Roads in the Fork: Railroads 2020 & Beyond

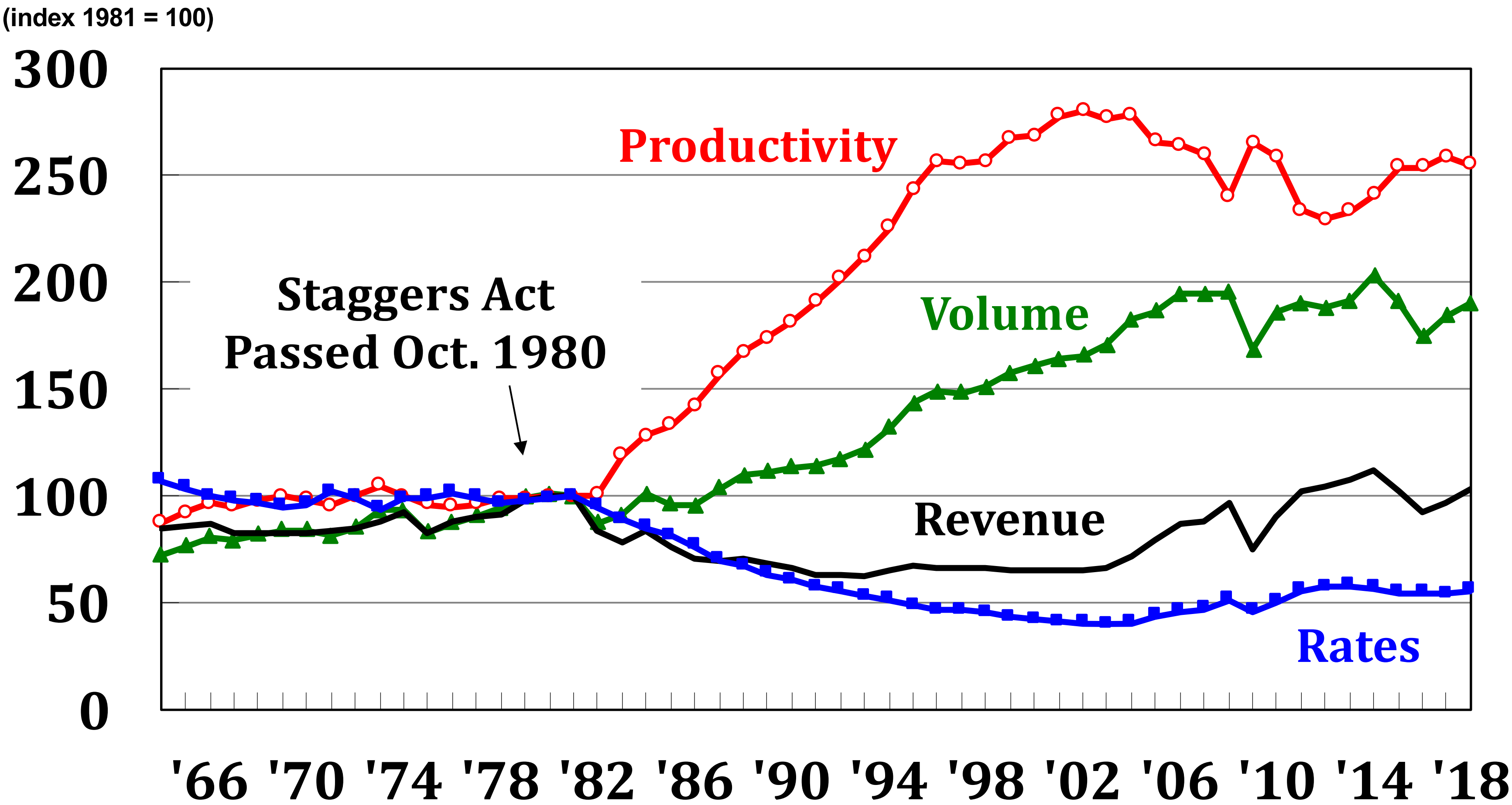
abh consulting

MARS

Chicagoland

January, 20*2*<u>*0*</u>

U.S. Freight Railroad Industry in One chart



Source: AAR

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)***

- *AV trucking?
- ** EV Trucking?
- *** Infrastucture Bill? (LOL)

Top 10 RailTrends 2019 Takeaways

1. DC matters, again
2. Tech Fear (energy, labor)
3. Tech being addressed (CN, KCS, NS….)
4. Year of the Short Line!
5. Class One Confidence in Growth (eventually)
6. Intermodal?
7. PSR is NOT only about cost reduction
8. PSR 2.0 is alive and well in Canada
9. Audience
10. KCS (& Pat Ottensmeyer) awarded

"2019 Will Be Calm & Simple" – *Not!*
The Year(s) of RISK

- *Rail Operating Risk* – Service Metrics* must improve! (and not just be "re-stated") – see weather, PSR – so far, so….OK
- *PSR Risk* (operational, regulatory; de-marketing)
- *Earnings Risk?* See Next Slide….
- *Economic Risk* – slowdown, at last? *Manufacturing/Freight Recession?*
- *Political Risk* - Nuff Ced
- *Trade Risk* (soybeans, autos – etc) & *Border Shutdown Risk*
- *Weather Risk* (Polar Vortex, Mid West flooding – so far….)
- *Oil Price Risk* – Now, cheap oil is a *bad* thing
- *Technological Risk* – long term maybe the biggest risk of all
- *Markets Risk* – and potential impact on Capex
- *Management Risk* – Activists, Succession, Big Transition Years (UP, BNSF, NSC, CSX….) – ability to capture *Big Canadian Game*….
- *In Q2, CSX spooked the markets (reported "near-miss" & simply stating the <u>obvious</u> about YTD volumes – which are reported weekly!)*

Earnings Risk?

Reiteration (Q1) vs. Capitulation (Q2) vs Re-State & Wait (Q3)

Q3 Theme – restating 2019 Guidance – wait for January for 2020 outlook – optimism at CP, KSU – the rest "glum but determined"

- *Freight Recession"? Revenues down 1% on average 3+% volume decline*
- *BUT Earnings grew 9% (still 6% w/o KSU); 4/6 "beat" Street estimates (by comparison the S&P500 will show flat-to-down earnings, although 3/4 showed "beats")*
- *Thoughts: RRs retained pricing power; sharecounts down 4-14%*
- *Canada continued to outperform the US, although the gap is narrowing*
- *BUT the rails OR average was below 60 (59.8%) and the average improvement was 190bps*
- *Remember Rails' historic "outperformance" in a recession*
- *Does PSR only (or even) mean "saving the way to prosperity"?*
- *Will the rails be ready for the inflection?*

2019 Volumes ***were*** 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. *Trucking overcapcity* (what a difference a year makes!) – Investors are questioning the very nature of the IM Value Proposition!
4. *PSR* – inadvertent or planned share loss (ex. CSX – and now, UP - IM)
5. *Lingering weather impacts* on operations (and on crops!)

