

# Railroads & Intermodal 2017



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# Issues for RR/Intermodal to 2020

- **Return to Growth?**
- **Fight over Capital – MoW vs Buybacks?**
- **M&A Fight fallout effect on Capex?**
- **RR Pricing Power Still?**
- **Factors: Oil Prices, Consumer Spend/GDP, Truck Capacity**
- **Infrastructure Advantage (vs subsidized highway)**
- **Trade and the Panama Canal impacts? NAFTA?**
- **Rail Service (& Safety) Improvements**
- **Coal stabilization**
- **Driverless beats One Man Crews to the market?**

# Hunter's Back!

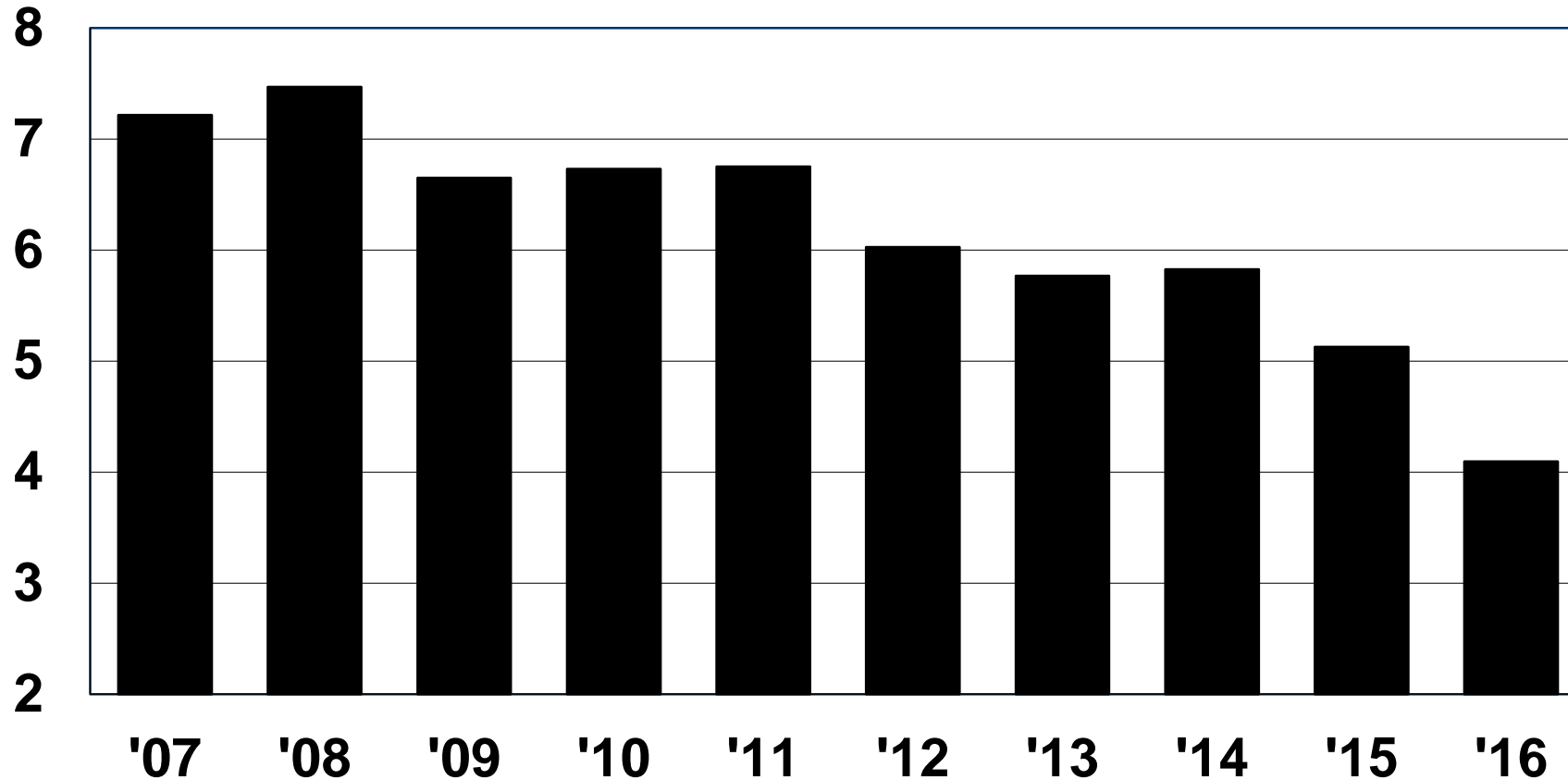
- Mantle/EHH proposal - EHH leaves CP
- *Not* about consolidation!
- As such, only 1 Stakeholder group – CSX shareholders – needed to approve! (2/10)
- Precision Railroading will improve OR but\
  - CSX isn't like CP (damaged goods)
  - CSX isn't like CP (density/complexity)
  - Customer Service is more important than ever!

# **New Administration “Promises”**

- 1. The end of the “War on Coal” – maybe a spark amongst the smoke?**
- 2. Drill, Baby, Drill (and pipelines, eh!)**
- 3. Infrastructure (Privately Financed)**
- 4. Bye-bye Trade (NAFTA)??**
- 5. Get out and stay out! End of the 150-year relationship of GOP & “Big Business” (ask Ford)**
- 6. War on Regulation (maybe) on Red tape (likely)**
- 7. Lower taxes – still waiting.....**
- 8. Labor – Who’s driverless, now?**

# U.S. Rail Carloads of Coal: Not Pretty!

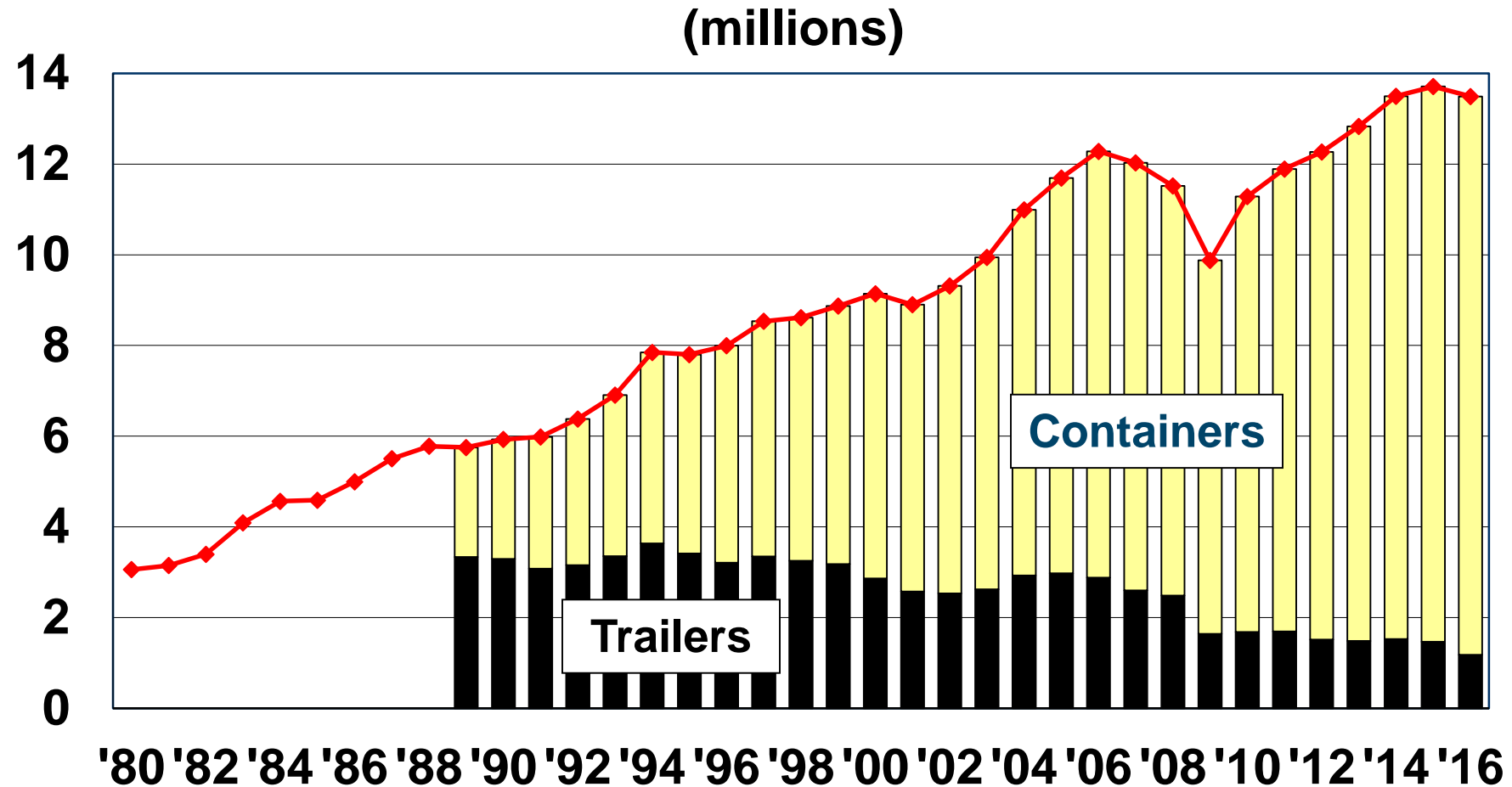
(millions)



Data are originations and do not include the U.S. operations of CN and CP.

