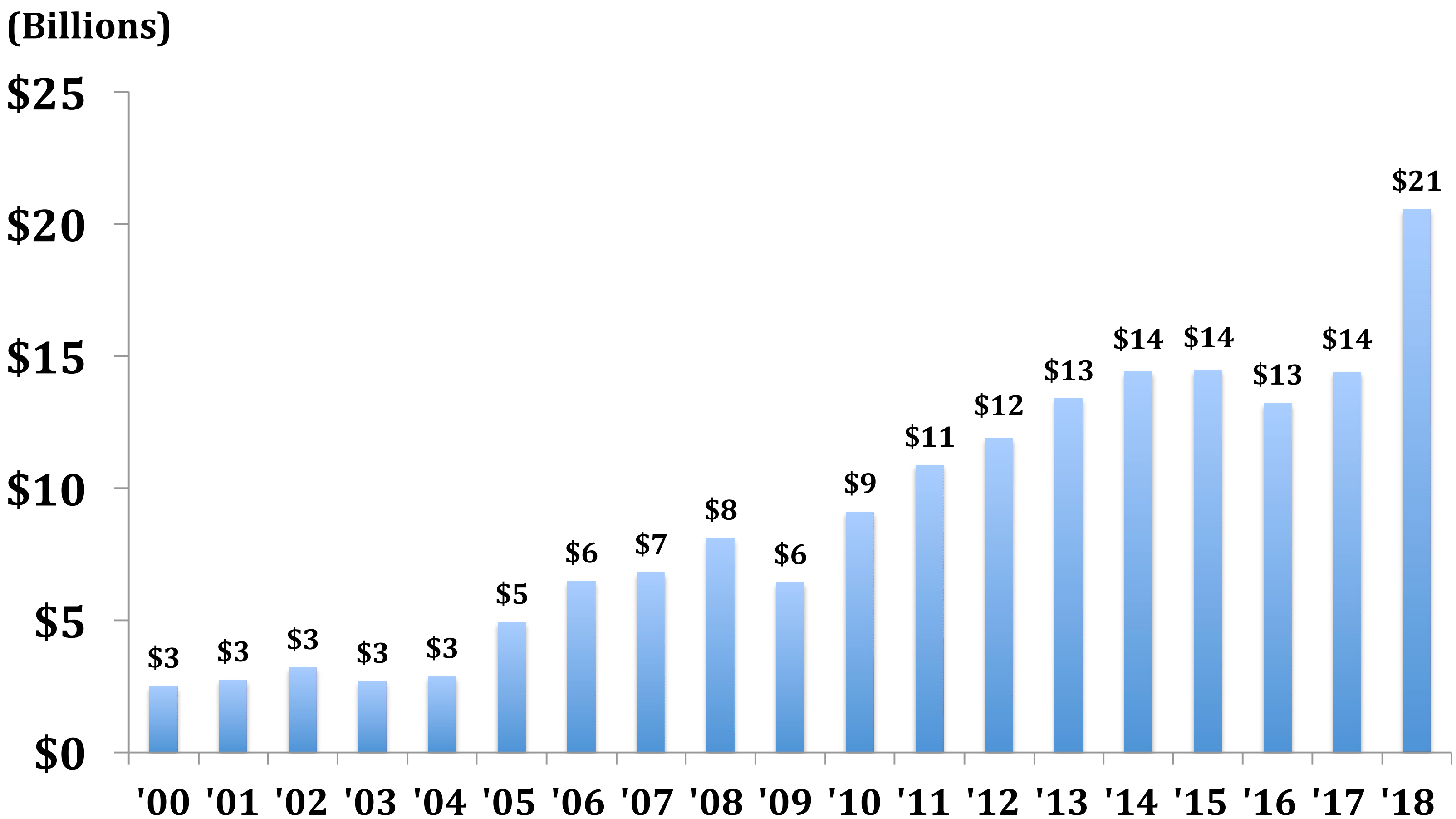
Emerging Trends:

- CSX (PSR and rail service) – asset-intensive focus
- 2017-18 AAR "Metrics" – Need improvement
- Longer trains, parked equipment
- OR Focus (vs ROIC) –cost, not service-sensitivity?
- Capex boom past peak? Forecast range 15-20%+ of revenues
- CN – orders 260 locos, renews hiring; CP & CN order Ag cars
- Increased IT spend (predictive MoW, ease-of-doing-business, visibility, etc)
- Insourcing vs. Outsourcing

The "Grand Bargain"