Winds of 2020 – trade/tail & head

- Better trade outlook? (“stop shooting yourself in the foot!”)
- (Even) slower economy, autos
- Energy? (coal/CBR/LNG/economic impact)
- Ag?
- PSR progress?
- Capex?
- PTC & Tech progress?
- DC?
- (and most importantly)Intermodal!

Newcomers Add to Investor Mix

- Traditional (family/entrepreneur/state) Private companies
- Public companies
  - Institutional "long only" funds
  - Hedge funds
    - "Traditional" short term investors
    - Concentrated funds
    - Activists
    - "Special Situations"
- Private Equity Funds
- Infrastructure Funds

Boom in Short Line Valuations

- Infrastucture Funds - low cost of capital and long term (moderate) return expectationbs
- GWR is going private– deal at ~14X – up from 7-9X! The SLHC had perhaps outgrown ability to remain publicly-traded (difficulties of the small deal)
- CSX Lines….?
- Demand *creating* supply – sellers' market! (Patriot/Pioneer/Regional/RailUSA/etc)

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

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?*

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 <u>and</u> in equities (CP & UP)***

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

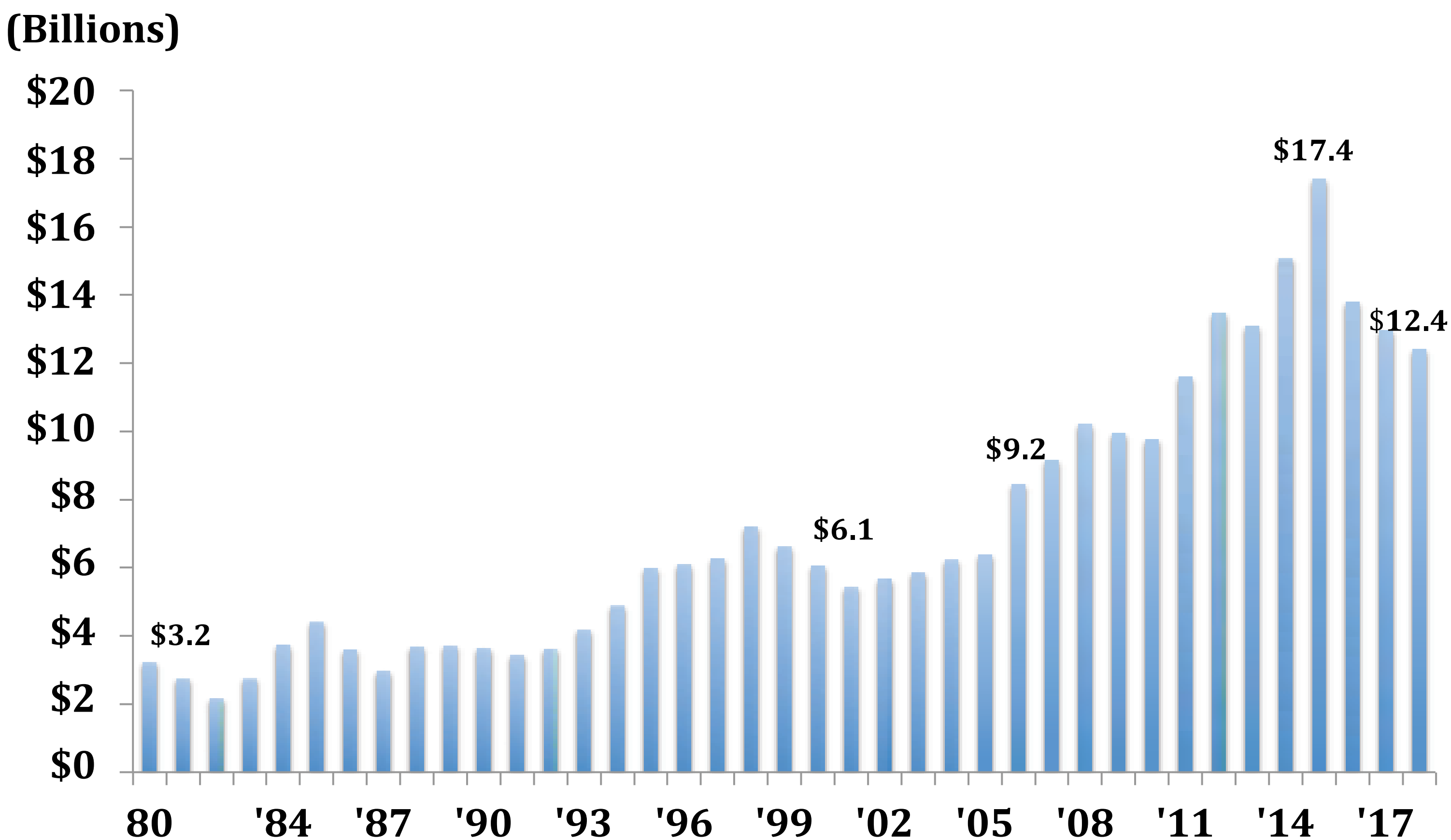
Capital Spending as a Percentage of Revenue

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.