Source: AAR *Weekly Railroad Traffic*

# Rapid Intermodal Growth



Source: AAR Weekly Railroad Traffic

# Silver Linings?

- Service (& Safety) Recovery Trend (Capex Pays Off)
- Productivity (& volume?) Inflection
- Restoration of the “Grand Bargain”
- Reduced (N/T) Political Pressure
- Coal “stabilization” (Part Two)??
- IM (etc.) latent demand....Bi-Modal results; Ag
- Gas-fired Industrial Buildout; Southbound migration of industry
- Revised MoW Capex (GTM/Mix) frees CF/2017+

# 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

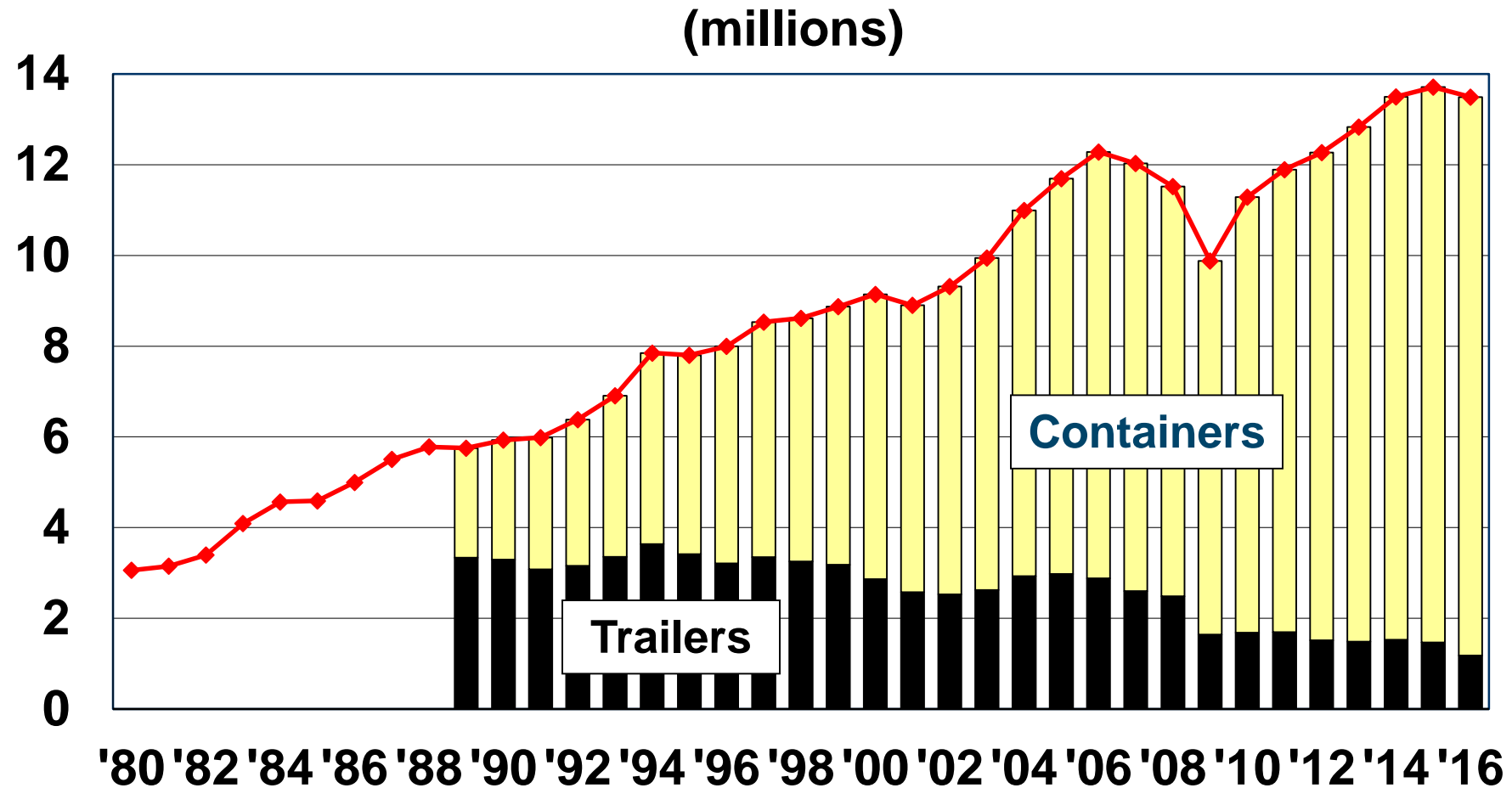


# Future Growth Potential (Revised)

Secular stories and specific targeted sectors (in order)....

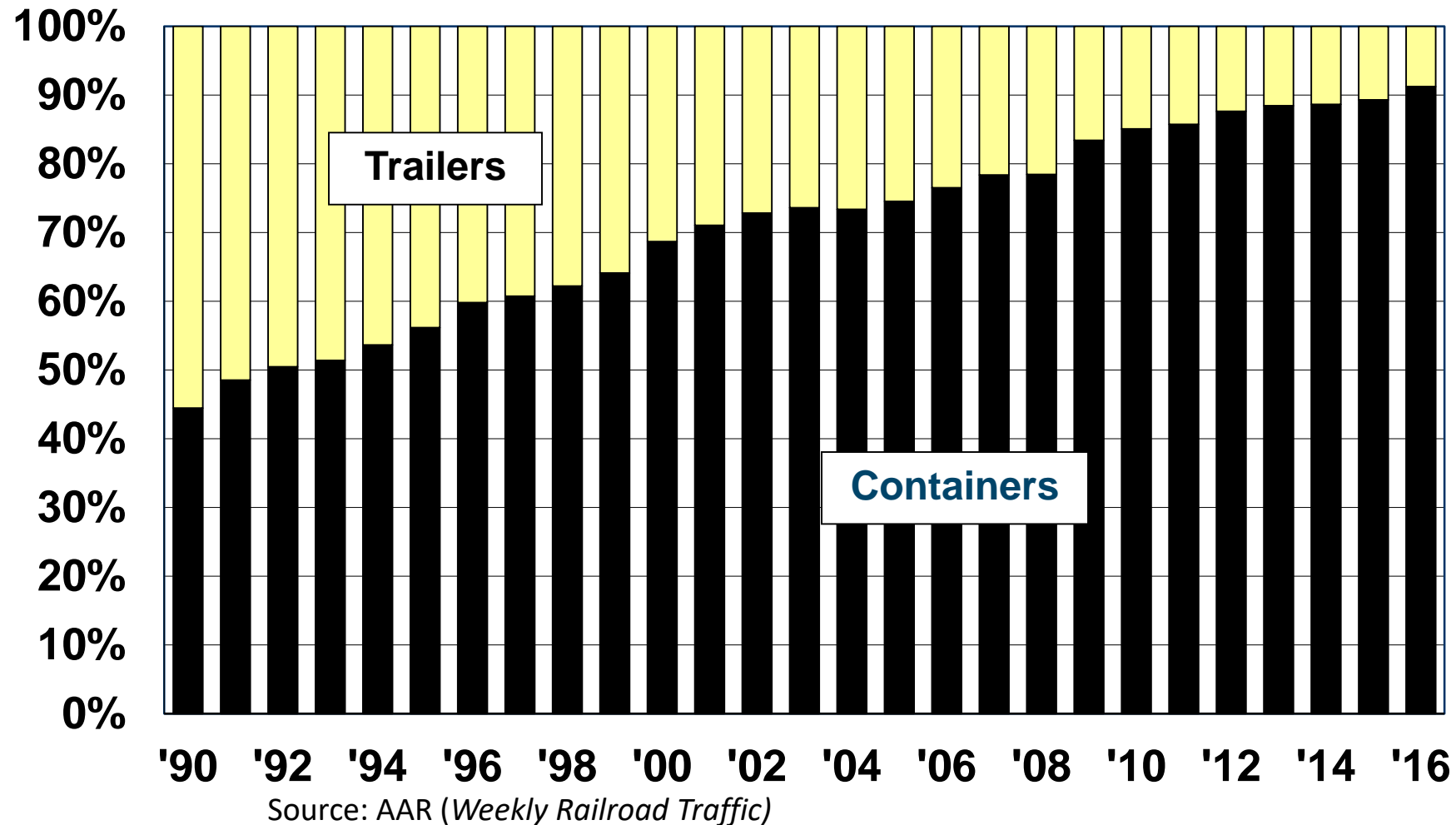
1. ***Intermodal*** – international *and now* domestic
2. ***Chemicals/re-industrialization?*** Near-sourcing/*Mexico* (??)
3. ***Cyclical recovery*** – housing, steel, autos (still....)
4. **Grain & Food** – Exports up 10% this CY? NA still the world's breadbasket, but obviously (un)*predictable*?
5. **Car-load merchandise – capacity available!**
6. **Shale/oil/sand** – demonstrated “flexibility”
7. **Other rail opportunities** exist but in smaller scale: for ex: The manifest/carload “problem”
  - Unitization
  - Industrial Products/MSW
  - Perishables