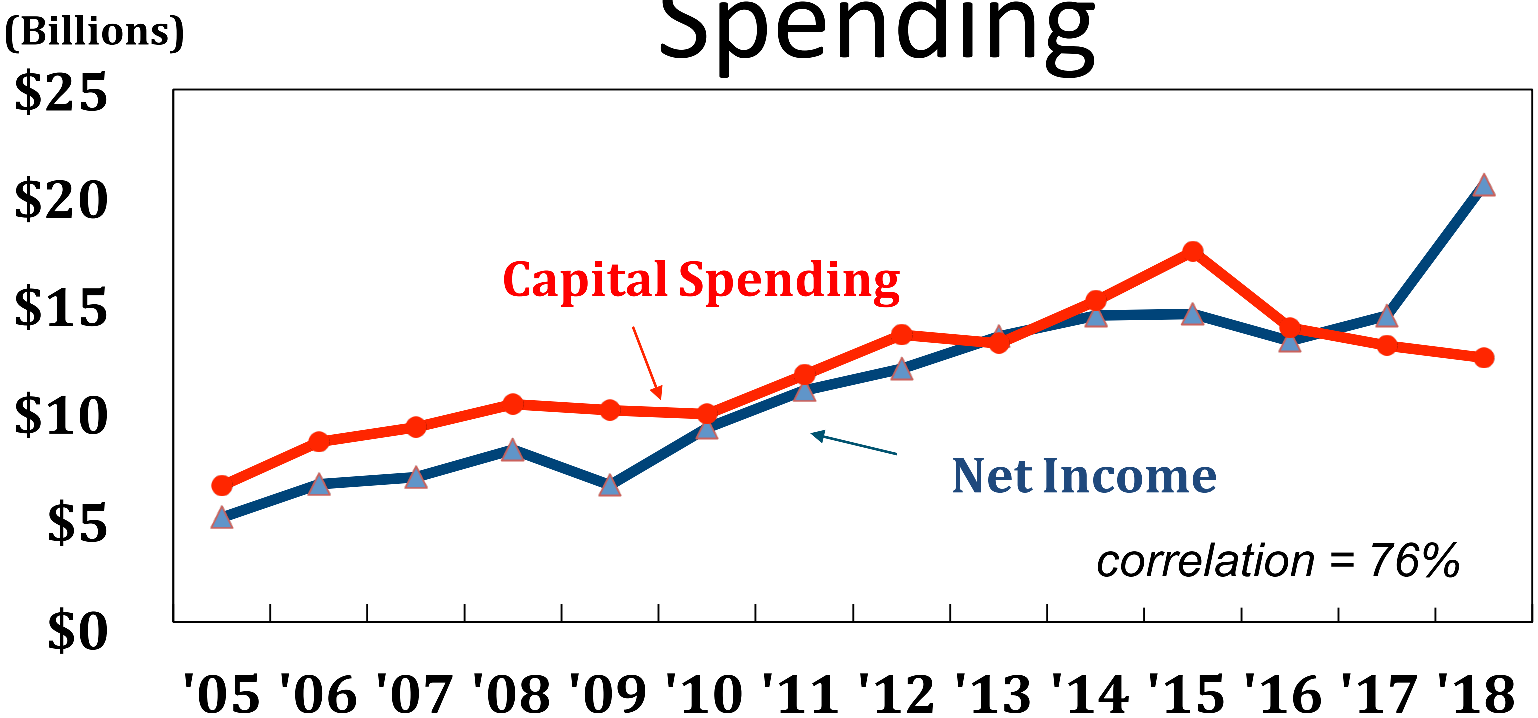
- *In return for higher prices (& ROI), rails spend, increase capacity & improve service* (2005-2012) – The unstated **"Grand Bargain"**
- Rails gain pricing power (~2003) & F/S
- Rails (re) Gain Market Share
- Rails Spend Cash "Disproportionately" on Capex (~18-20% of revenues)
- Promotes "*Virtuous Circle*" – all stakeholders benefit
- Under challenge, perceived and real – *Vicious Circle?*