Source: Association of American Railroads

ASSOCIATION OF AMERICAN RAILROADS

Railroad Capital Spending

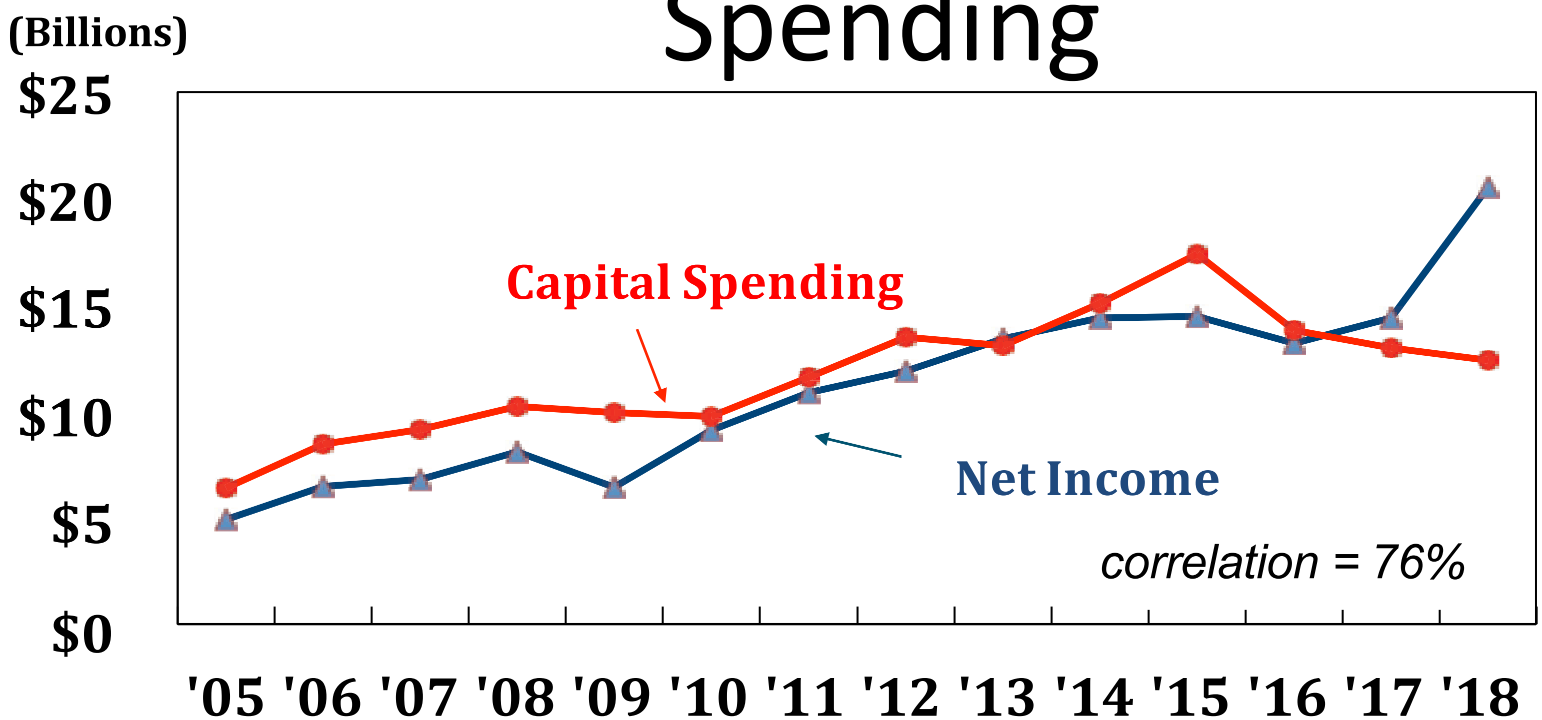


Source: AAR

Growing Railroad Net Income

Source: AAR

Higher Railroad Profits Have Boosted Capital Spending



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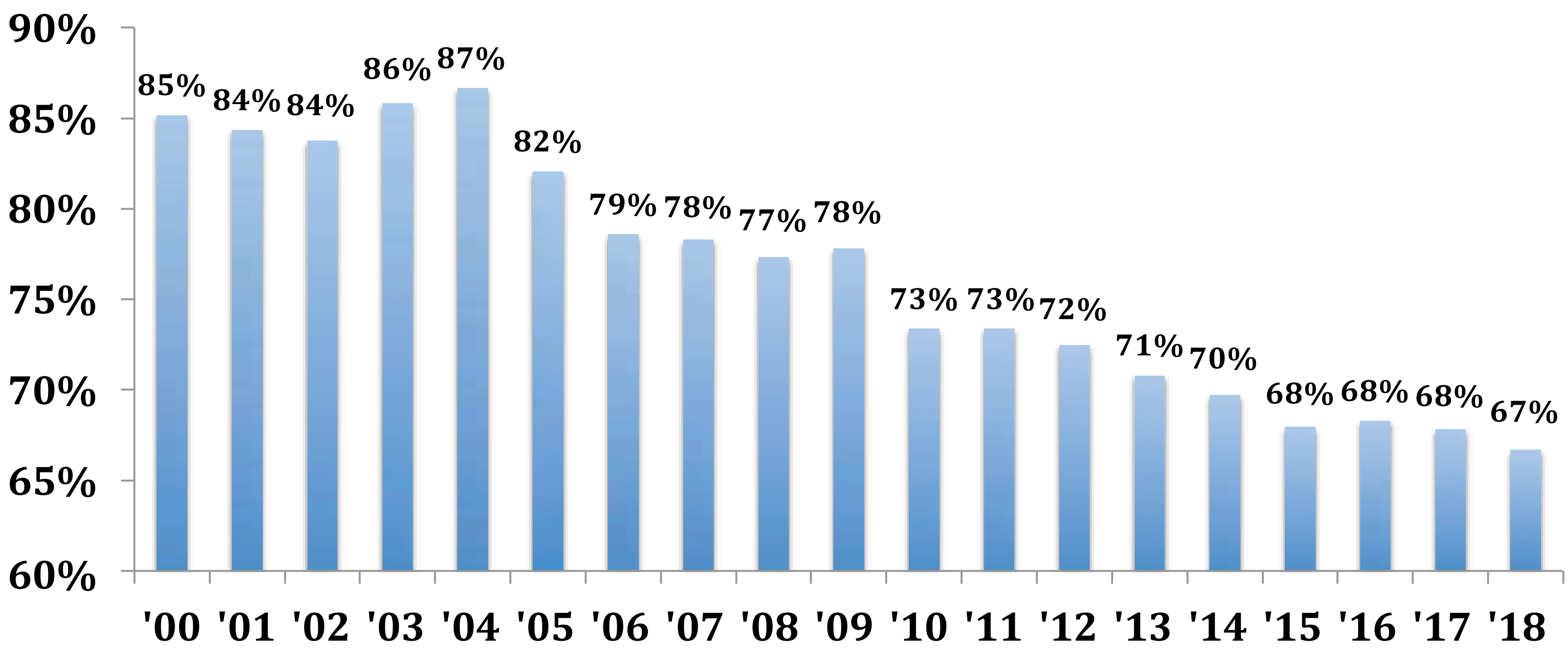
Much Improved Operating Ratio