# Rapid Intermodal Growth

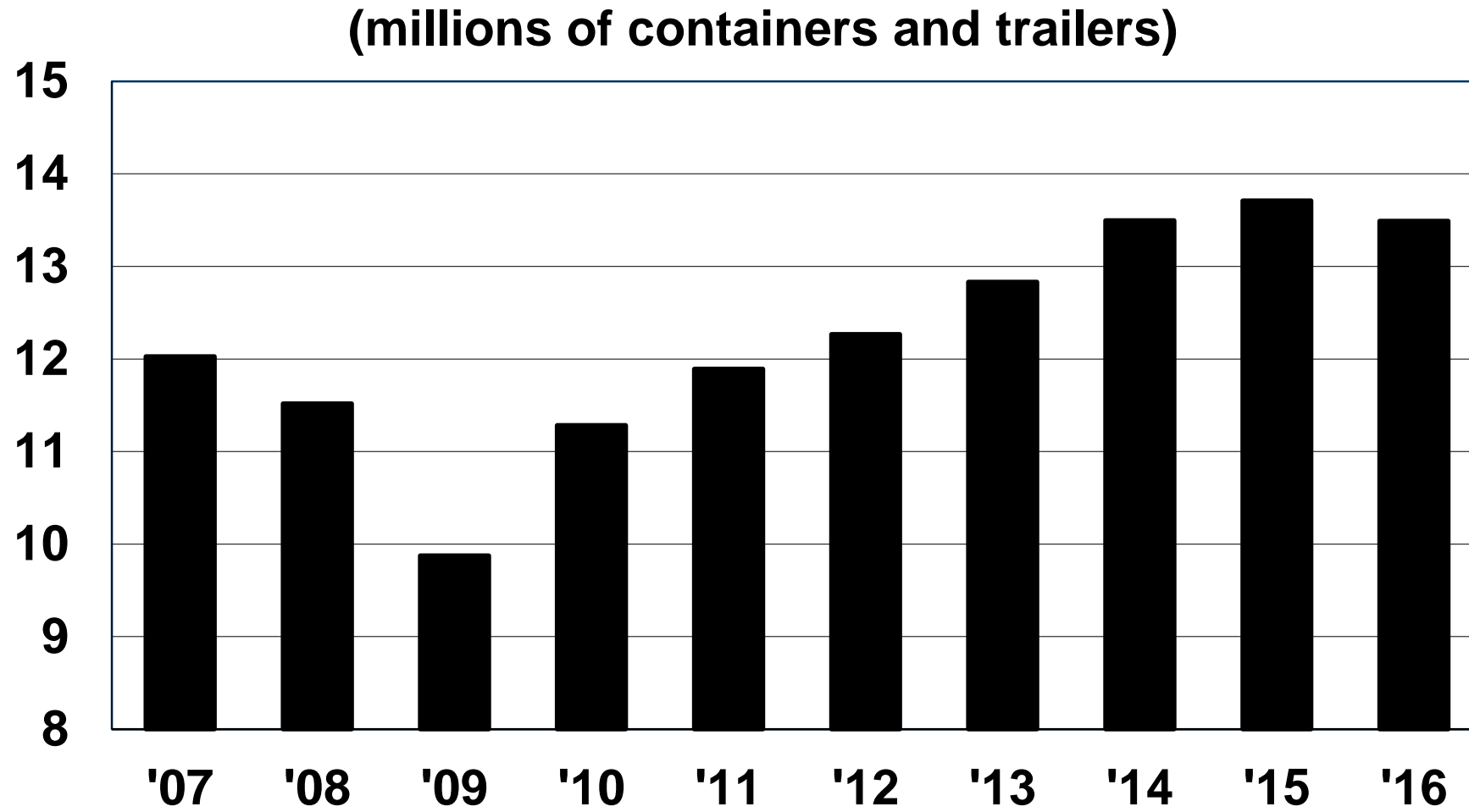


Source: AAR Weekly Railroad Traffic

# Containers vs. Trailers as % of U.S. Rail Intermodal Traffic

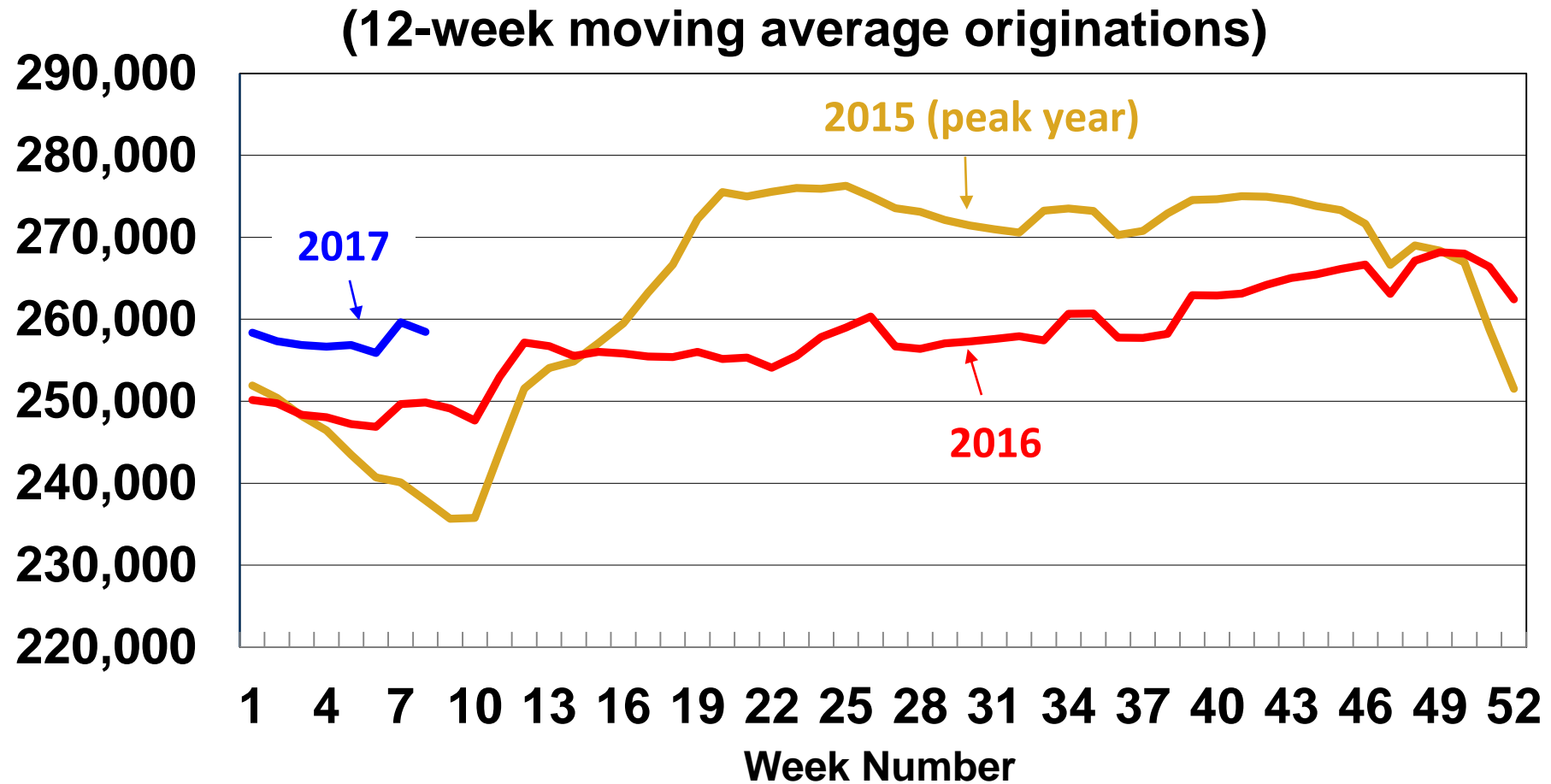


# Lower Intermodal Volumes in 2016



Source: AAR (*Weekly Railroad Traffic*)