Growing Railroad Net Income



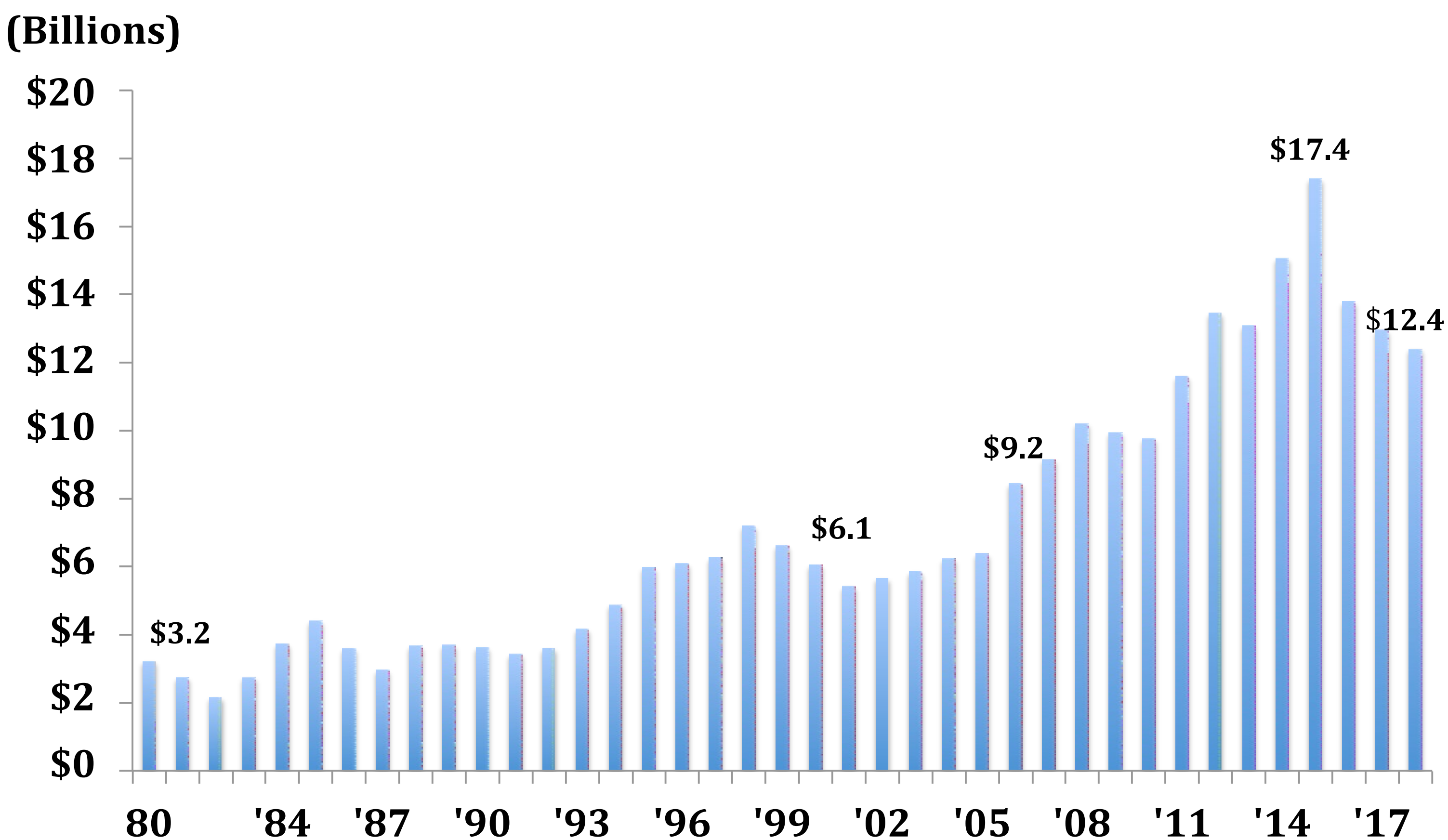
Source: AAR

Higher Railroad Profits Have Boosted Capital Spending



Source: AAR

Railroad Capital Spending



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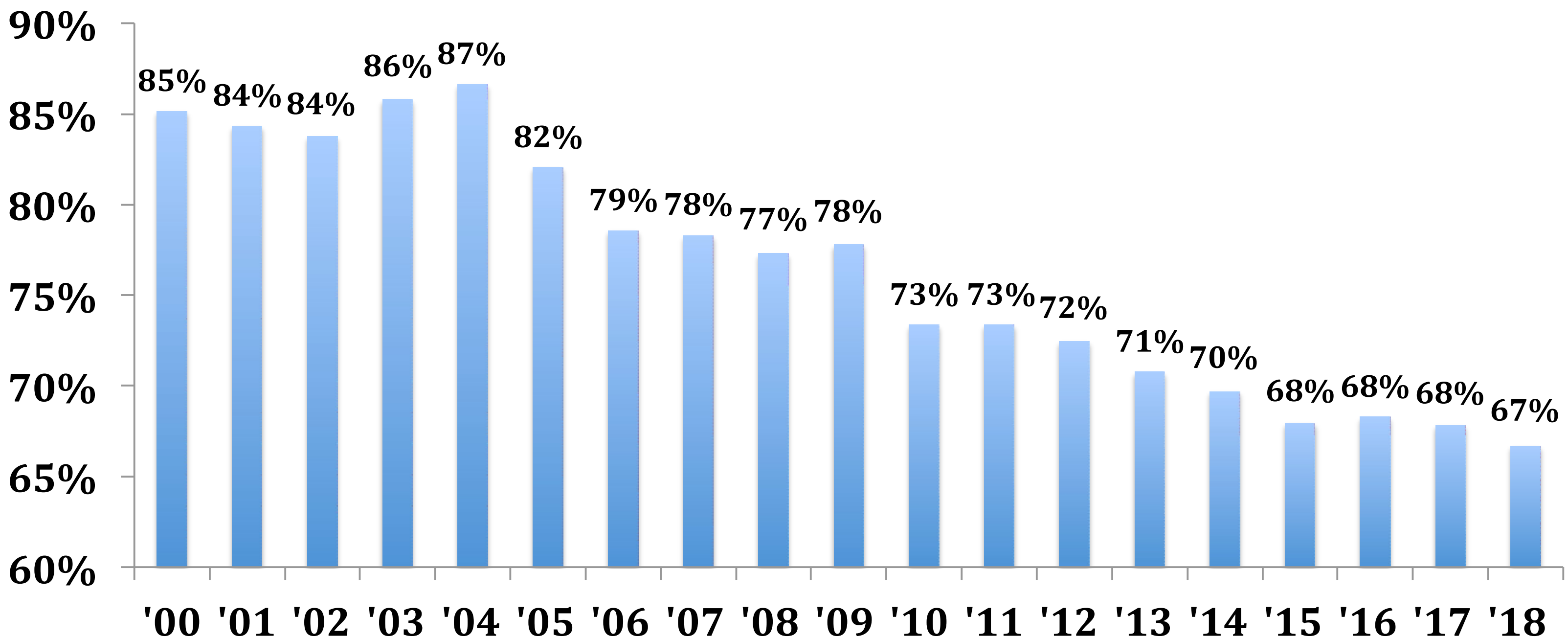
Much Improved Operating Ratio