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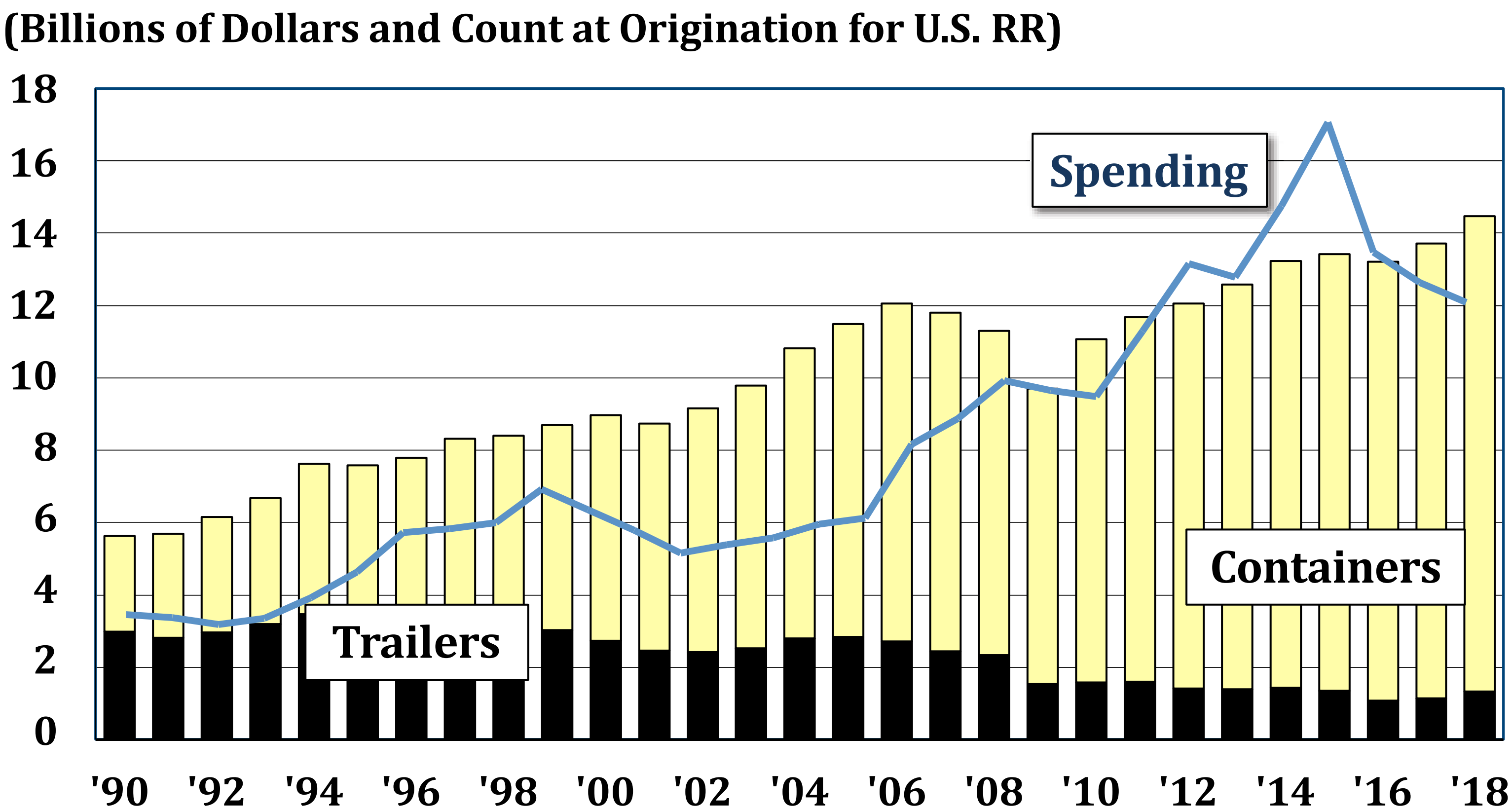
Rapid Intermodal Development



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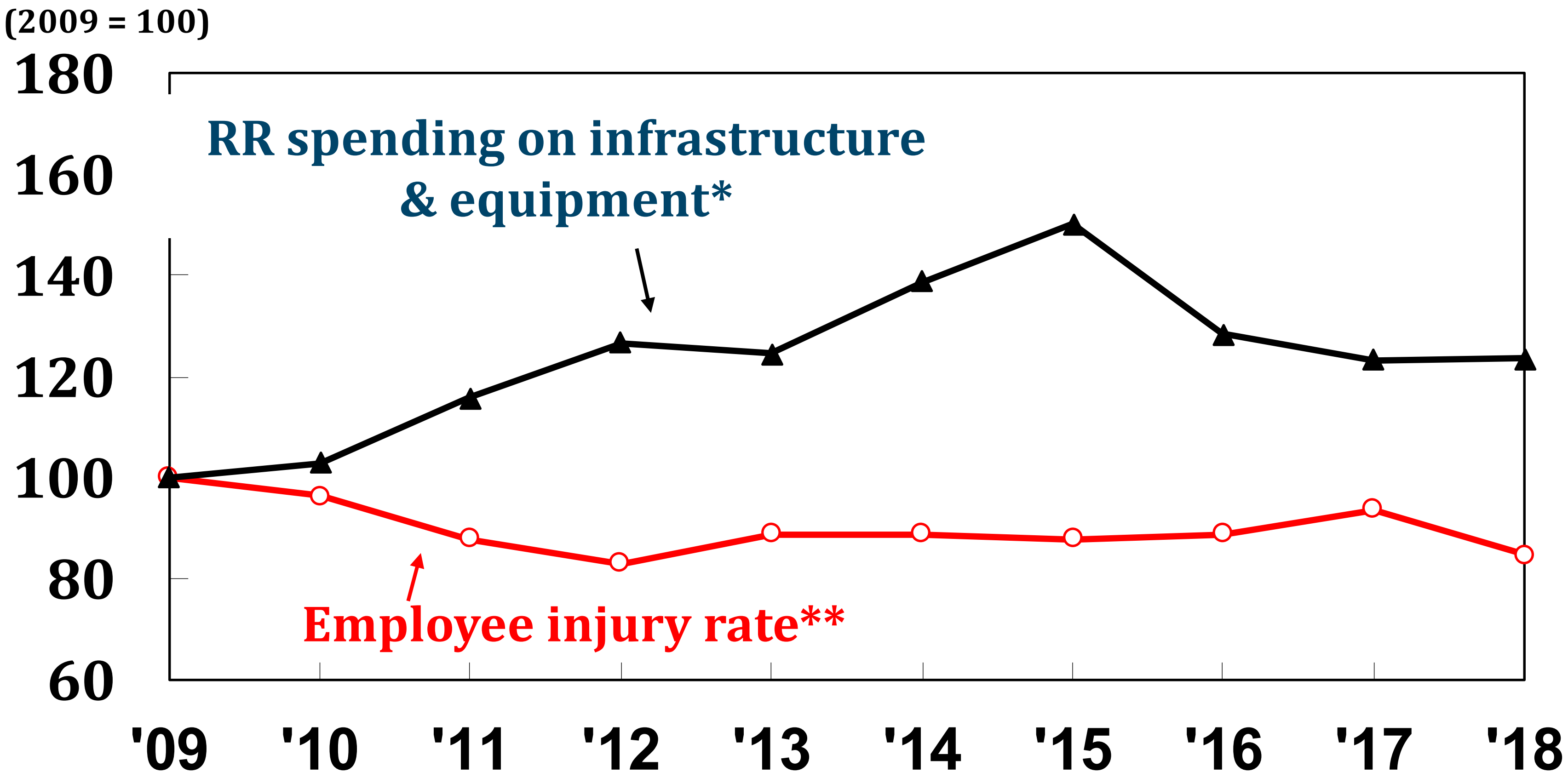
Railroad Spending Enhances Employee Safety



