Railroads on the Brink – The "Great Experiment" (Over Before it Even Begins?)

After Renaissance, Retreat – Now What?

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NSC & East Palestine – Existential Threat?

- NS accident couldn’t be worse timed or to a more unfortunate carrier
- NS safety history, efforts at Common Carriage, originator of TGE
- Rails are not *allowed* to carry haz-mat, they are *compelled* to do so
- ASCE Grade of B; Big & Consistent Capex
- Everyone on the attack:
  - Train length??
  - Crew size???
  - **ECB Brakes (*car-based!*) – *your thoughts??***
  - *Corp Greed/share buybacks??*
  - *Don’t trust the EPA*
  - *Fix <u>everything</u> but the problem!*
  - *Doubling hot-box detectors price tag $1-2B*
  - *Etc*

Union Pacific's Sunday Surprise

- Soroban forces a change of leadership (sometime this year)
- Suggests Vena (again)
- Another "existential fight for the soul of the rails"? (from growth to margin focus?)
- Many gaffes - Capex at 15% or less; G55; STB issues
- Chronic under-perfomance (of *potential*)
- Still the best job in the business
- KC "otherwise occupied" – right?

RailsTop10 (Winter 2023)

1. Service Issues/Trendline
2. Just-in-Time for Recession? (Sub Q – Inflationary impact/Pricing)
3. Or will 2023 (finally!) be a base/normal year?
4. Labor – Ratification & Recession Choices?
5. What is the (quantifiable) “Pent-Up Demand”?
6. *Does “Service* (really) *Beget Growth*”?
7. CPKC *will* pass; Conditions (if any)? Synergy timing?
8. Is this therefore *Peak STB? H*as the “axis of evil” shifted to the FRA?
9. Will intermodal finally get its MOJO workin’ again?
10. Talking the talk – Growth/Tech/ESG

Bonus Round:

- What trends will actually, really emerge from the pandemic? JIC? Near or Re-shoring?

Railroads Today (2023)

- ***<u>Tactical not Strategic</u>*** – All Hands On Deck as ALL stakeholders demand service improvement
  - The service crisis is labor-driven, not capacity (Capex plans inflected up, however)
  - So much for H2 improvement? Trendline improving, anyway
  - Still more hearings (UP)
- <u>Tailwinds</u>:
  - Pent up demand;
  - Unfilled demand
  - inflation/oil;
  - ESG;
  - graduating crew classes
  - The dollar
- <u>Headwinds (besides the obvious)</u>:
  - LABOR (Rail *and* Port)
  - The FRA!!
  - Inflation (and it's impact on JIC)
  - The dollar
  - Perceptions of Management/Performance; reduced Bench Strength? Newcomers

Eh, Canada

- Regulatory Differences (in light of a rampant STB – and FRA)
- Grain regulation & Reciprocal Switching
- PTC/ETC?
- ITC for short lines (in light of the short line valuation/service boom)
- Canadian economic risk (household debt, housing)
- Global Trade
- USMCA Issues (“Buy American”??)
- Success of CPKC
- New Leadership/Direction at CN
- Importance of retaining growth vs margin focus
- Duel ownership?

Rail Strike – "Crisis Averted" (Or, "When you're right, you're right!")

- This was business-as-usual – the every 5 year three years-plus-back pay negotiations
- The system (The RLA) was *designed* to go slow, cool off, mediate, PEB, etc; also remember rail contracts run *in perpetuity* and although nationally negotiated (in the US) actually fall down to small historic groups (think NS = N&W, Southern, CRR, etc etc)
- The only unusual item was how the face cards all fell labor's way – the Democrats in power, the labor shortage, the Supply Chain "crisis", rail record earnings, inflation
- So rail labor played their cards out – as expected – to the (almost) very last minute
- Got 24% (including back pay), which was a PEB split-the-baby slight lean Labor; got no real change in beneifits, some work rulke (attendance, doctor trips) changes
- The PEB recommendations were ALWAYS going to be the template!
- Rails did not get consist or other automation productivity reform (as we might have hoped back in 2019); FRA might supersede whatever they achieve in "local negotiations" anyway
- Worry – with back pay coming so might another bump in attrition
- Hope – with labor issues resolved for 3+2 years, hiring and retaining thereafter goes back towards normal – shareholder aligned here with labor
- What was truly unusual was media reaction to the "*Impending Economic Crisis*" – see Time Magazine (??)
- From transport to business to the Front Page!
- Fallacious issue of "paid sick leave"
- And the issue of crews, retention, scheduling all trace their roots to H2/20 – and The Pandemic

Recurring and Accelerating Rail Trends

(Not to be confused with RailTrends November 2023!)