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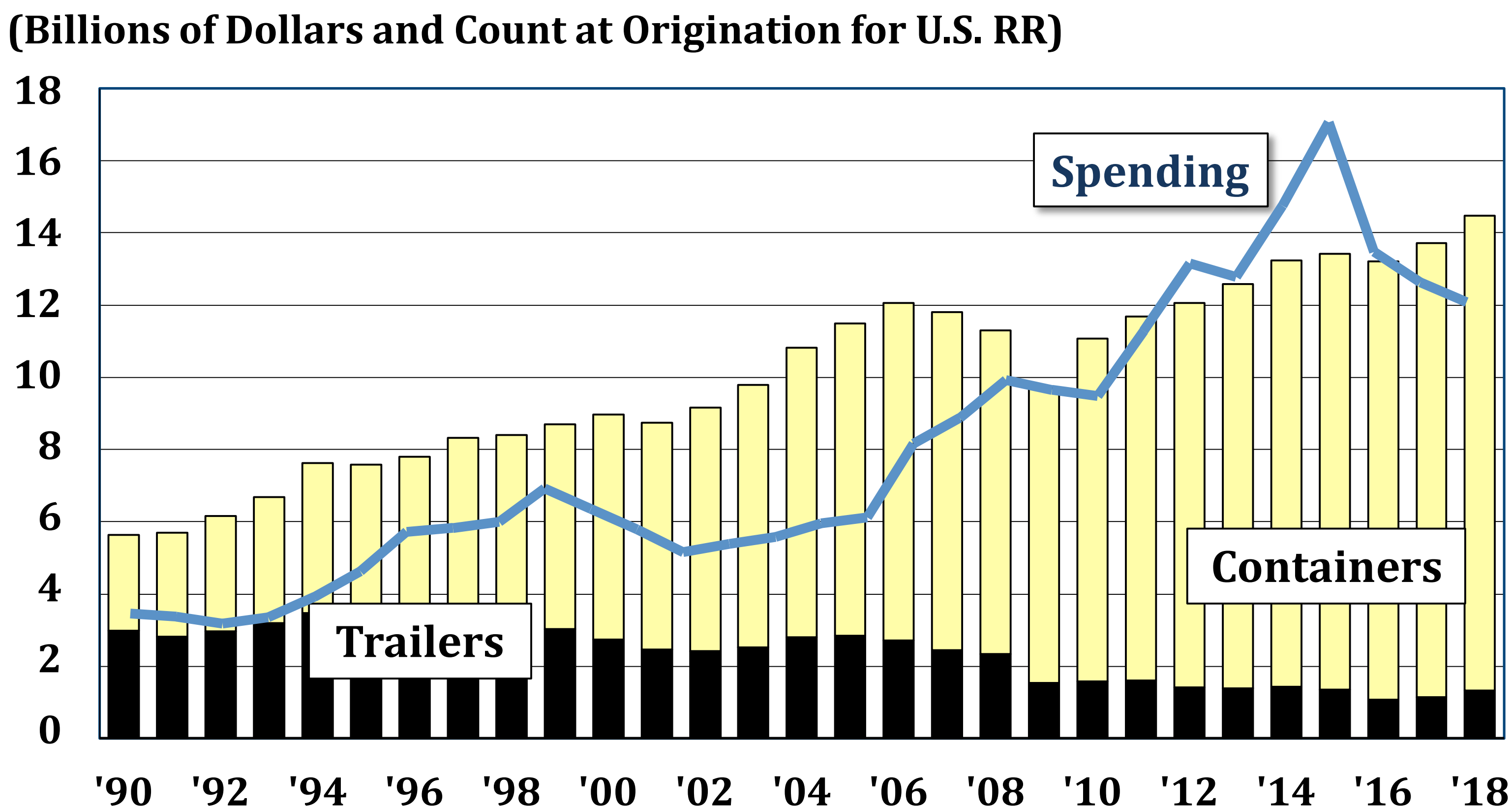
Rapid Intermodal Development



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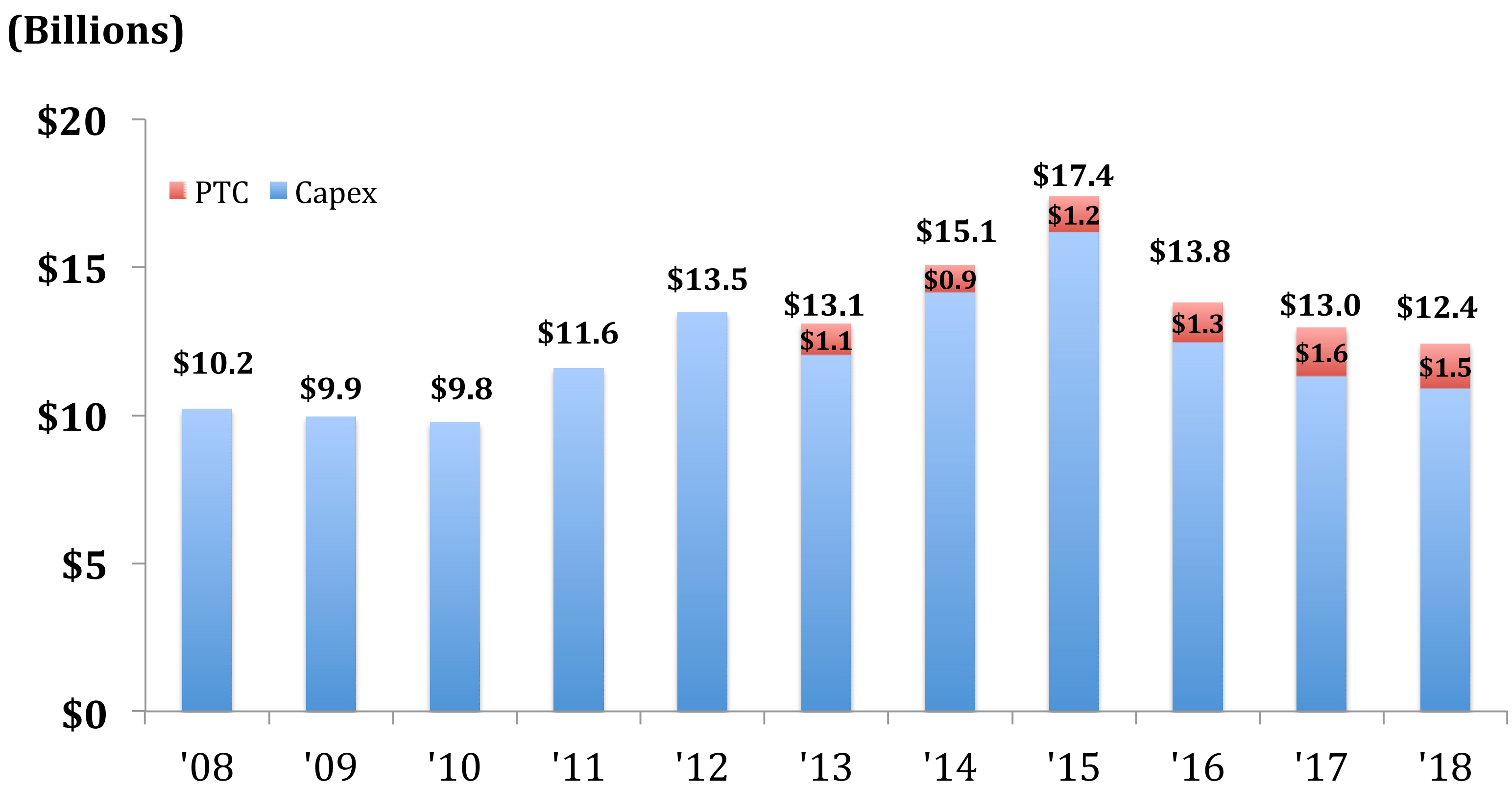
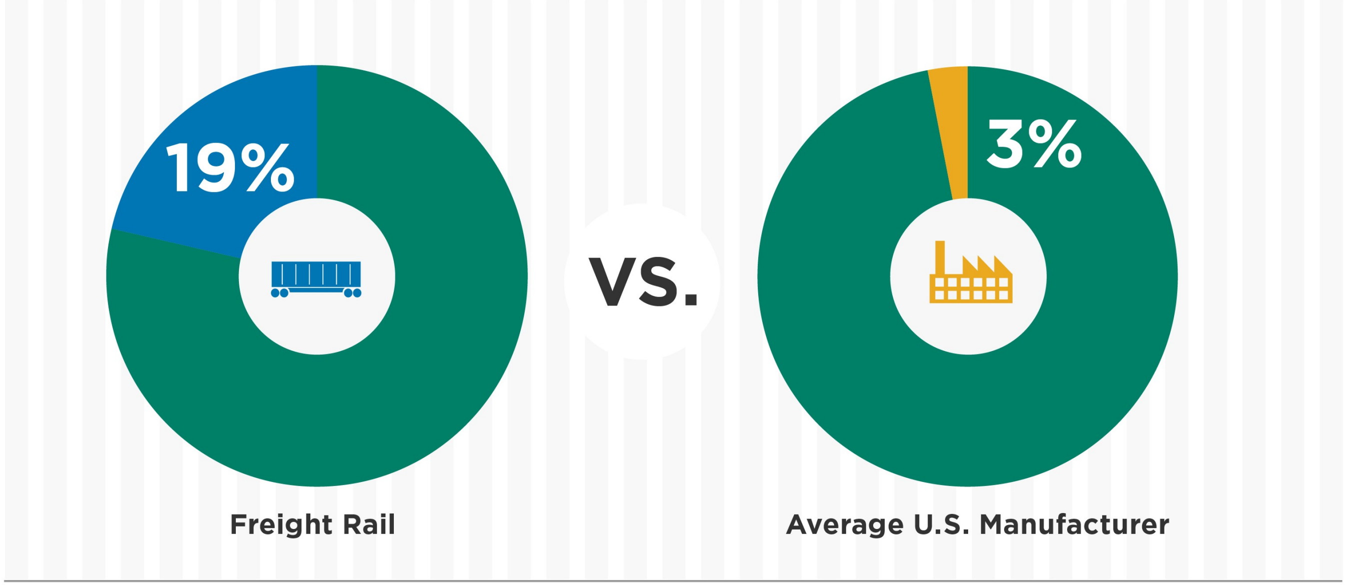
PTC Share of Railroad Capital Spending (USA)