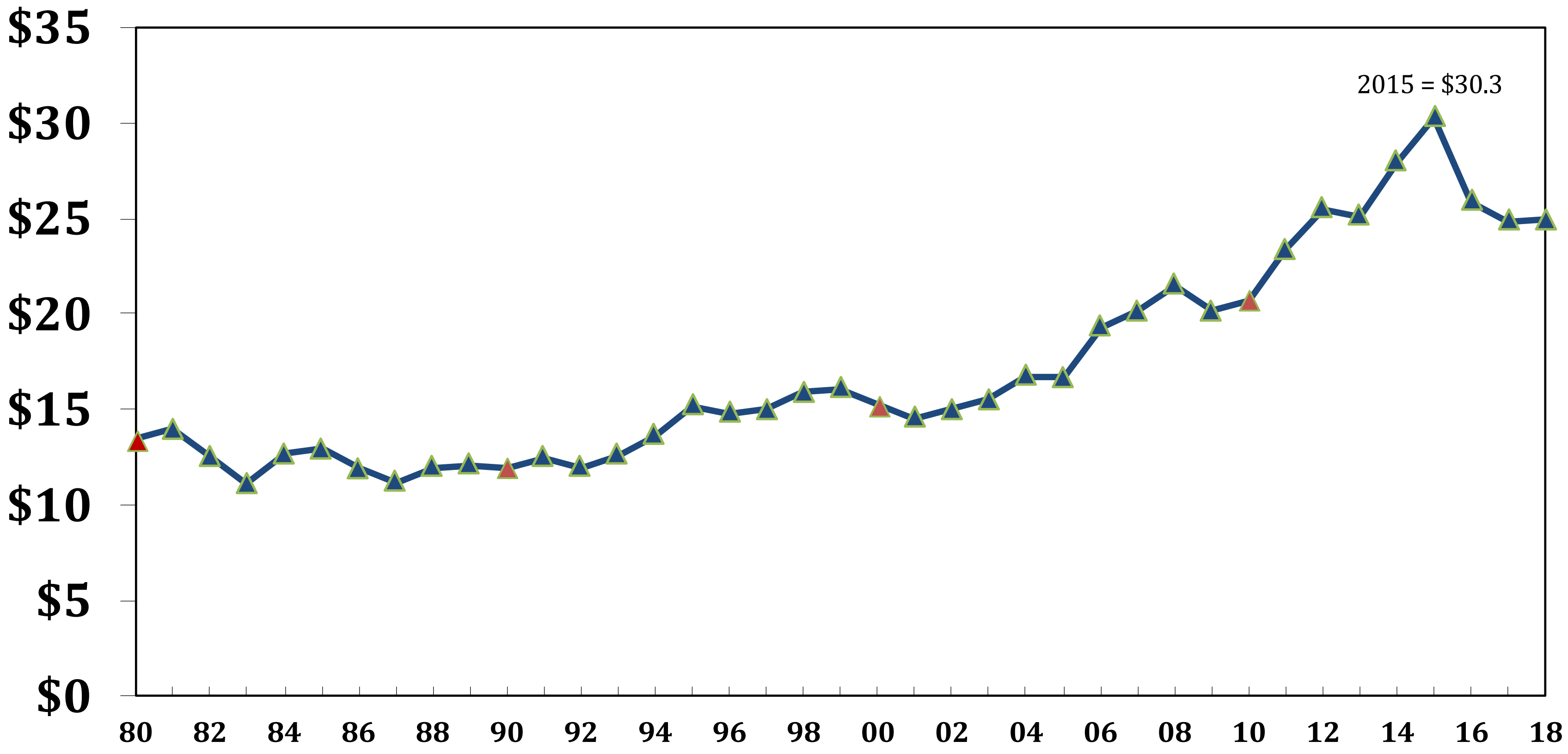
*Capital spending + maintenance expenses.

**Employee injuries per 100 full-time equivalents. Source: AAR, FRA

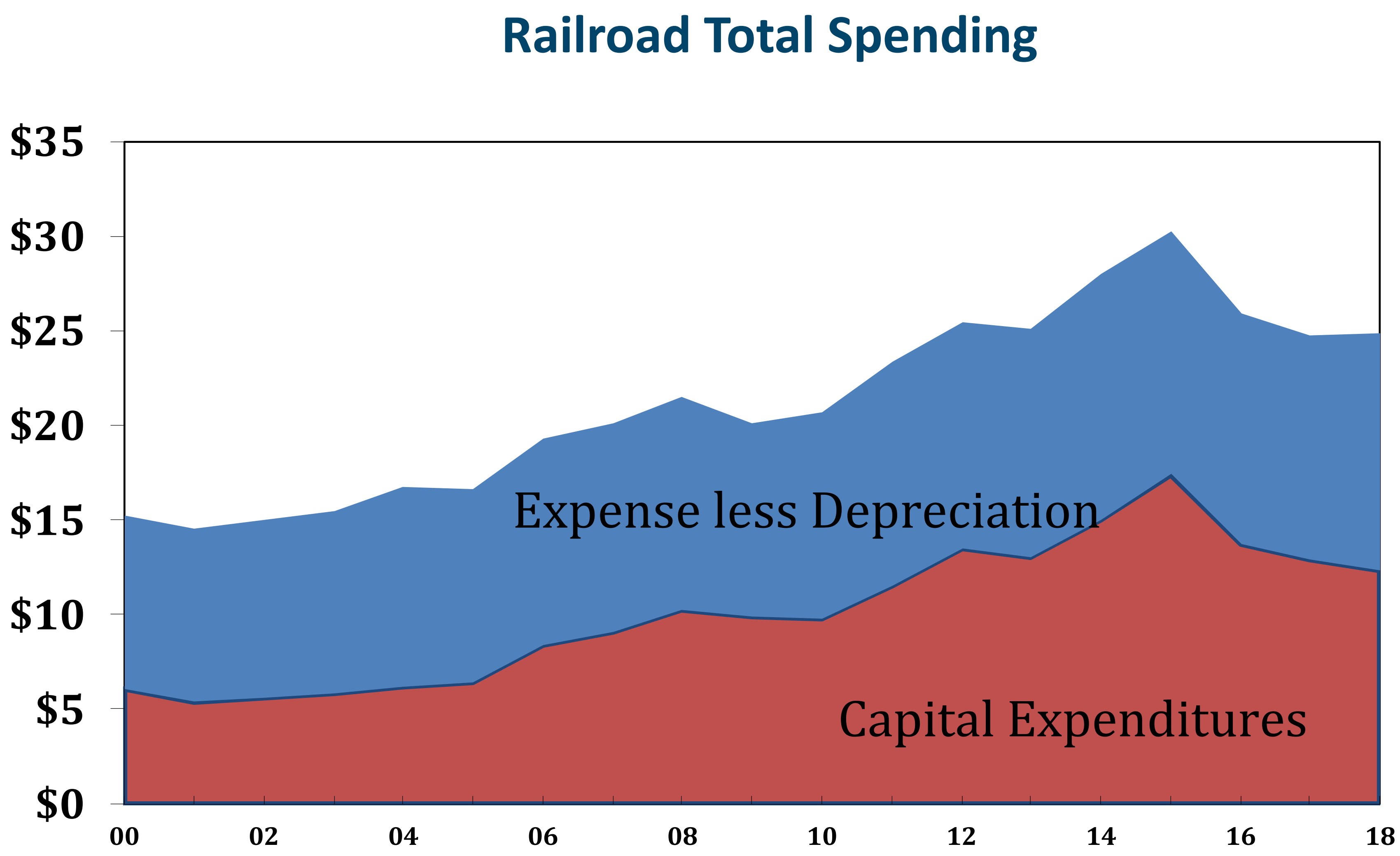
RAIL SPENDING HAS LED TO FEWER EQUIPMENT-CAUSED ACCIDENTS

The Rate of Equipment-caused Accidents Down 34 Percent Since 2000

Class I Freight Railroads Have Spent More Than $660 Billion on Infrastructure and Equipment Since 1980