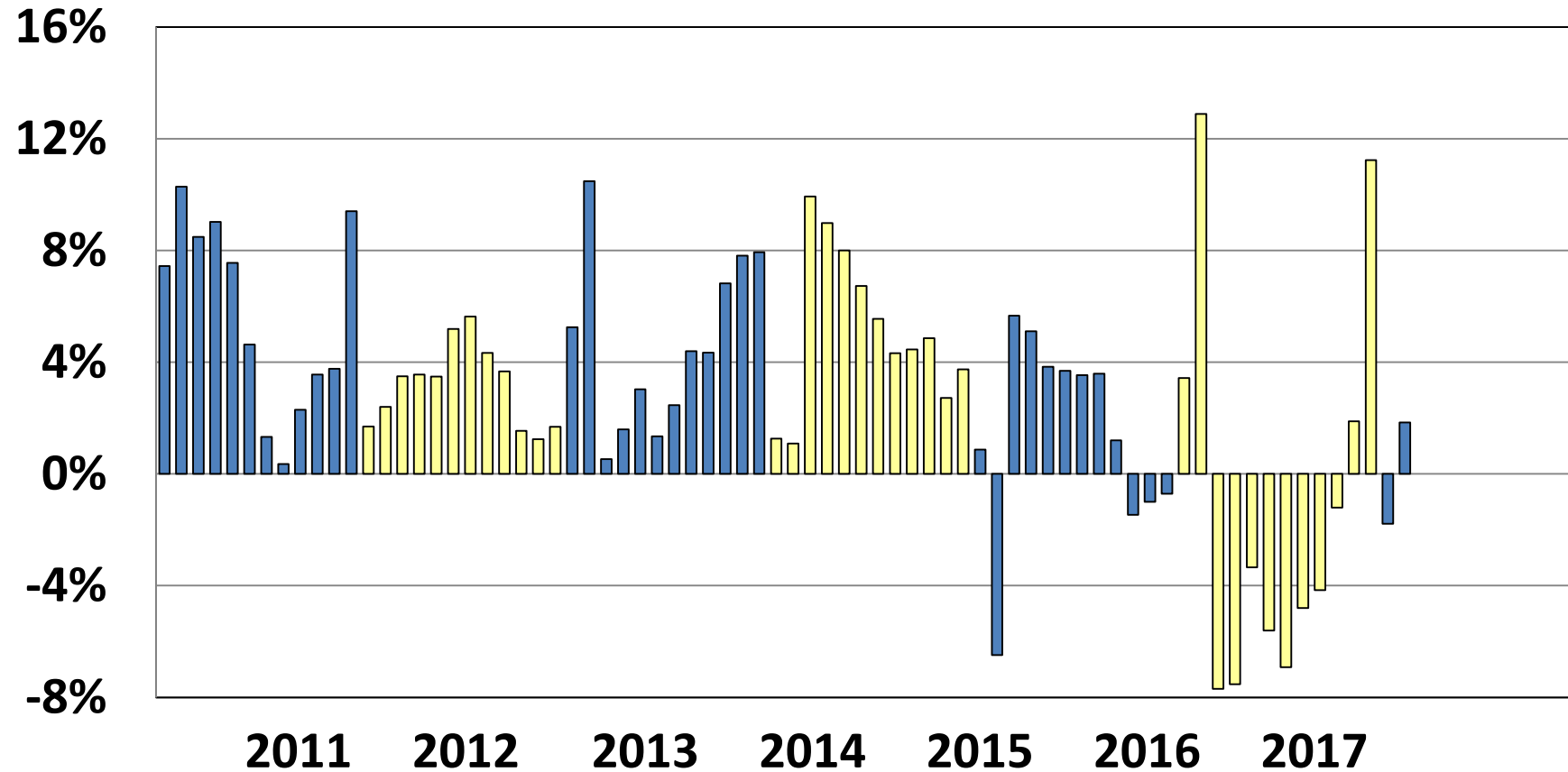
# U.S. Rail Intermodal Traffic



Data do not include the U.S. operations of CN and CP. Source: AAR

# U.S. Rail Intermodal Traffic

(% change from same month previous year)



Data are based on originations, are not seasonally adjusted, and do not include the U.S. operations of CN and CP. Source: AAR *Weekly Railroad Traffic*

# Why Has Intermodal Grown Over the Years?

- Better service
- Huge RR investments
- Truck problems
  - fuel
  - driver shortages
  - congestion
- Switch from other freight cars
- Growing economy and trade



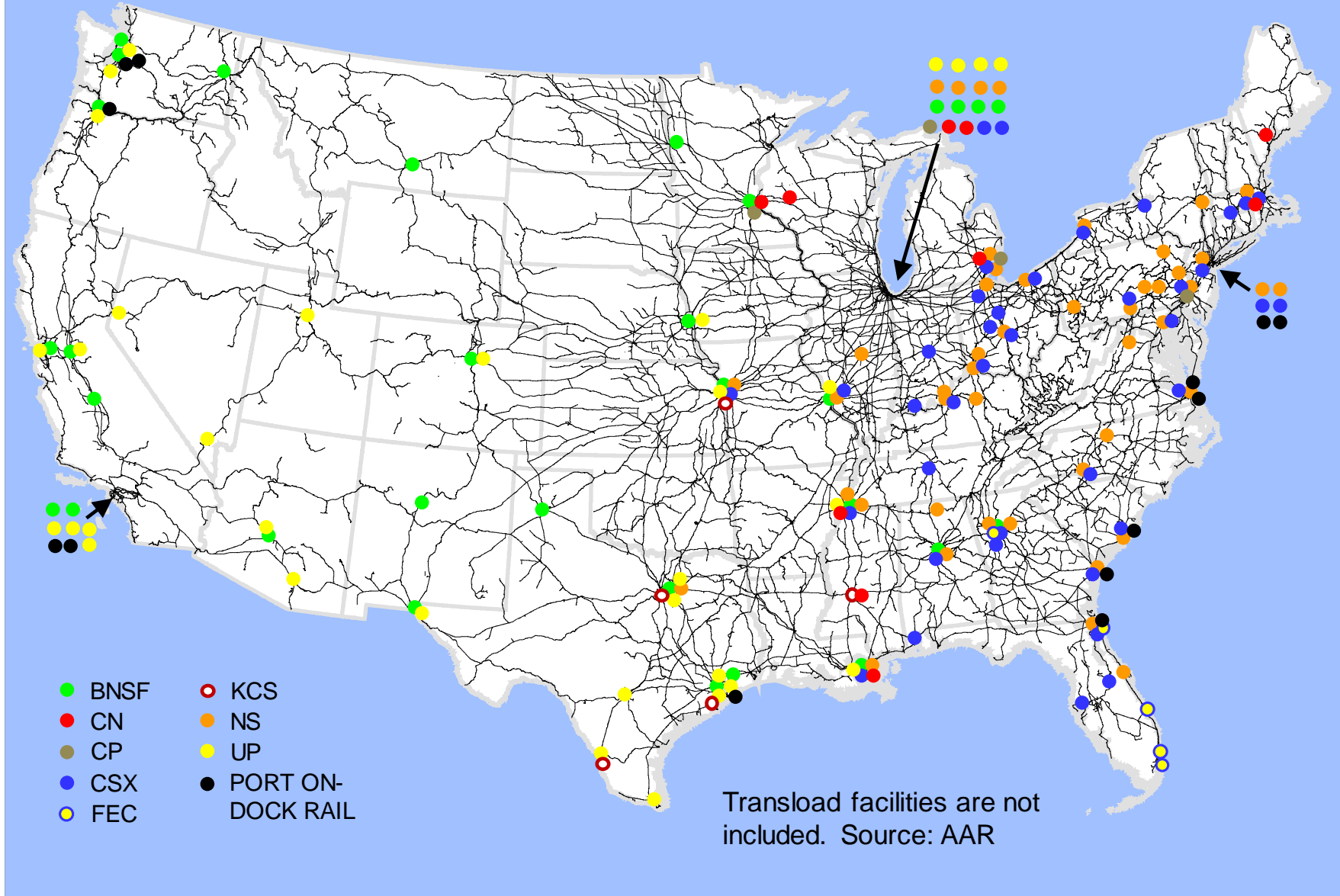
# Why Did Intermodal Fall in 2016?

- Cheaper diesel fuel partially offsets RRs' fuel efficiency advantage
- Inventory overhang
- Truck overcapacity
- Driver turnover “only” ~75%
- Lack of strong economic growth





## MAJOR U.S. RAIL INTERMODAL TERMINALS



**Figure 3-5 Average Daily Long-Haul Truck Traffic on the National Highway System: 2011**



**NOTE:** Long-haul freight trucks typically serve locations at least 50 miles apart, excluding trucks that are used in movements by multiple modes and mail.

**SOURCE:** U.S. Department of Transportation, Federal Highway Administration, Office of Freight Management and Operations, *Freight Analysis Framework*, version 3.5, 2015.



Figure 3-6 Average Daily Long-Haul Truck Traffic on the National Highway System: 2040



NOTE: Long-haul freight trucks typically serve locations at least 50 miles apart, excluding trucks that are used in movements by multiple modes and mail.

SOURCE: U.S. Department of Transportation, Federal Highway Administration, Office of Freight Management and Operations, *Freight Analysis Framework*, version 3.5, 2015.

### Top 15 Markets for Intermodal Traffic Handled in the United States in 2013\*

Market	Containers and Trailers
1. Chicago / Elwood / Joliet, IL	5,669,000
2. Long Beach / San Pedro / San Bernardino / City of Industry, CA	4,881,000
3. Atlanta, GA	1,302,000
4. Dallas / Ft. Worth / Saginaw, TX	1,268,000
5. Seattle / Bremerton / Tacoma / Everett, WA	1,035,000
6. Little Ferry / North Bergen / South Kearny / Jersey	989,000
7. Memphis, TN / West Memphis, AR	796,000
8. Kansas City, MO / Kansas City, KS	632,000
9. Harrisburg, PA	610,000
10. Stockton, CA	561,000
11. Jacksonville, FL	540,000
12. Norfolk / Portsmouth, VA	507,000
13. Detroit / Pontiac, MI / Toledo, OH	470,000
14. Houston, TX	455,000
15. Columbus / Marion / Marysville, OH	376,000

\*Originated and terminated Source: AAR analysis of 2013 STB Waybill Sample

# Characteristics of the Intermodal Network

- Must accommodate both domestic and international business
- Focused on high volume origin-destination pairs
- Best when operated as single origin to single destination trains
- Cost control and service reliability are critical



# Characteristics of Strong Intermodal Corridors

- Sufficient capacity to keep trains moving
- Long enough to compete with trucks
- Sufficient volume to keep unit costs competitive
- Strong highway feeder system at each end and at intermediate terminals