Source: AAR

FREIGHT RAIL INVESTS SIX TIMES MORE THAN THE AVERAGE U.S. MANUFACTURER

Capital Spending as a Percentage of Revenue

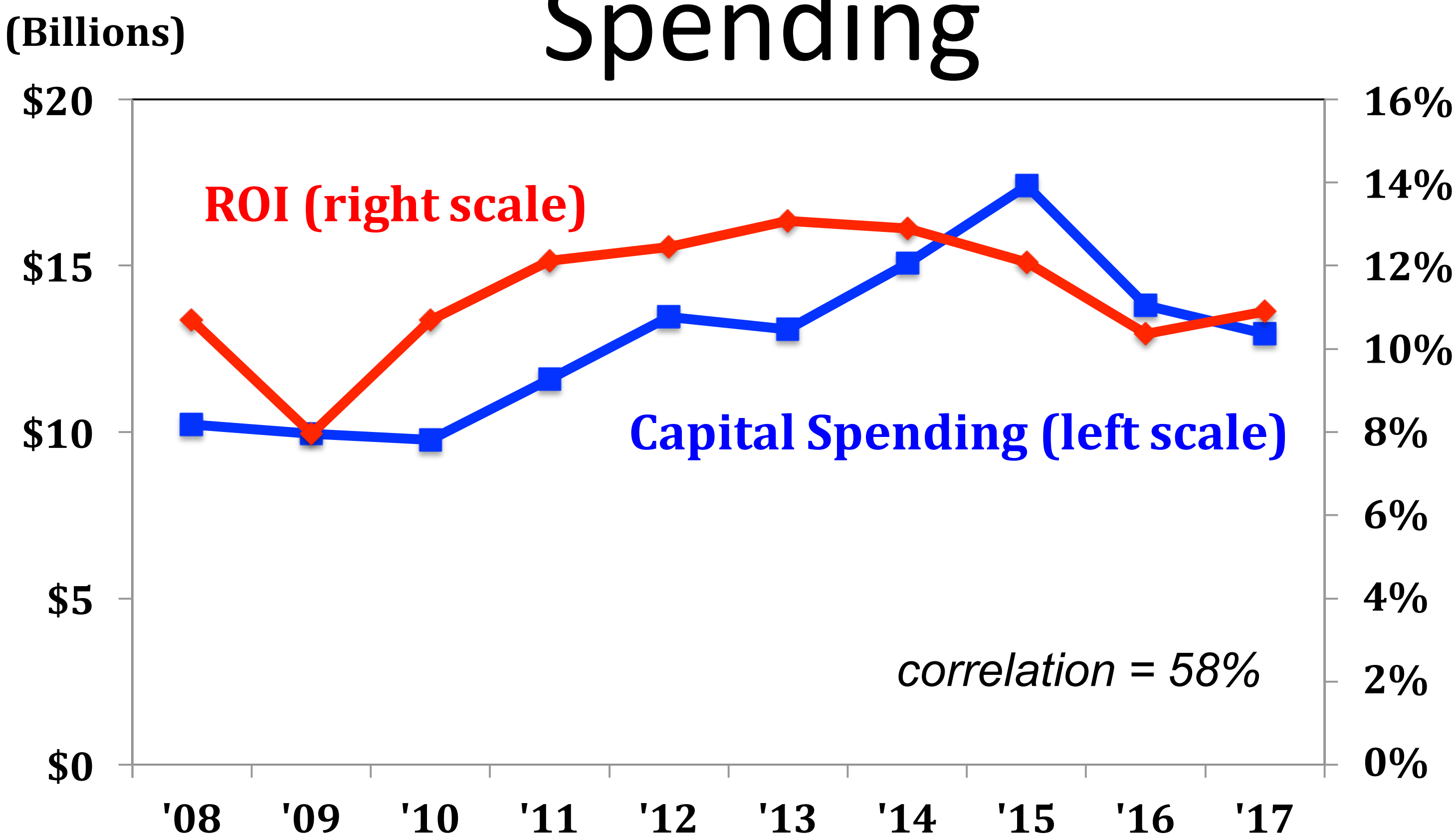


America's privately owned freight railroads have spent more than $660 billion since 1980 on capital and maintenance expenditures to create a rail network that is second to none in the world. The average U.S. manufacturer spends approximately 3 percent of revenue on capital expenditures. The comparable figure for U.S. freight railroads in recent years has been around 19 percent — six times higher. Going