Unlike trucks, barges, and airlines, America's privately owned freight railroads operate almost exclusively on infrastructure that they own, build, pay for, and maintain themselves. In recent years, freight railroads have been spending more than ever before – an average of $26.5 billion per year from 2013-2018 – on their infrastructure and equipment. Spending defined as capital expenditures plus operating expenses less depreciation for infrastructure and equipment.



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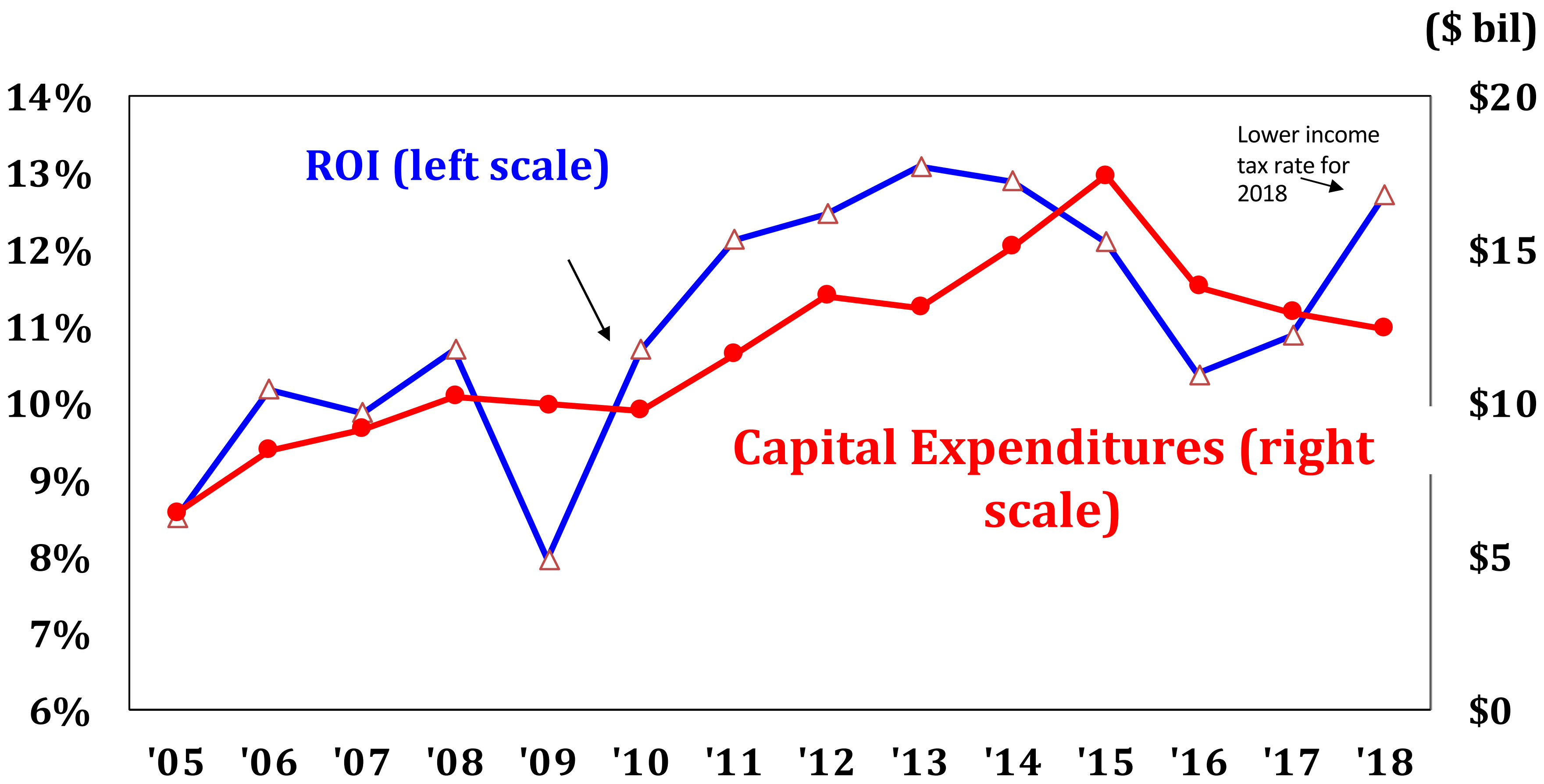
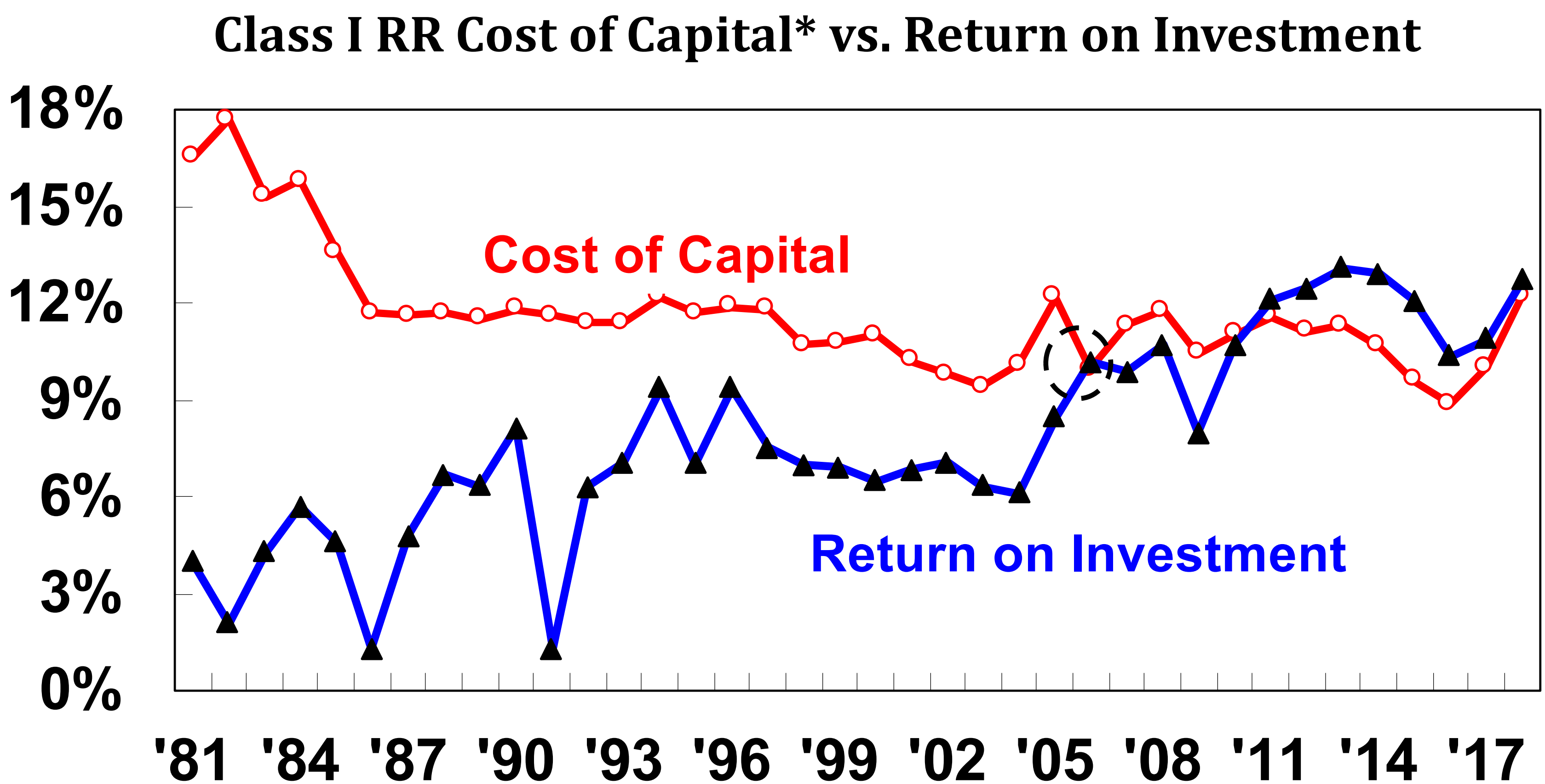
Close Correlation Between Railroad ROI and Capital Spending



