2016 ABH Presentation

It’s always something – The Rail Renaissance & the Brave New World

NUTC/TRF Sandhouse Xmas Luncheon!

abh consulting
December 2016
NYC
Deregulation & Vertical Integration Works!

U.S. Freight Railroad Performance Since Staggers
(1981 = 100)

Staggers Act passed Oct. 1980

"Rates" is inflation-adjusted revenue per ton-mile. "Volume" is ton-miles. "Productivity" is revenue ton-miles per constant dollar operating expense. The decline in productivity in recent years is largely due to the effect of higher fuel prices in the productivity calculation. Source: AAR
21st Century: the Railroad (equity) Renaissance: From Triumph to Challenged

- Rails have well beaten the stock market 2001-2014 – 7 Big Reasons
  - Globalization/trade (IM)
  - Capex&Productivity&Service
  - Pricing & ROI
  - Through economic turmoil (manufacturing/energy/markets)
- Of Late – “Not So Much” (now regaining “par”)
- Energy Impact: real (coal) and hype (CBR)
- Visibility & Sentiment change – financial & government/public
- Earnings Power (always) misunderstood: Rails beat Street estimates – in the Boom, in the great Recession, and the tepid recovery, in this period
- 2015: Record margins & results (and Capex and Buybacks/DPS and....) despite the coal - and drought and lukewarm economy, etc....
- Rails are still re-gaining market share from the highway despite oil prices (2017?)
- Brave New World
The World Turned Upside Down

• Looking back, who forecasted this?
• In a world with no base assumptions, how does one plan?
• Regional Bitterness to ensue
• Some commodities will be winners (barley, oats)
• Some Losers (goats)
• Oh! The humanity!!
New Administration “Promises”

1. The end of the “War on Coal”
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
8. Labor – Who’s driverless, now?
Overview of North American Rail Environment & Key Issues

- **Rail Renaissance** (and heavy Capex!) is the theme (1980-) 2001-2013;
- **OVER??** Major Challenges Emerge – **Energy Decline (Coal/Oil)**
- End of the “**Commodity Super Cycle**” (?); Trade Slowdown; $/FX
- **Service & Safety Issues; Rereg threats re-emerge**
- **Service & Productivity & Safety (all related to Capex) are a) getting resolved & b) Even More Important Than Ever....**
- **Intermodal performance more critical than ever (recently confusing)**
- Rails, however, are **still** re-gaining market share from the highway
- Managements, New & Challenged: **Visibility, Guidance; Capex & Cash**
- **Asked & Answered:** Is M&A the Solution? (What’s the problem?)
- What now?
Close Correlation Between RR ROI and Reinvestments

*Capital spending + maintenance expense.  **Net railway operating income / average net investment in transportation property.  Data are for Class I railroads.  Source: AAR
Class I Freight Railroad Capital Spending
($ billions)

Source: AAR
Returns Finally Justify the Massive Expenditures – *But Do Future Prospects??*

Note: In 2006, the Surface Transportation Board significantly changed the method by which it calculates the rail industry cost of capital. Source: STB
Change in U.S. + Canadian Rail Carloads: 2015 vs. 2014

Note: intermodal is not included in this chart. Intermodal was up 364,192 units (2.2%) in 2015 over 2014.

Source: AAR

Coal: -755,916 (-12.0%)

Metallic ores: -182,607 (-18.5%)

Petrol. & petr. products: -73,056 (-6.1%)

Primary metal products: -93,070 (-13.8%)

Iron & steel scrap: -47,095 (-17.7%)

Crushed stone, gravel, sand: -39,766 (-2.9%)

Nonmetallic minerals: -20,710 (-6.3%)

Grain: -25,526 (-1.6%)

Primary forest products: -682 (-0.4%)

Stone, clay & glass prod.: -32,131 (-6.6%)

Food products: 480 (0.1%)

Primary metal products: -93,070 (-13.8%)

Waste & nonferrous scrap: -7,870 (-4.1%)

Pulp & paper products: -10,883 (-2.3%)

Nonmetallic minerals: -20,710 (-6.3%)

Grain: -25,526 (-1.6%)

Primary forest products: -682 (-0.4%)

Stone, clay & glass prod.: -32,131 (-6.6%)

Food products: 480 (0.1%)

Primary metal products: -93,070 (-13.8%)

Motor vehicles & parts: 40,656 (3.6%)

All other carloads: 28,133 (9.4%)

Chemicals: 10,704 (0.5%)

Lumber & wood products: 7,095 (2.1%)

Grain mill products: 4,436 (0.8%)

Farm products excl. grain: 1,360 (0.6%)

Coke: 1,027 (0.5%)

Source: AAR

Weekly Railroad

Change in U.S. + Canadian Rail Carloads: 2015 vs. 2014

Note: intermodal is not included in this chart. Intermodal was up 364,192 units (2.2%) in 2015 over 2014.

Source: AAR

Weekly Railroad
Shale-Related Rail Traffic Relative to Coal Loadings

U.S. Quarterly Carloads Originated

Source: Surface Transportation Board, PLG Analysis March 2016
New Energy Rail Growth Story – Crude & Frac Sand

Source: AAR (Freight Commodity Statistics)
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 (GTMs/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
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
Issues for RR & Intermodal 2017-21

• 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?
Railroad Respond to the Challenges

• “Traditional Response” – cost cutting
• Strategic response to secular changes – coal
• Capex response – TBD (stakeholder division?)
• Radical change (ex. M&A)?
• (Continue to) Focus on growth areas
• Retain concentration on Service & Productivity
• Innovate! (“regain tech ‘mojo’”)
Class I Railroad Employment

Source: STB
CALGARY SOUTHERN
The Beaverhorse of transportation, eh?
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
2016+ Capex

- **Most Important Decision Period in Years**
- **Capex down across the board (announced average -16%!**!) – except CN!
- **Further cuts (NS, UP) and hints (CN) during the year (FY -20%?)**
- 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?
Railroads: Far More Capital Intensive Than Other Industries

Capital Expenditures as a % of Revenue: 2014

- Class I RRs
- Computers
- Nonmetallic Minerals
- Wood Prod.
- Motor Vehicles
- Food
- Petr. & Coal Prod.

Sources: Census Bureau, AAR
Railroads Are Far More Capital Intensive Than Most Other Industries

Capital Spending as % of Revenue*

- Average all manufacturing: 3%
- Food: 2%
- Petroleum & coal products: 2%
- Machinery: 3%
- Chemicals: 3%
- Wood products: 3%
- Primary metal products: 3%
- Fabricated metal products: 3%
- Motor vehicles & parts: 3%
- Plastics & rubber products: 3%
- Paper: 4%
- Nonmetallic minerals: 5%
- Computer & electr. products: 5%
- Class I Railroads: 18%

*Avg. 2005-2014  Source: Census Bureau, AAR
Maintenance Spending Remains Durable

Select Class I Capex Budgets

Note: CN in CAD. SOURCE: Greenbriar!
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
Take-Aways From *RailTrends16*

- **Good**: IM & (especially) Merchandise Opportunities and near-term inflection; plastics, Ag,
- **Maybe Good**: reduced taxes and regulation? Infrastructure?
- **Bad**: Railcar production, coal (war is over)
- **Ugly**: Visibility, Trade
- **Really, really ugly?**: AV trucking
- **Have Faith & Innovate**: Canadian National
Competitive Advantage: RR Capex vs Aged National Infrastructure

Older assets may need renewal...

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

Source: BEA.
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