forward, it is crucial that the regulatory structure under which railroads operate remain balanced. Otherwise, railroads will be unable to earn the revenue required to pay for the network their customers will need in the years ahead.

ASSOCIATION OF AMERICAN RAILROADS

Source: Association of American Railroads

Close Correlation Between Railroad ROI and Capital Spending



Source: AAR

Note: ROI excludes accumulated deferred income tax credits.

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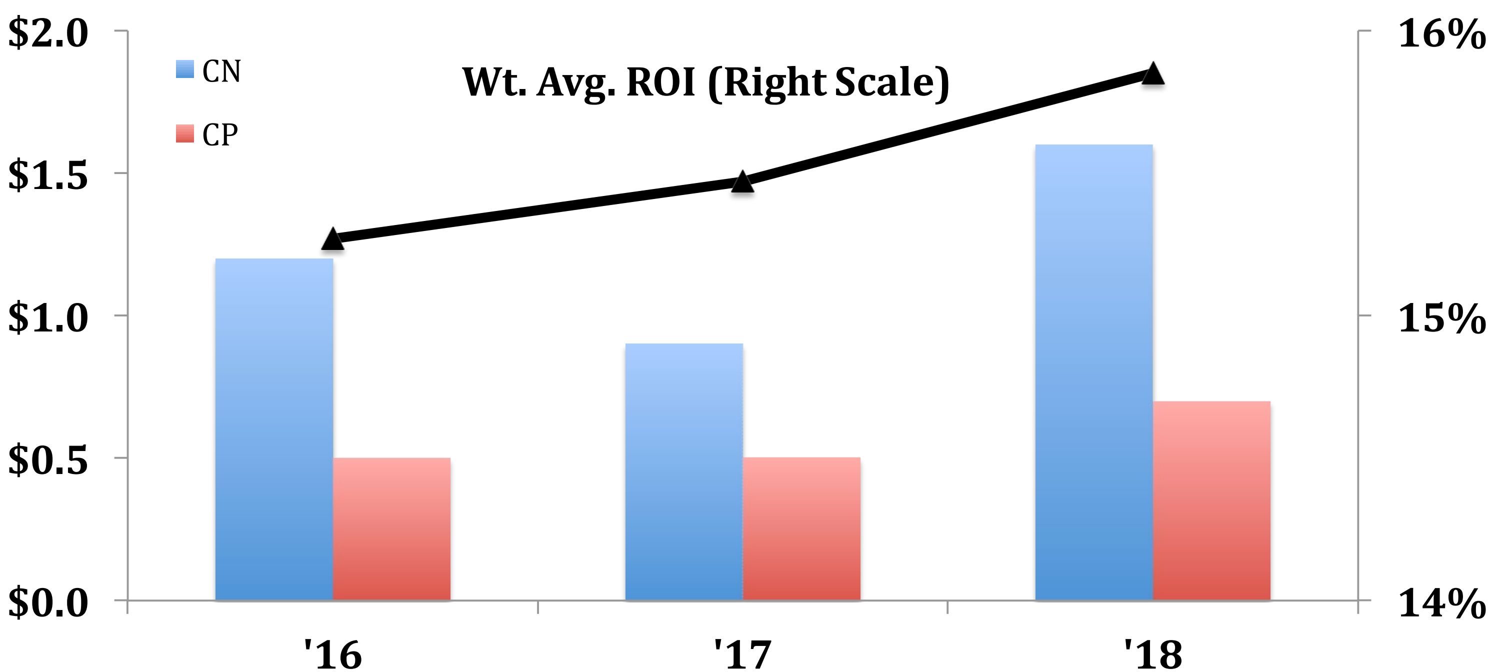
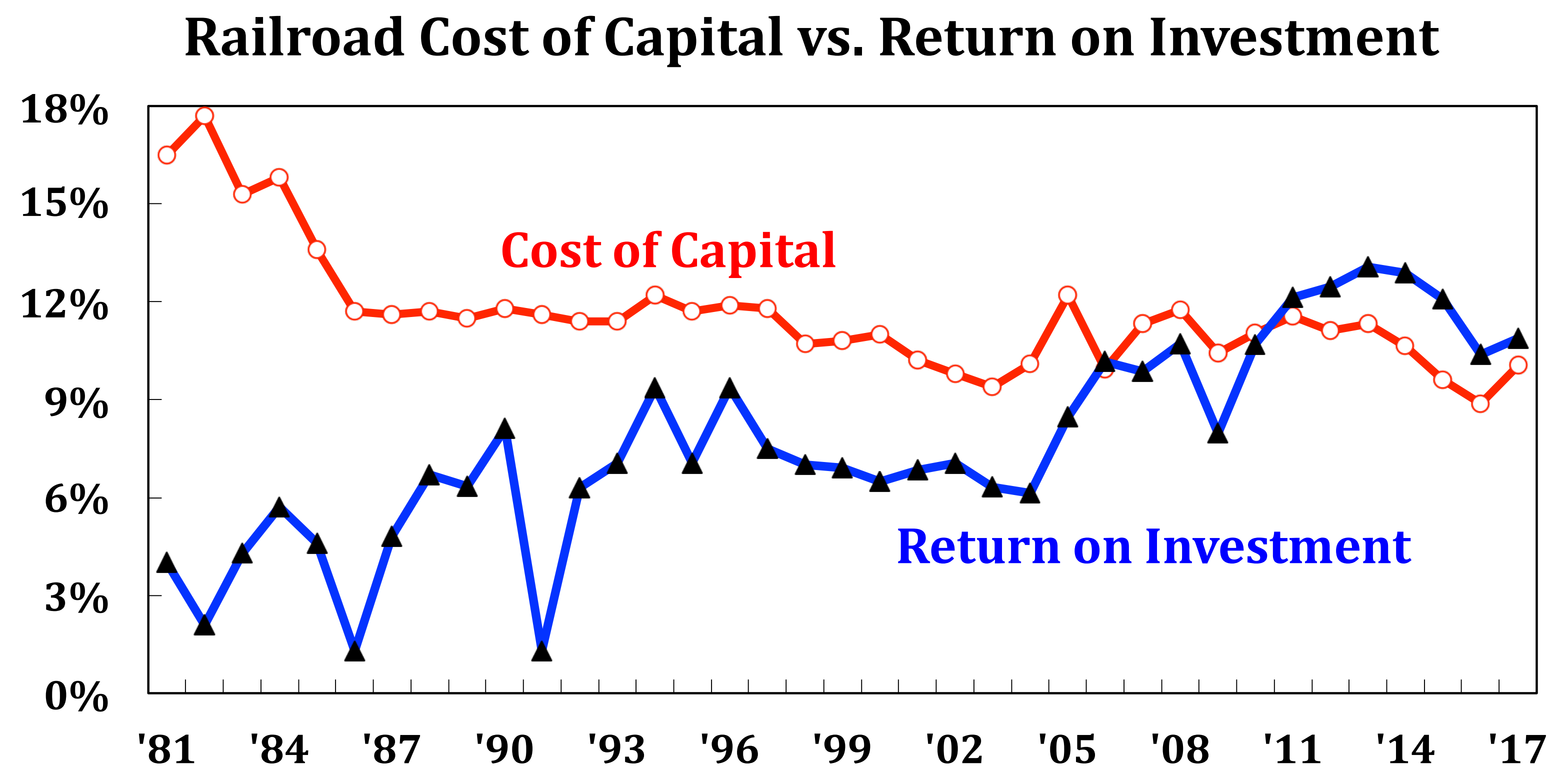