Source: AAR

Note: ROI excludes accumulated deferred income tax credits.

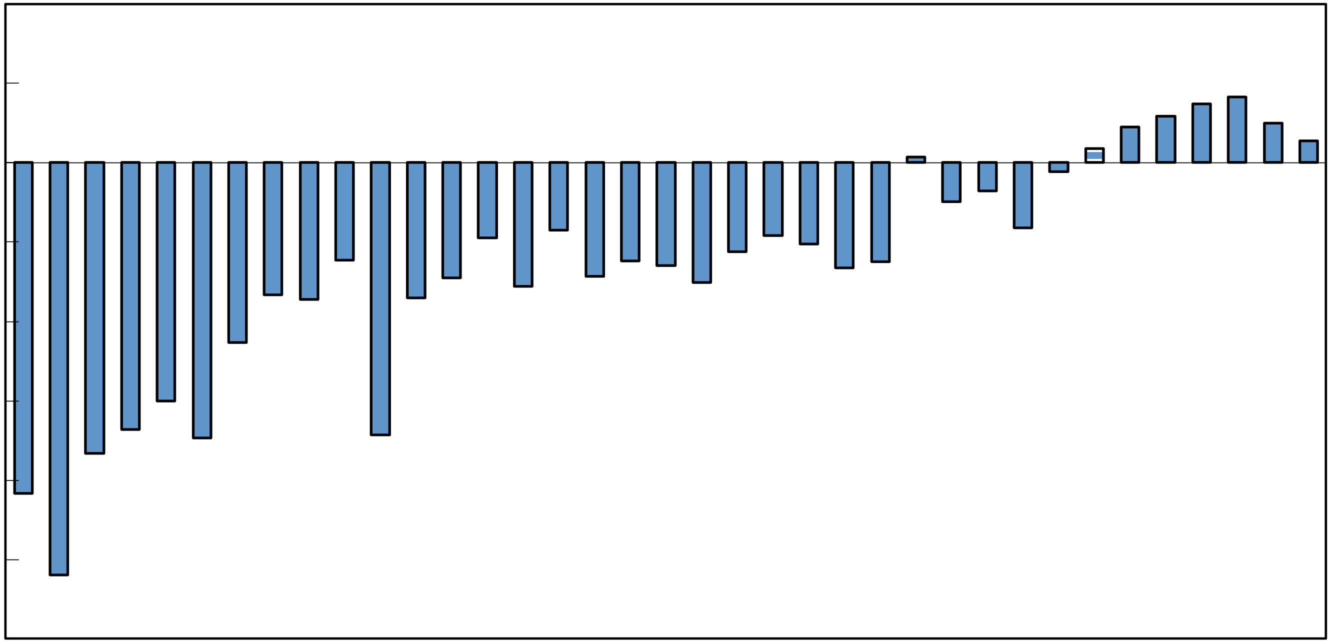
Rail Industry as a Whole
Now Earns Its Cost of Capital



*In 2006, the Surface Transportation Board significantly changed its cost of equity model.
ROI excludes accumulated deferred income tax credits.
Source: STB

