Rails 2021: CP+KSU, CNI/TCI, the STB....plus *REAL-RR bidness*  
SANDHOUSE 2021  
Live in NYC/Virtual in Chicago
Rails Top 10
Pandemic/Recovery 21-??-

1. Covid (duh) – Delta Blues-Not done quite yet
2. The Shark’s Tooth – How RRs handled the down & the ups- and now everyone knows what a “supply chain” is!
3. Uncertainty/Visibility/(Lack of) Guidance – Getting Clearer (or is it?)
4. Accelerated (Not Altered) Trends
5. Intermodal! (see #4)
6. Zooms and (Rail) Trends (now we’re going back Live!
7. Technology – from Portals to Pulses: Tu Simple!
8. ESG
9. Ag
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)

2. **Fuel Advantage**
   (4:1 ton/mile; AAR)
   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)

4. **Railroads’ Excellent Financial Condition, Liquidity, Free Cash flow**


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1. AV trucking?
2. EV Trucking?
3. Infrastructure Bill? (LOL)
4. Newly Added (in response to C19)
**New Administration: A Return to “Normalcy”?**

- STB Impact? *Even more relevant*
- Infrastructure? At long last….  
- Crew Size!! (FAST Act Re-auth)  
- Emissions, etc? Plays to RRs/ESG  
- Ethanol?  
- Amtrak & Passenger?  
- Trade!! The only unequivocal good (?)
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, many others BTR
• Off Market & Smaller Deals (ex. SLGW)
• Spanner in the works? Problematic STB?
  • Massena Line & lawsuits
  • Amtrak in the Gulf (& elsewhere)
  • *Pan Am still “Incomplete” (NEARS)*
  • *WC-Watco*
  • KSU? A *Slam Dunk?*
• Buyers (all with different CoC, timeframes, ROI expectations):
  – Strategic (above)
  – PE (and PE/partner)
  – Infrastructure Firms
  – Class Ones as sellers (CN?) and/or Buyers (CP-CMQ, CSX-PAR?)
Rails Fall 2021 – Realities & Perceptions

• RR investing themes (managers & investors) move from “Cult of the OR” (alone) to
  • Growth
  • Technology
  • ESG
  • COMPARISONS – mostly useless and about to get harder in H2/21
  • Rails modestly trail the market H1/21

• Rails get unofficial “B+” for H2/20 Recovery (both operationally & financially)- and by ASCE

• But….Today it’s a “C” as Rail Service is an issue (again) – perception & reality
  • ACC and other Shipper groups
  • House T&I Committee
  • STB commentary
  • Churchill: “never let a good crisis go unused!”
  • Rail metrics improving by the end of the quarter into summer – but NOT (YOY) RR traffic

• Rail Q3/21 EPS – 4 “wins” 2 “losses” (slight – but from CP & KSU, interestingly)

• As Supply Chain “fragility” tests globalization, sparks inflation, makes headlines
  • A truly world-wide issue, and labor based– ocean, ports, rails & trucks, warehouses, shippers
  • JIT to JIC actually benefits rails
  • Near-shoring?
  • Front page news!

• Add Consolidation to the mix….giving the STB an opportunity?....
• Add the White House to the mix....
Executive Order (&Leak) Sows Confusion

• Biden’s EO against power consolidation/BIG business includes rail
• Clearly a late addition
• Leaked as “part 2” to the WSJ, the scoop send sends RRs stocks down
• So….2 paragraphs/page 9 (“Is That All There Is?”) – only an Encouragement (STB is “very, very independent”)
  • Advises freight rail to work with Amtrak (remember the POTUS nickname)
  • Suggests “fairness”
  • NO mention of current M&A (KSU); almost definitely coincidental
  • DOES provide “cover” for the STB opposition to the merger (if....)
  • DOES support the consistently public statements by the STB/Chairman that RRs have too much power and are:
    • Monopolistic (EO suggested Duopoly)
    • Overly focused on cost - & headcount – reduction
    • “In bed with Wall Street”, in thrall with PSR
    • So consistent with existing STB viewpoints

• Most likely outcome: HEARINGS!
STB says “NYET” to CN’s VT; TCI gets Active

• The STB *unanimously* turns down the VT application, with nods to “Downstream Effects”
• That was game-over for CN proposal (*never had a chance under 2 sets of rules*)
• I expect that’s game-over for *any* future C1 consolidation (on *this* I agree with Marty!)
• KSU pivoted back to CP – filed the application – reveals revenue benefits form rail share opportunity higher than publicly discussed; STB timing?
• This move relieves some industry pressure – but *succession issues* remain
• TCI (remember them?) owns 5% of CN (and shades of Jay Gould, 8% of CP!) and issues a challenge:
  • Jim Vena to replace JJ? JJ to retire
  • OR “gap” must be closed, pivot *away from* growth!
  • Letter seems rushed (typos) & inaccurate (in OR accounting)
  • But activists, including TCI-CSX, are 3-0 in the modern era
  • New vote is March 2022
To meet coming “existential threats”, Rail Tech Innovation is Accelerating (T10) – 2022

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.....
U.S. Class I RR Gross Revenue in 2020
($ billions)