Source: Company Reports

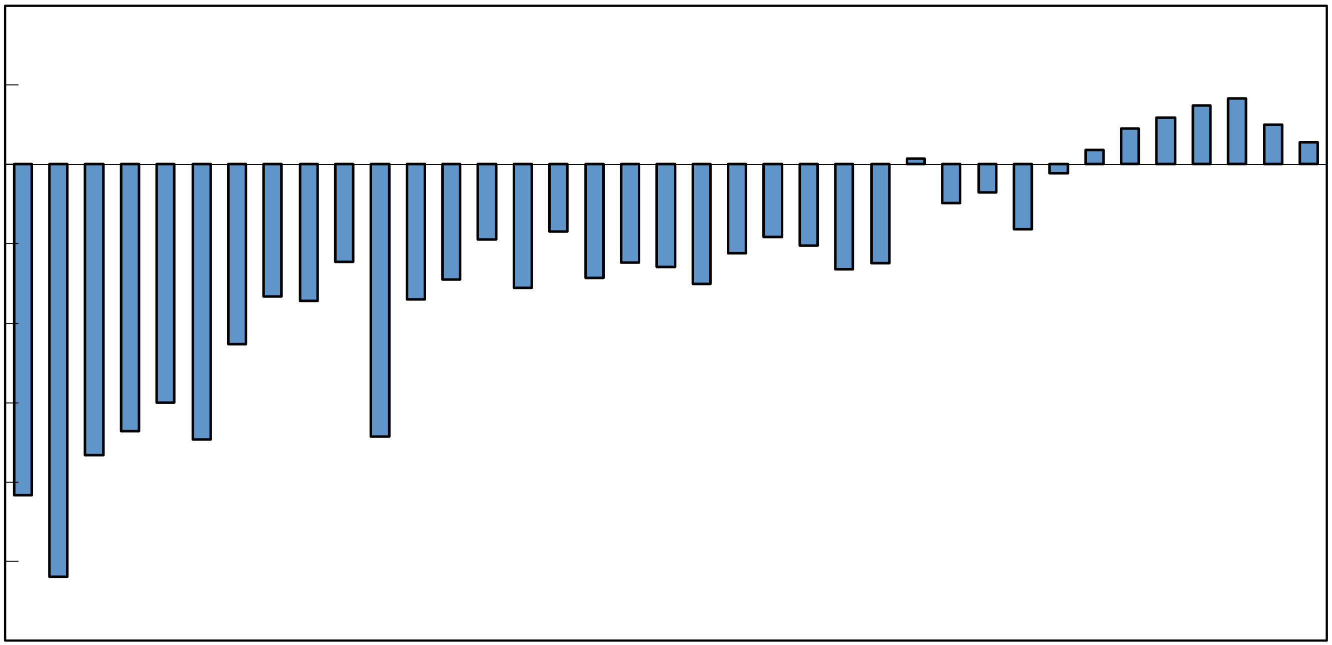
Rail Industry Now Earns Its Cost of Capital



Source: STB
Note: ROI excludes accumulated deferred income tax credits.