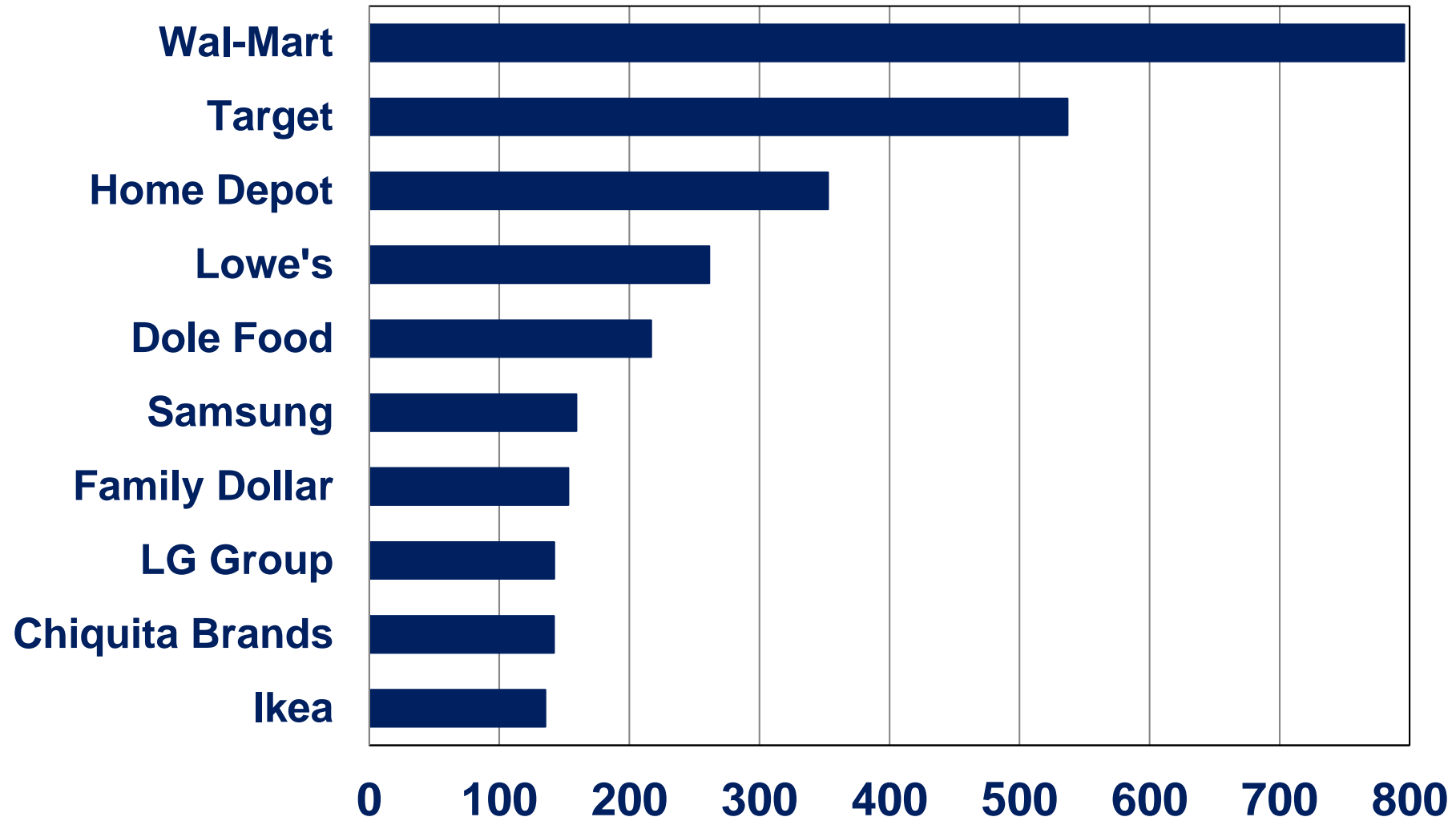
# Characteristics of the Newest Intermodal Terminals

- Usually outside urban areas
- Easy highway access
- Designed to accommodate adjacent distribution / production centers
- Land for future growth
- Minimize “on terminal” truck movements



## Top 10 U.S. Container Importers: 2015

(000s of 20-foot equivalent units)