Rail Industry Return Minus the Cost of Capital has Turned Positive

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



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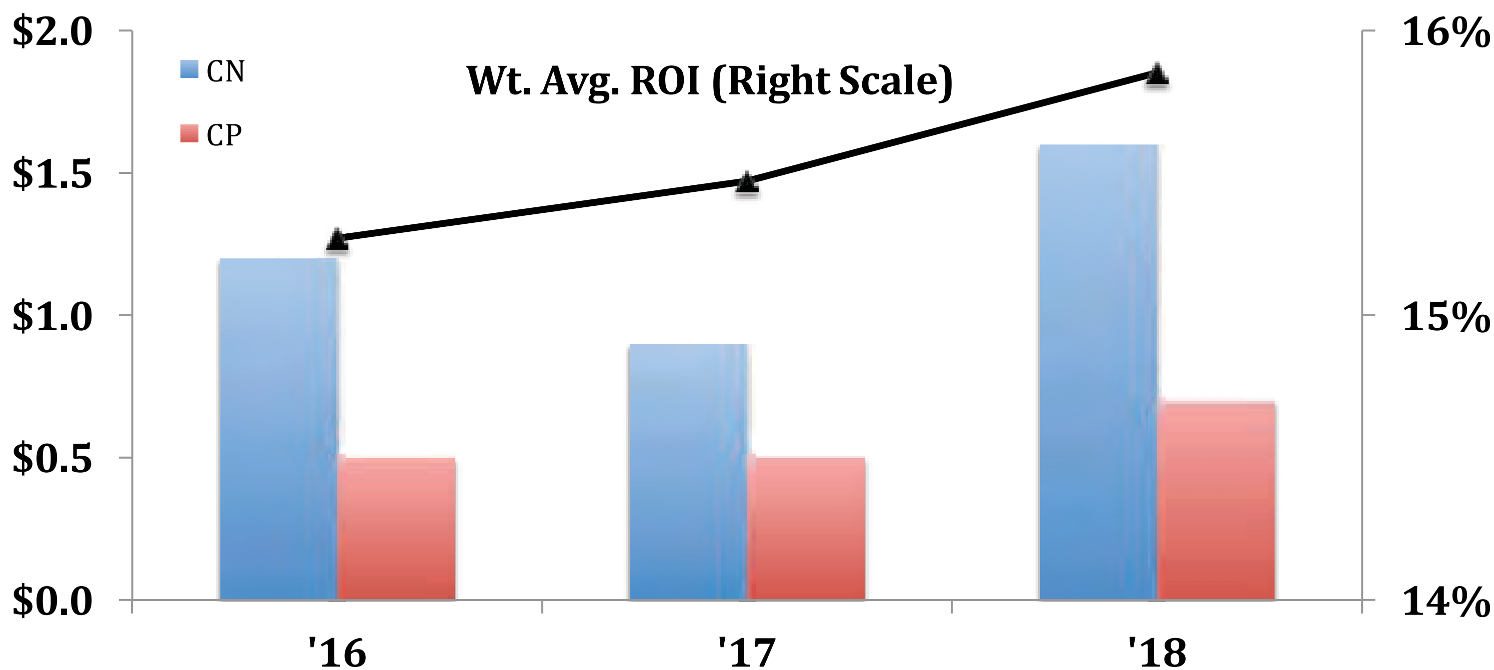
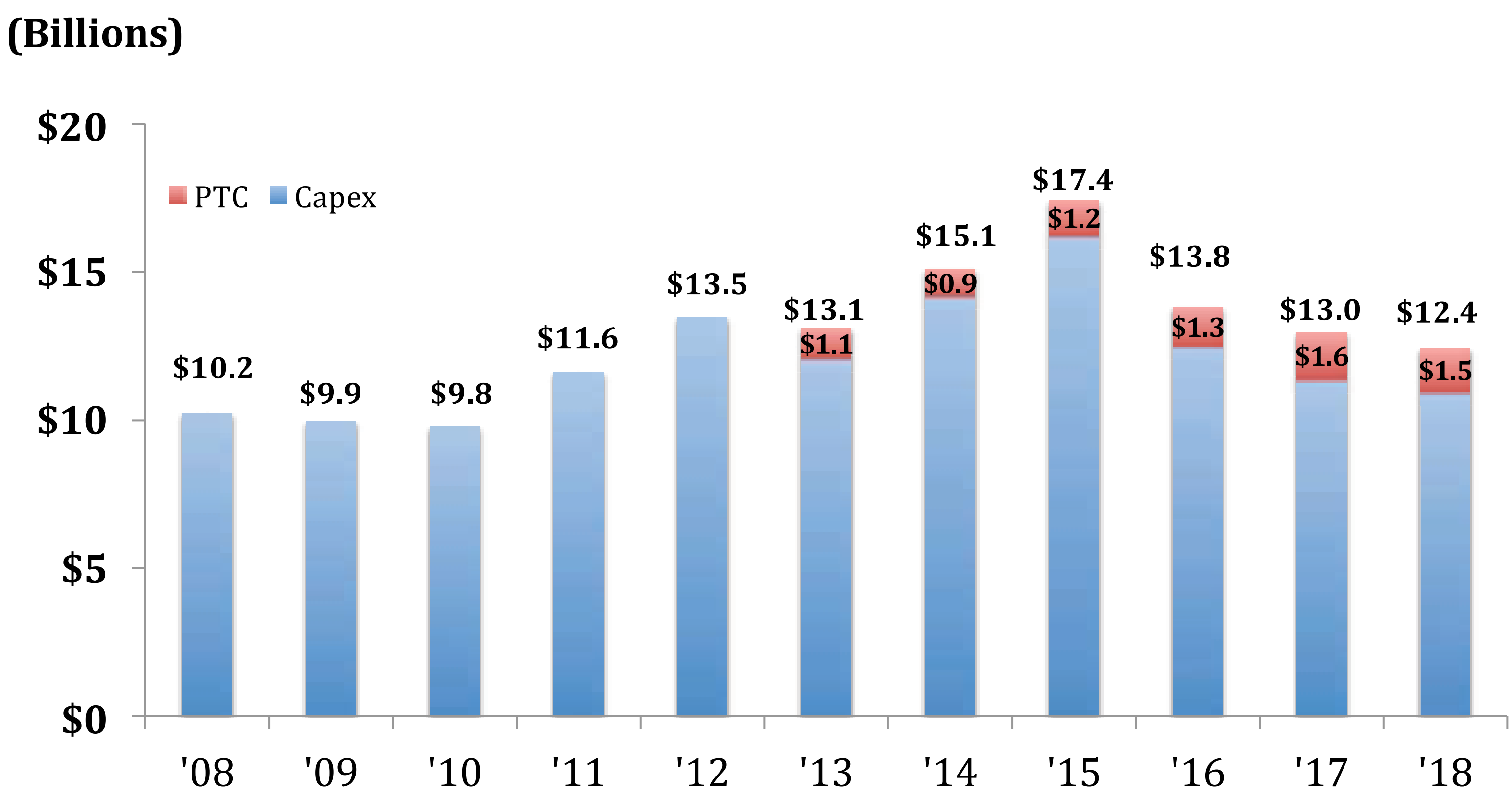
Canadian Railroads Capital Spending and ROI



Source: Company Reports

PTC Share of Railroad Capital Spending (USA)



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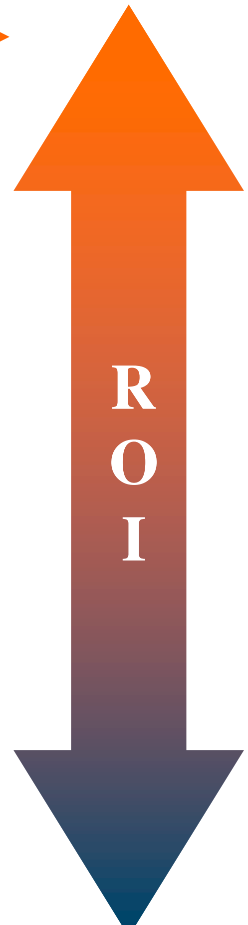
Return on Investment is Crucial

If ROI > cost of capital:

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



If ROI < cost of capital:

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

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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!

ABH Consulting/www.abhatchconsulting.com

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