- 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)[1]

2 & 3 **Fuel Advantage (2A)**
(4:1 ton/mile; AAR)[2] – So 2B is ***EMISSIONS***/Environmental Advantage (see…WMRT, Unilever, etc.)

3 **Infrastructure Advantage**
(after the IHS buildout; user-pay and capex to support changing logistics patterns – ex: transcon)[3]

4 **Railroads' Excellent Financial Condition, Liquidity,** Free Cash flow

5 **Railroads' Historic Ability to Reduce Expenses in a Known Slowdown** (2009, 2020)[4]

1. AV trucking?; 2. EV Trucking?; 3. Infrastructure Bill? (LOL); 4. Newly Added (in response to C19)

Dealers' Choice? Deal-Fever in Short Lines (still)

- ***Short Lines & Regionals still hot properties***
  - Multiples have doubled in the last 5 years
  - No public companies left (GWR)
- Many small recent deals (by OmniTRAX, RJ Corman, etc.)
- Watco-Dow and CN deals a new prototype?
- On the market: At least four? Lake State Railway just completed
- Off Market & Smaller Deals (ex. SLGW)
- Financial Partnerships (RDC, Watco, etc)
- Spanner in the works? Problematic STB?
  - Massena Line & lawsuits - Withdrawn
  - WC-Watco, Pan Am finally finished!
  - KSU? A Slam Dunk? Views from my trip to DC
- Buyers (all with different WACC, timeframes, ROI expectations):
  - Strategic (above)
  - PE (and PE/partner)
  - Infrastructure Firms
  - Class Ones as sellers (CN?) and/or Buyers (CP-CMQ, CSX-PAR, BNSF-MRL)?

Short Lines To the Rescue of Class Ones?

- ***Class One service crisis and the impact on/of regulators (STB/FRA) and Legislators***
  - New focus, data on First Mile/Last Mile (and it ain't pretty!)
  - Service failures are manna to STB concerned about rail market power (price)
  - Reciprocal Switching (which is about pricing power!) is coming, in modified form
  - STB use of *common carrier obligations* as a lever (UP/Foster Farms), focused on weekly switches
  - Declining Class One carload growth since the 2008-9 Financial Crisis
- **SOLUTION? Increased use/creation of Short Lines!!**

  - Short lines have consistently out-grown C1 in carloads
  - Short lines offer tailored, customizable switching services
  - Short Lines have better work rules, less severe labor shortages
  - Short Lines are looked upon quite favorably by regulators and legislators!
  - Watco's Dow and especially Dutchtown Southern (Louisiana/CN) increased weekly switching from 3-5 to 7+ and grew carloads by over *one third* in the first *year* of operations – win (customer switches)/*win* (Watco new business)/win for C1 partner CN (more cars for its long-haul business)
  - All SLHCs have logistics/switching arms etc
- ***So why is the momentum of C1 strategy seemingly to buy or retake SLs*** (see DMQ/Pan Am/MRL)??
  - I support a "feed the beast" strategy (looking to extend a C1 market reach – ex CN 2018-21
  - However that should not preclude thoughtful C1-SL partnerships (that solve customer problems!) – ex RailPulse
  - *Nonetheless, I see no evidence of C! leadership taking these steps (yet?)*

Common Short Line Related Questions

- New short line spinoffs by Class 1's – *Hopefully – see slide*
- Will the pace of new shortline creations pick up? Why? *Hopefully – not a lot of evidence (CN-WC-Watco was a disposition; CN Guismer LA was a creation)*
- What are the drivers? cost cutting? economics? growth? politics? *Short line/switching creation would solve customer complaints, ease the great political pressures on rail, grow share – and, yes, lower the C1 OR. Also through 45G, US SLs have capex benefits*
- Which Class 1's are more or less likely? Why? *Likely US based, perhaps NS under new management; after the Massena Line sale to CN collapsed, CSX took it off of the market*
- How will the next cycle differ from the past? *The period from Staggers in 1980 through the beginning of this century saw Class Ones sell, spin or lease out low density short lines for focus on their core main lines; that reversed after rail pricing power ('03)*
- Will there be a reverse cycle? Class 1's buying shortlines? *That is occurring*
- What would the benefits or threats be to the other stakeholders? customers, labor, wall street, DC, suppliers, etc.? *Short lines use outsourced track/mechanical/etc; assuming done well all of those stakeholders would benefit.*
- **So why isn't it being done?** *FOMO? Hyundai? A negative fallout form the positive C1 focus on maintaining their network advantages? No time to think strategically in a crisis? Historic lack of creativity?*

To meet coming "existential threats", Rail *Tech*/Innovation is Accelerating (T10) – 2023 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?)