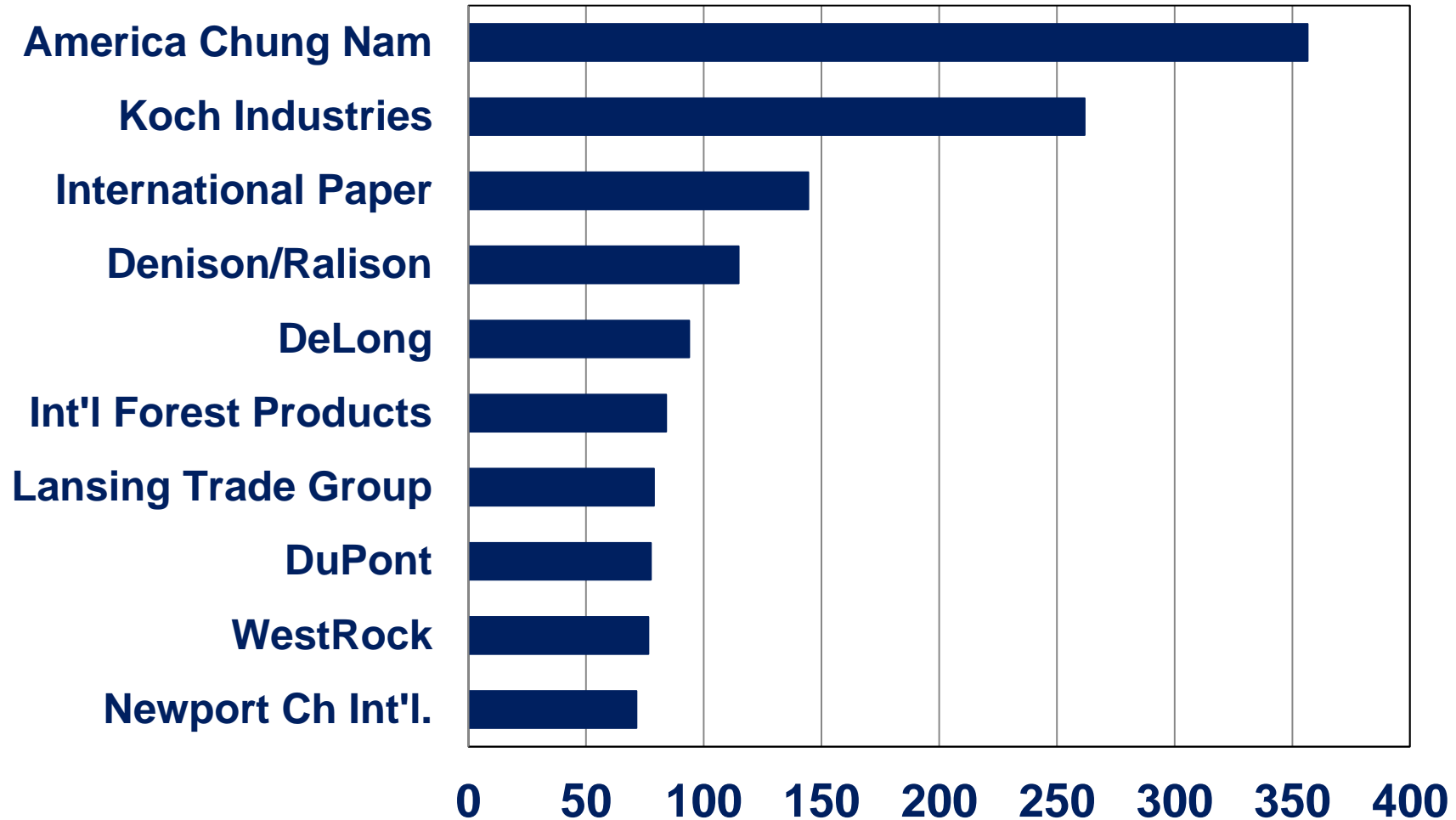


Source: *Journal of Commerce*



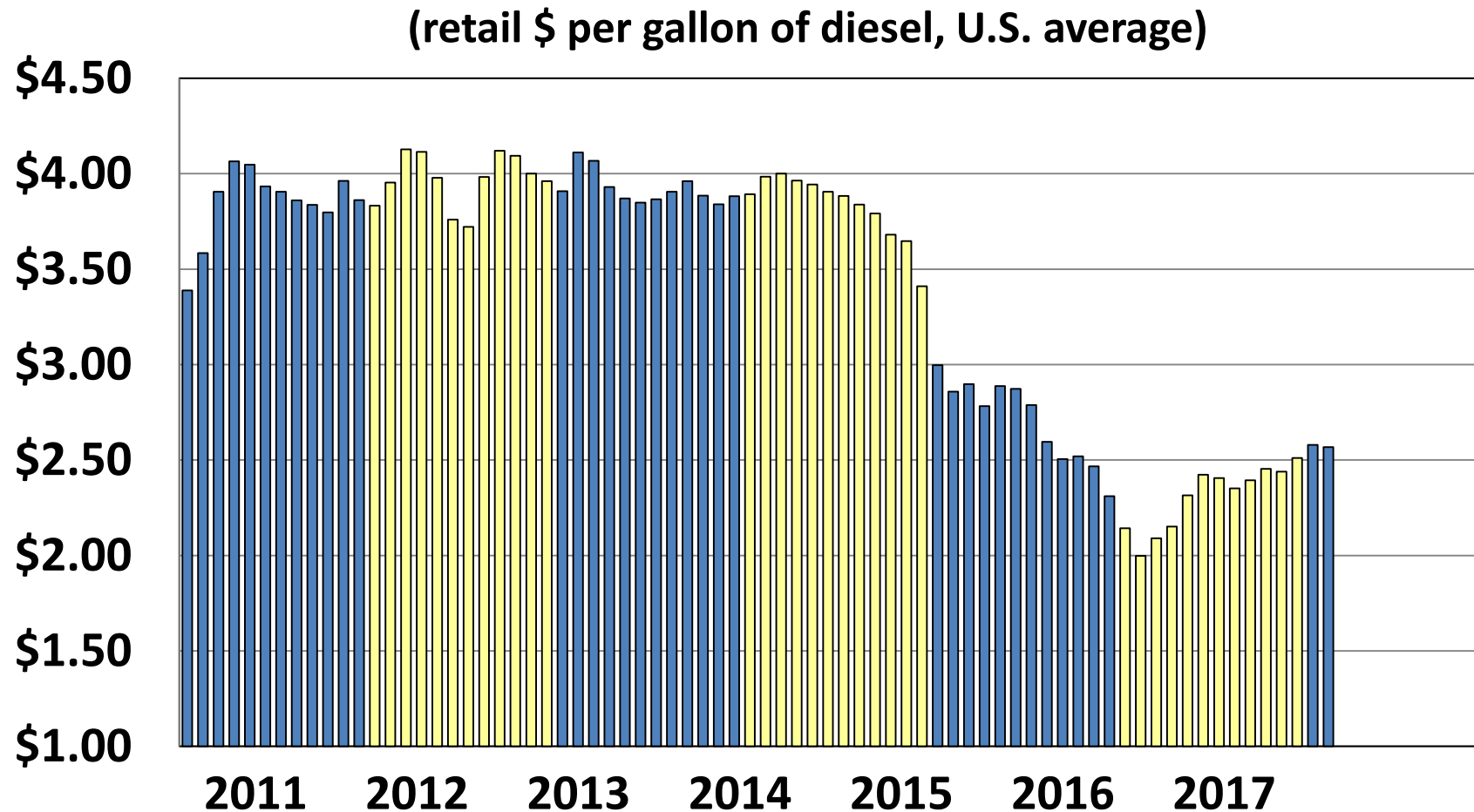
## Top 10 U.S. Container Exporters: 2015

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Source: *Journal of Commerce*

# Expensive Fuel Helps RRs, Cheap Fuel Helps Trucks



Source: Energy Information Administration

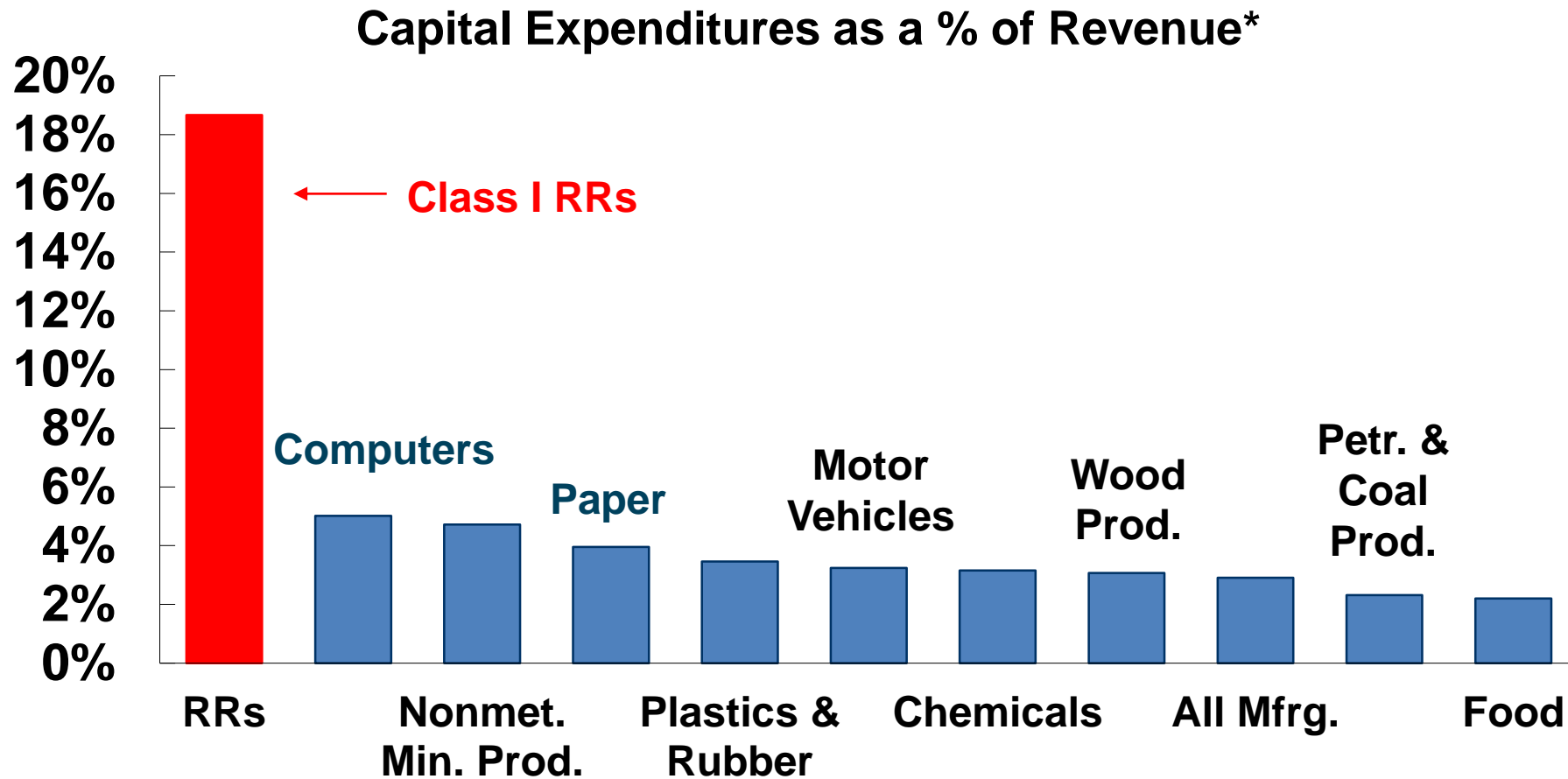
# 2017-18 RR EPS/Expectations

- RR earnings 2016-Q1 struggled to match improved sentiment & increased expectations
- H2/16 Volume inflection (coal stabilizes/IM grows)
- Q2 well above bullish expectations; H2?
- Productivity (and price) retention
- Capex down...but not out (?)
- Guidance & Visibility slightly improved....
- Winter is coming (and going) – AV, etc
- Big Labor Year
- He's Baaaaaack! (Fall, 2017)

# Issues for RR/Intermodal to 2020

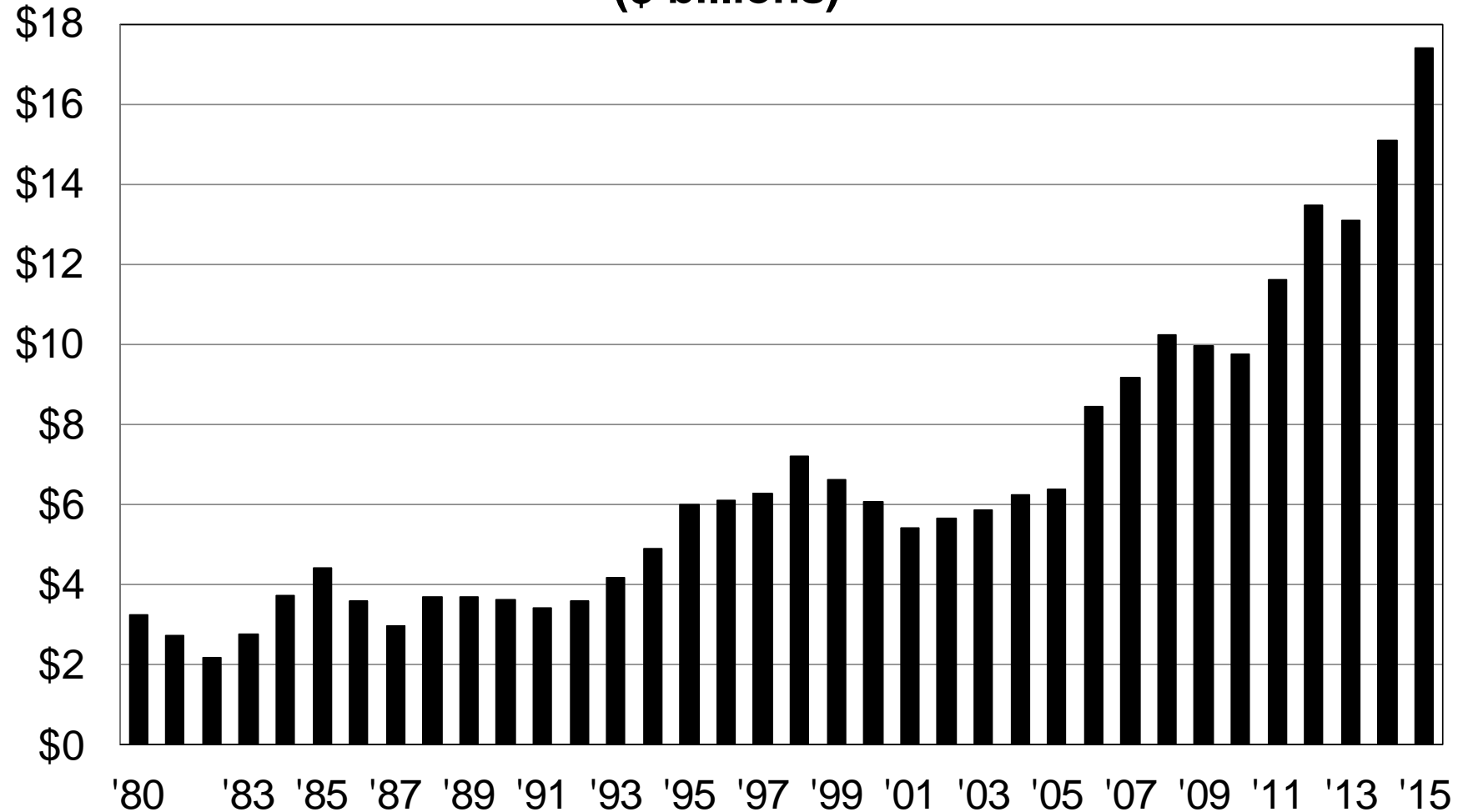
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- Factors: Oil Prices, Consumer Spend/GDP, Truck Capacity
- Infrastructure Advantage (vs subsidized highway)
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# Railroads: Far More Capital Intensive Than Other Industries