Rail Industry Return Minus the Cost of Capital has Turned Positive

- 6%
- 3%
- 0%
- -3%
- -6%
- -9%

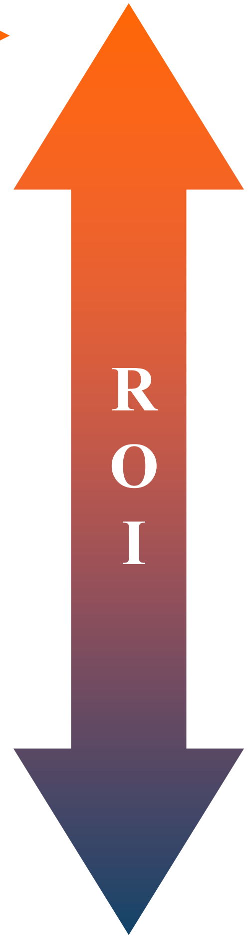


Note: ROI excludes accumulated deferred income tax credits.

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
- Safety!



If ROI < cost of capital:

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

Freight Rails Earn High Marks

- America’s rail network was awarded the highest grade in 2017, a “B.” from The American Society of Civil Engineers (ASCE).
- The high marks for America’s privately funded freight rail system stand in stark contrast to taxpayer-funded transportation infrastructure. Bridges, ports and roads, for example, continue to age and suffer from overuse.
- Reflecting their poor condition, ASCE respectively gave these public systems grades of “C+” “C+” and “D.”

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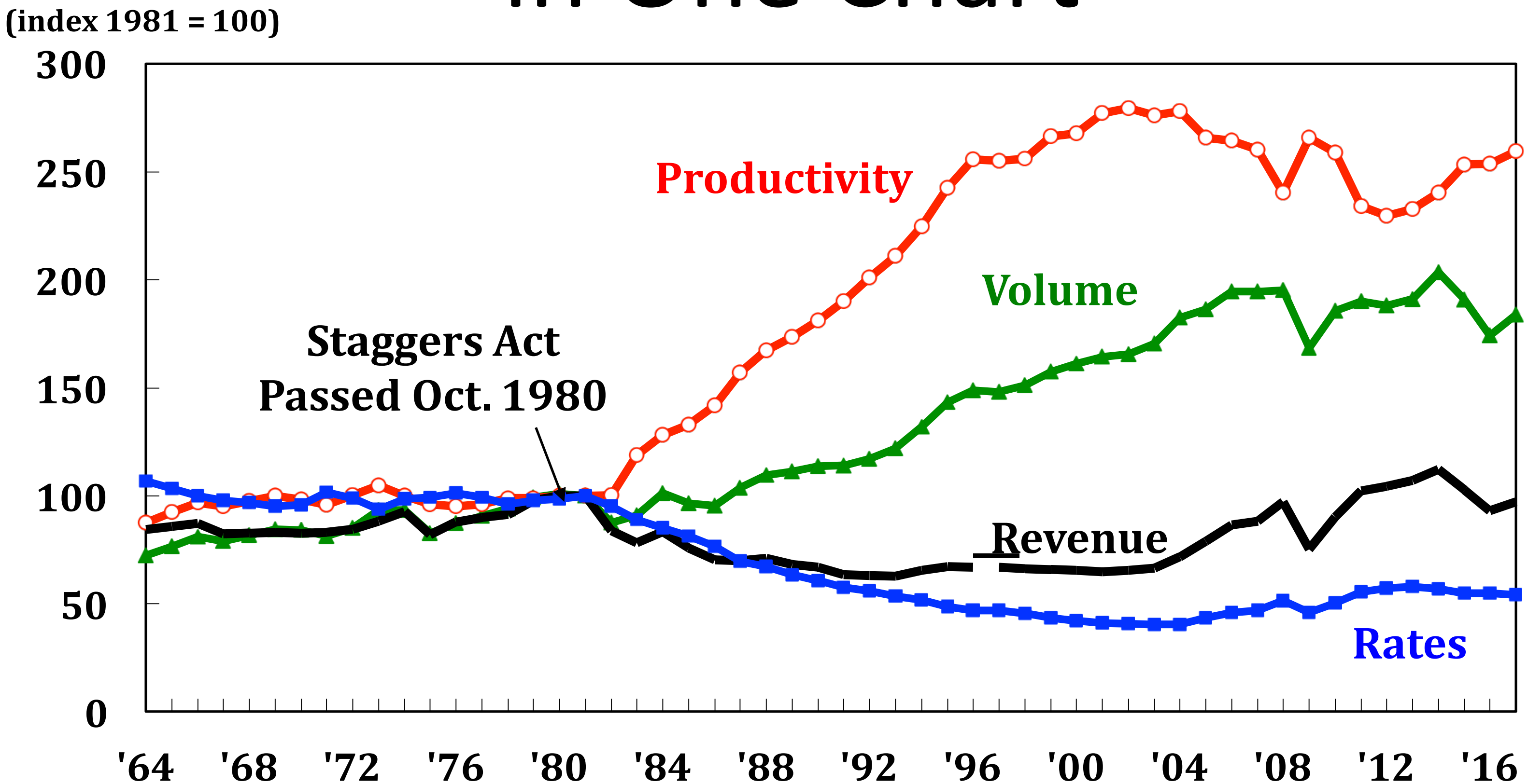
U.S. Freight Railroad Industry in One Chart



Source: AAR

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