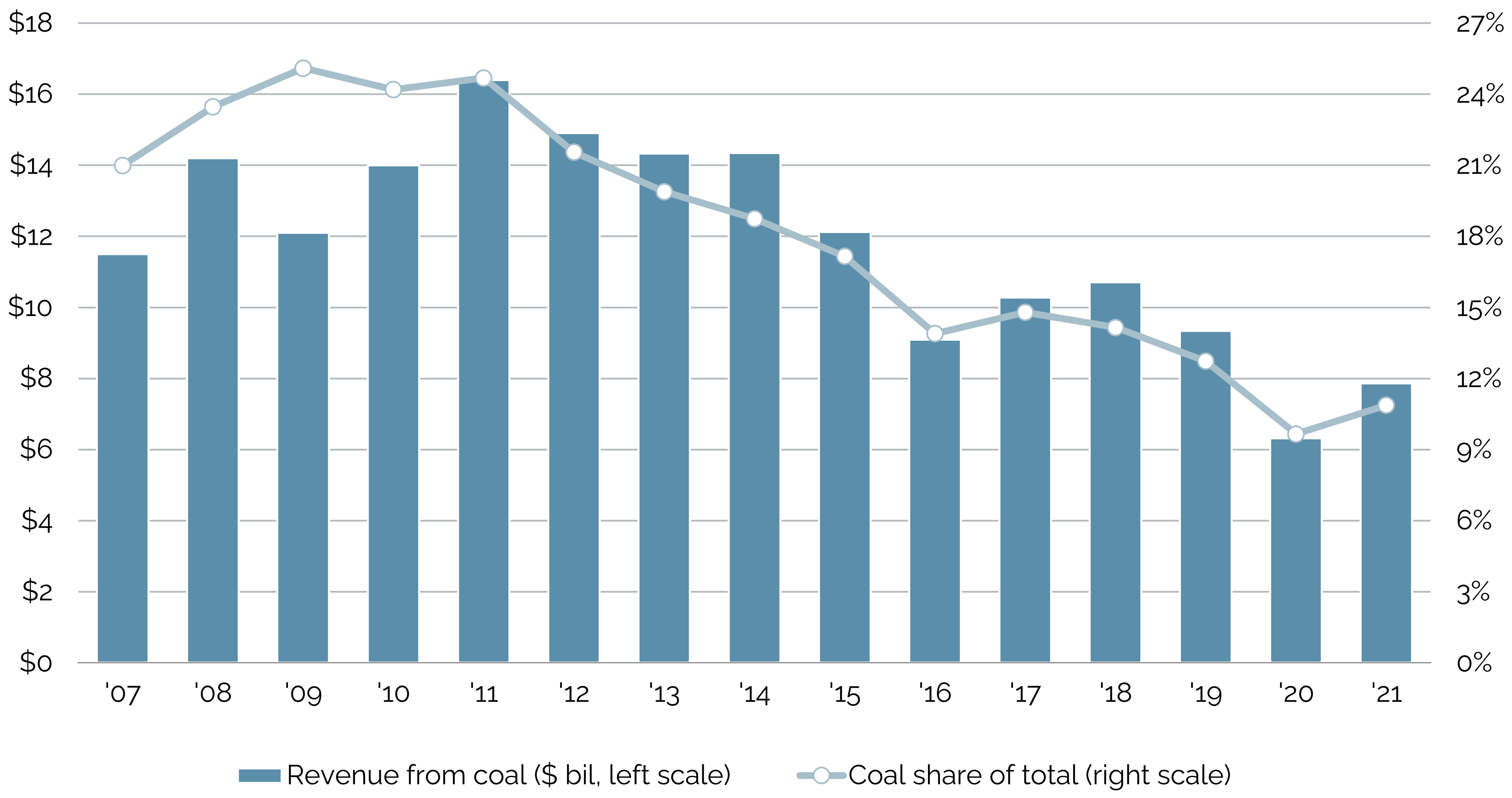
7. Big New Hires at CN (WAB) and UNP (WMRT); Innovation; LOS to the CEO?