\*Average 2006-2015 Sources: Census Bureau, AAR

## Class I Freight Railroad Capital Spending (\$ billions)

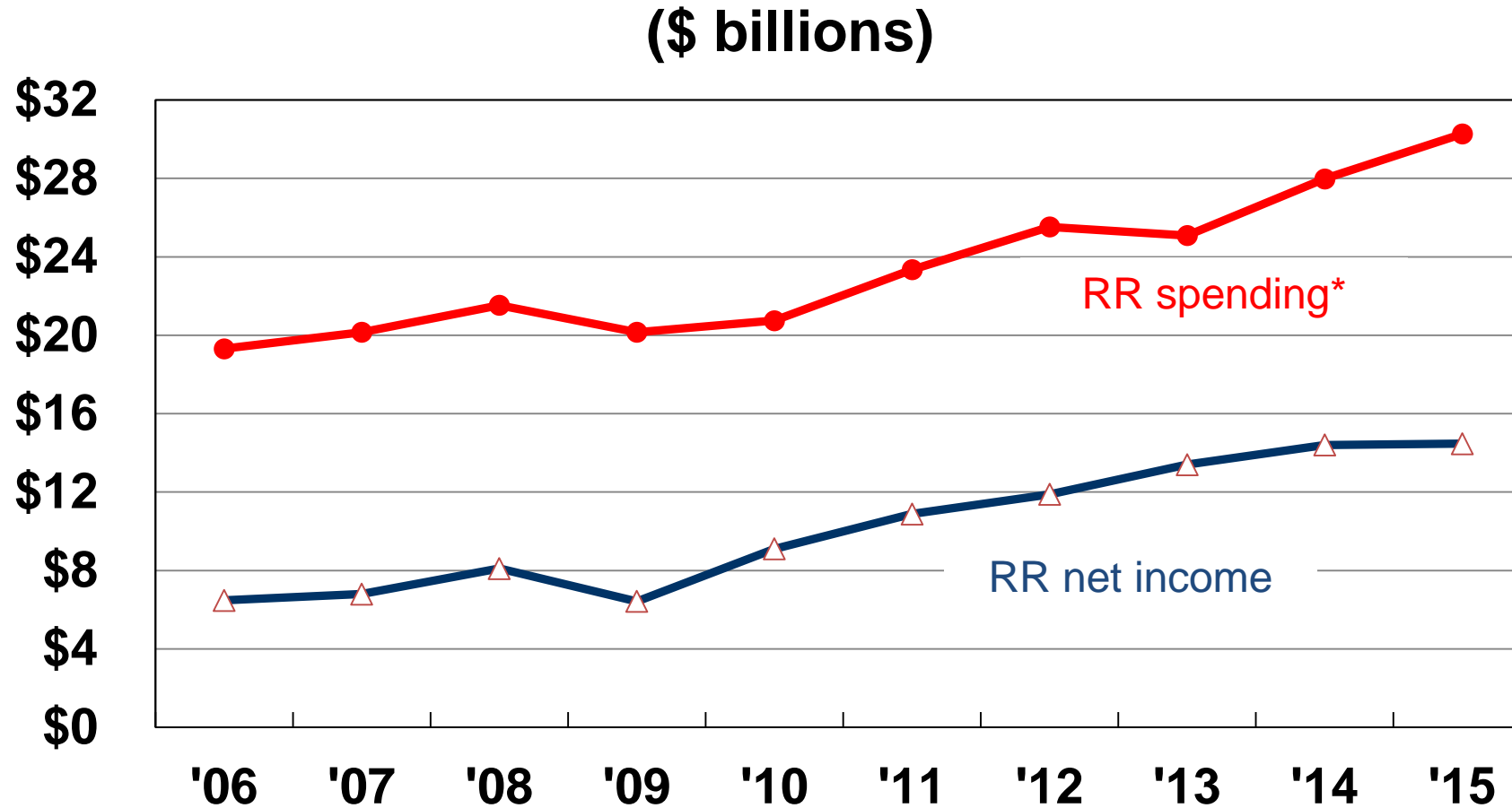


Source: AAR

# Future RR Capex

- 2016 Capex down across the board (announced average -16%!) – except CN and further midyear cuts bring 2016E to -20%?
- Changing Mix of volumes - Most Important Decision Period in Years
- 2017 -Further cuts – Still able to avoid muscle?
- Coal: “Stranded Assets”? NS selling segments....CSX of Tomorrow
- Coal/Mix: Reduced Gross Ton Miles=Reduced Maintenance of Way?
- *Yet remember: Service & Safety are even more critical to future RR success*
- *Changing mix of capex?*
- Changing %revenues (16%)?
- PTC Extension resolution – more to develop? ECP?

# Higher Rail Profitability = Higher Rail Spending

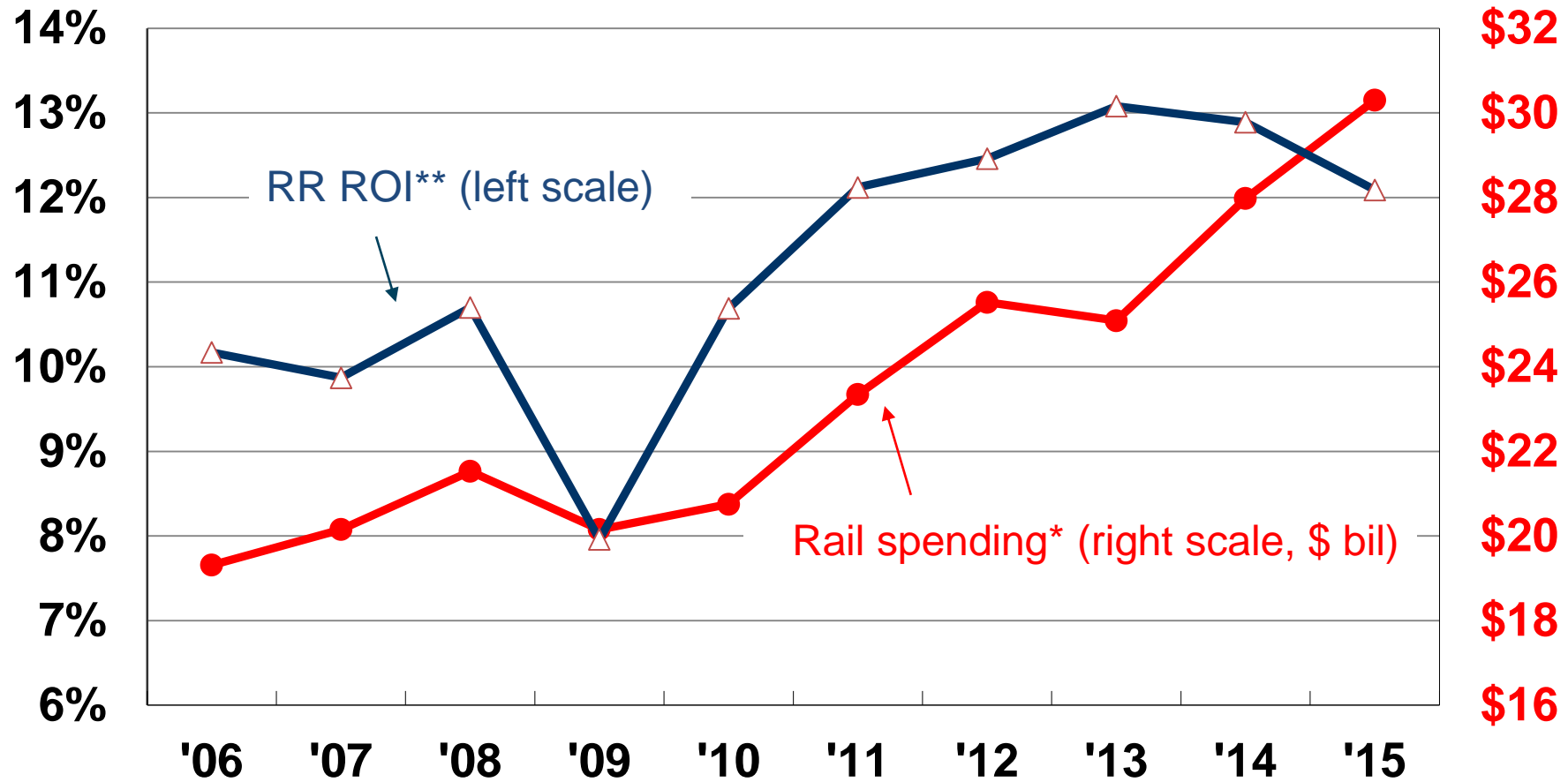


\*Capital spending plus maintenance expenses.