Total = $65.4 billion

- Farm products $6.5 11%
- Intermodal* $9.4 16%
- Food $6.2 11%
- Chemicals $10.8 19%
- Coal $6.3 11%
- Lumber & wood $2.0 3%
- Pulp & paper $2.3 4%
- Nonmet. minerals $2.1 4%
- Petr. & coal prod. $3.1 5%
- Transp. equip. $5.5 9%
- Stone, clay, glass pr. $1.8 3%
- Pet. & coal prod. $3.1 5%

*STCC 46. Some intermodal is included in other commodities. Source: AAR (FCS)
Data are originations, do not include intermodal, and do not include the U.S. operations of CN, CP, and GMXT. Source: AAR *Rail Time Indicators*
US CHEMICAL SHIPMENTS ON RAIL
6-week moving average

Data are originations, do not include intermodal, and do not include the U.S. operations of CN, CP, and GMXT. Source: AAR Rail Time Indicators
U.S. Rail Revenue From Coal

Source: AAR Freight Commodity Statistics
TOTAL US COAL CARLOADS 6-week moving average

Data are originations, do not include intermodal, and do not include the U.S. operations of CN, CP, and GMXT. Source: AAR Rail Time Indicators
Rail Coal Volumes Are Closely Tied to Electricity Generation From Coal

Coal tonnage based on originated tons by U.S. Class I railroads.
Sources: Energy Information Administration, Association of American Railroads
US (ONLY) GRAIN CARLOADS (6-week moving average)

Data are originations, do not include intermodal, and do not include the U.S. operations of CN, CP, and GMXT. Source: AAR Rail Time Indicators
Rapid Intermodal Growth

Source: AAR Weekly Railroad Traffic
(TOTAL US-ONLY INTERMODAL LOADS 6-week moving average)

Data are originations, do not include intermodal, and do not include the U.S. operations of CN, CP, and GMXT. Source: AAR Rail Time Indicators
Data are based on originations, are not seasonally adjusted, and do not include the U.S. operations of CN, CP, and GMXT. Source: AAR Rail Time Indicators
Job Openings: Transportation, Warehousing, & Utilities

(000s)

Source: Bureau of Labor Statistics
Summary/Winter Themes

• CP+KSU will be approved (under the old rules); the Last Merger
• CNI & TCI will dominate near term headlines (11/21) – except for supply chain coverage/misunderstanding
• RailTrends in November; Christmas (will happen) in December
• RRs must improve metrics – in the face of losing business, share and (any) govt. support
• Expect Hearings next year! Discussions of Reciprocal Switching, Demurrage, headcount….etc
  • Street Influence/Buybacks/OR/Duopoly?
  • 5/7 US RRs “earn CoC” – in 2020
• Other STB Issues: Massena/PAR/WC/Amtrak/PSR/train length?
• Succession Issues must be resolved
• Key Themes to re-emerge: Growth/Tech/ESG
• Q3 Results solid – but supportive? Q4?
• Coal – the last stand?
Operating ratio

Except for CP, KCS, and KCSM, all carriers saw year-over-year operating ratio decreases. Still, KCSM had the lowest overall OR at a calculated 54.1 percent, with UP following at a reported 56.3 percent.

Operating ratio percentage
Q3 2021 compared to Q3 2020

Note: Adjusted operating ratios in Q3 2020 for NS (unadjusted OR: 66.5%) and in Q3 2021 for CN (62.7%) and KCS (66.1%). Operating ratios for BNSF, FXE, and KCSM are calculated. All other operating ratios are as reported by the carriers.

Note: BNSF is BNSF Railway, not BNSF, LLC

Note: KCS’s operating ratio reflects the company’s operations in the US and Mexico.

Sources: Industry financial reports; railroad company press releases; Surface Transportation Board, Quarterly Revenue, Expenses, and Income; and Oliver Wyman analysis
*OR – US-ONLY - Operating expenses as a percentage of operating revenue. Source: AAR
Return on invested capital (ROIC)

All carriers, save KCS, saw a year-over-year increase in ROIC. KCS’s decline was due to merger-related charges $720.8 million and $36.5 million taken in the second and third quarters of 2021, respectively.

Return on invested capital
Q3 2021 compared to Q3 2020

Note: BNSF is BNSF Railway, not BNSF, LLC
Note: KCS’s return on invested capital figure reflects the company’s operations in both the US and Mexico
Sources: Industry financial reports, Ycharts.com, press releases, and Oliver Wyman analysis

Q3 2020 Q3 2021

- CN 10.39% 14.05%
- CP 13.82% 17.50%
- CSX 9.69% 12.19%
- NS 7.34% 10.55%
- BNSF 9.52% 10.37%
- UP 12.15% 14.18%
- KCS 1.18% -83.29%
- FXE 15.73% 18.46%

Total increase: +35.23% +26.63% +25.80% +43.73% +8.93% +16.71% +17.36%
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
Data are for Class I railroads. Source: AAR
RR CAPEX $ billions, current dollars

Data are for Class I railroads. Source: AAR
There's a Strong Positive Correlation Between Railroad ROI and Spending

RR spending* ($ billions, right scale)

RR return on investment (left scale)

correlation = 80%

*Capital spending + maintenance expenses. Source: AAR
CORRELATION BETWEEN NET INCOME AND RR CAPEX $ billions

*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
By using available capacity, railroads could add $61B 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.

Forecasted:

- Rail share
- Rail share with growth
- Maintained rail share

Revenue:

- $177 Billion
- $61 Billion

Sources:

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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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