Data are current dollars and are for Class I railroads. Source: AAR

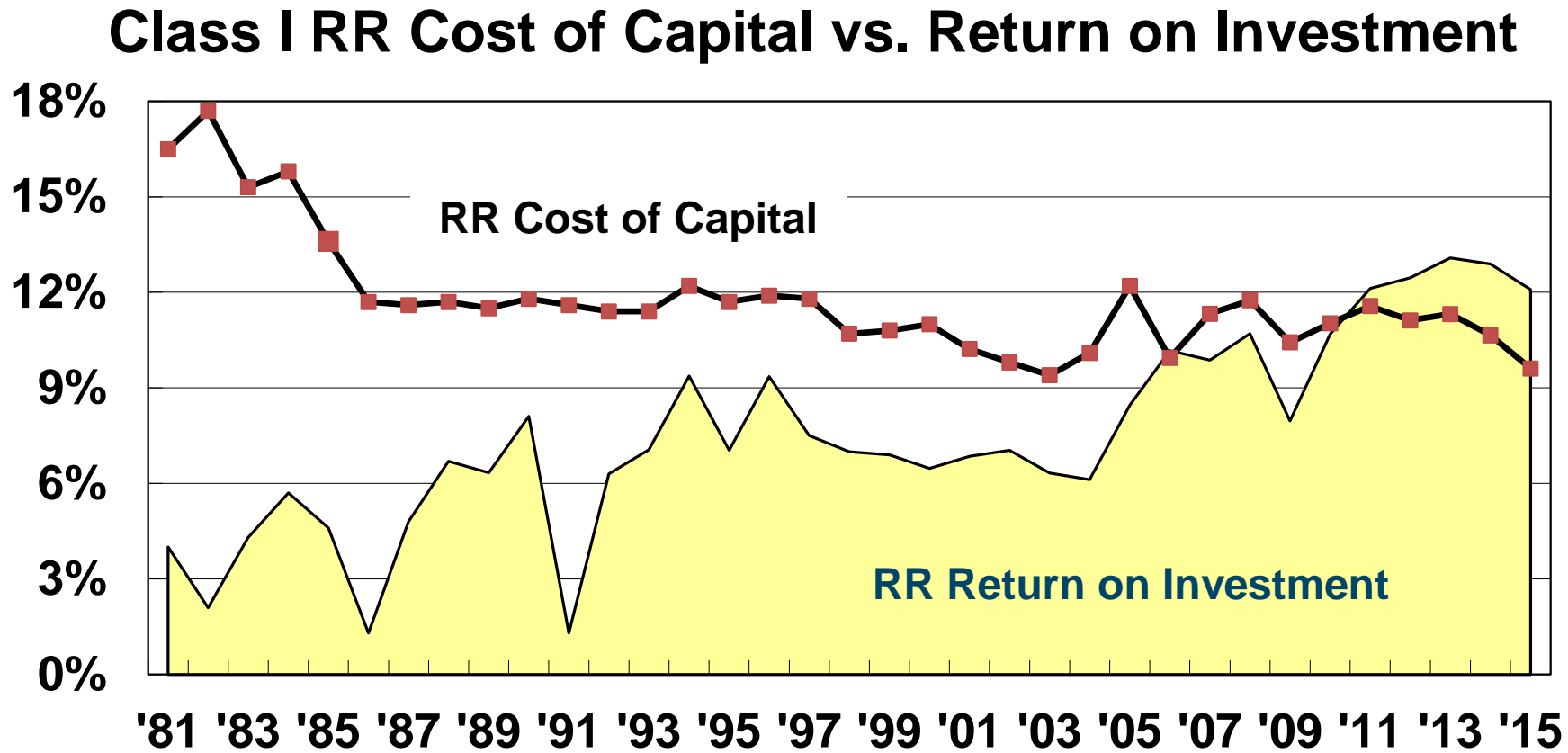


# Close Correlation Between RR ROI and Spending



\*Capital spending + maintenance expense. \*\*Net railway operating income / average net investment in transportation property. Data are for Class I railroads. Source: AAR

# Railroads Have Only Recently Earned Their Cost of Capital



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

# Railroad Philosophy

- Critical to the “RR Renaissance” has been Capex
- Private vs public capital (failing US infrastructure)
- Capex sparked by growth and ROI prospects – examples: IM, CBR
- “Open Access” antithetical to this....right?
- Is a RR its **Network** (Class One belief) OR is it its **Operators** (Hunter)??
- Cult of the OR vs ROIC; short-termism

# Railway Night Sweats

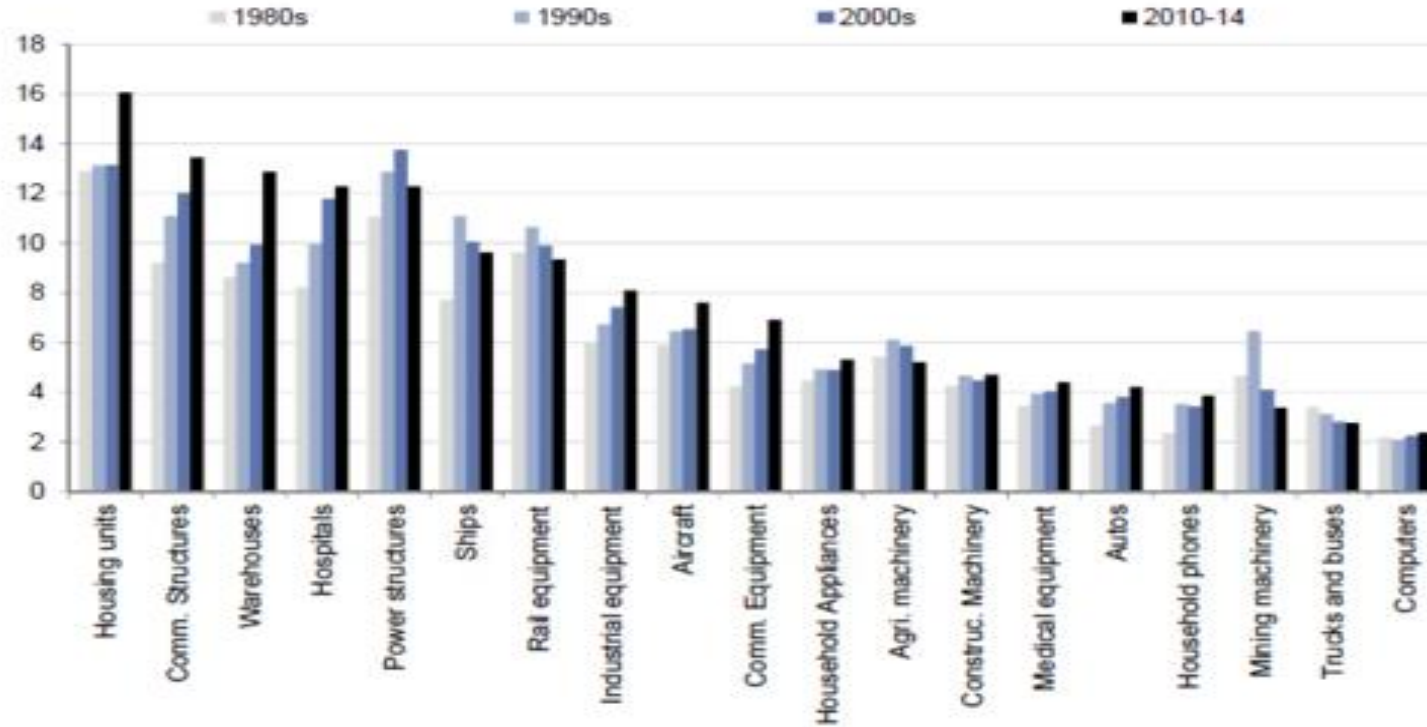
- Politics (& Regulation)
- Trade – Globalization over?
- (Specifically) NAFTA – which impacts S....&N!
- Driverless – AV beer runs! (ahh the irony)
- Amazon – who isn't scared?
- 3-D Printing – good enough for combat?
- *Short-Termism/Over-reactions*
- *Capex and FCF planning*

# Competitive Advantage: RR Capex vs. Aged National Infrastructure

Older assets may need renewal...

Older assets may need renewal...

Average age of infrastructure in years, historical cost method, US



Source: BEA.

# Our Troubled Industry?

- Q4 OR averaged 63%
- Rails in best-ever condition: network, finances, IT, managements
- Coal has stabilized
- Volumes have inflected
- Intermodal is growing again
- What's next?

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