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. Rail Revenue From Coal



Source: AAR Freight Commodity Statistics

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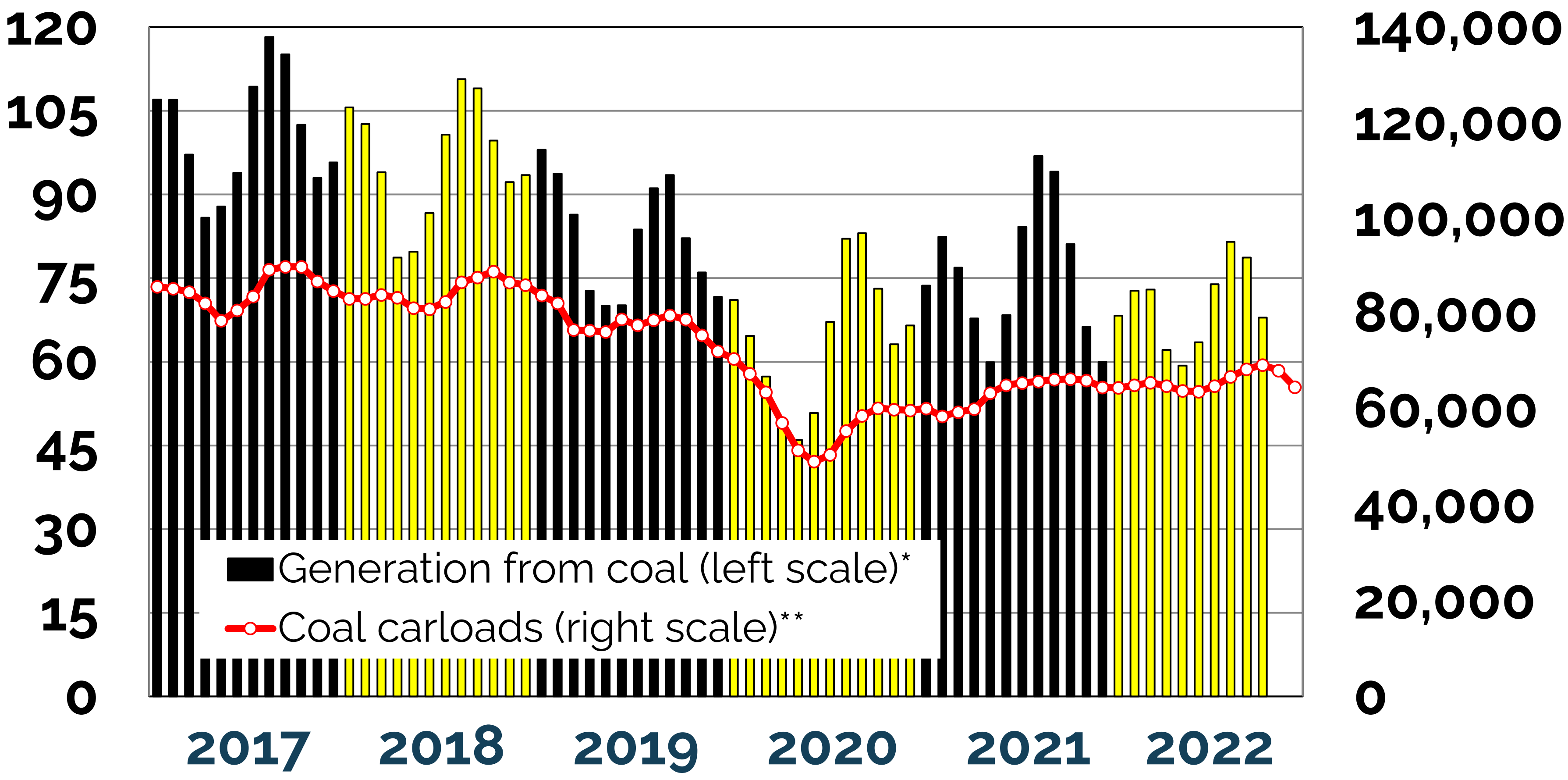
U.S. Electricity From Coal/CLs



*3-month moving average, million megawatthours.

**3-month moving average based on weekly originations.

Source: EIA, AAR

Rail Coal Volumes Are Closely Tied to Electricity Generation From Coal

(2000 = 100)

Coal tonnage based on originated tons by U.S. Class I railroads.
Sources: Energy Information Administration, Association of American Railroads

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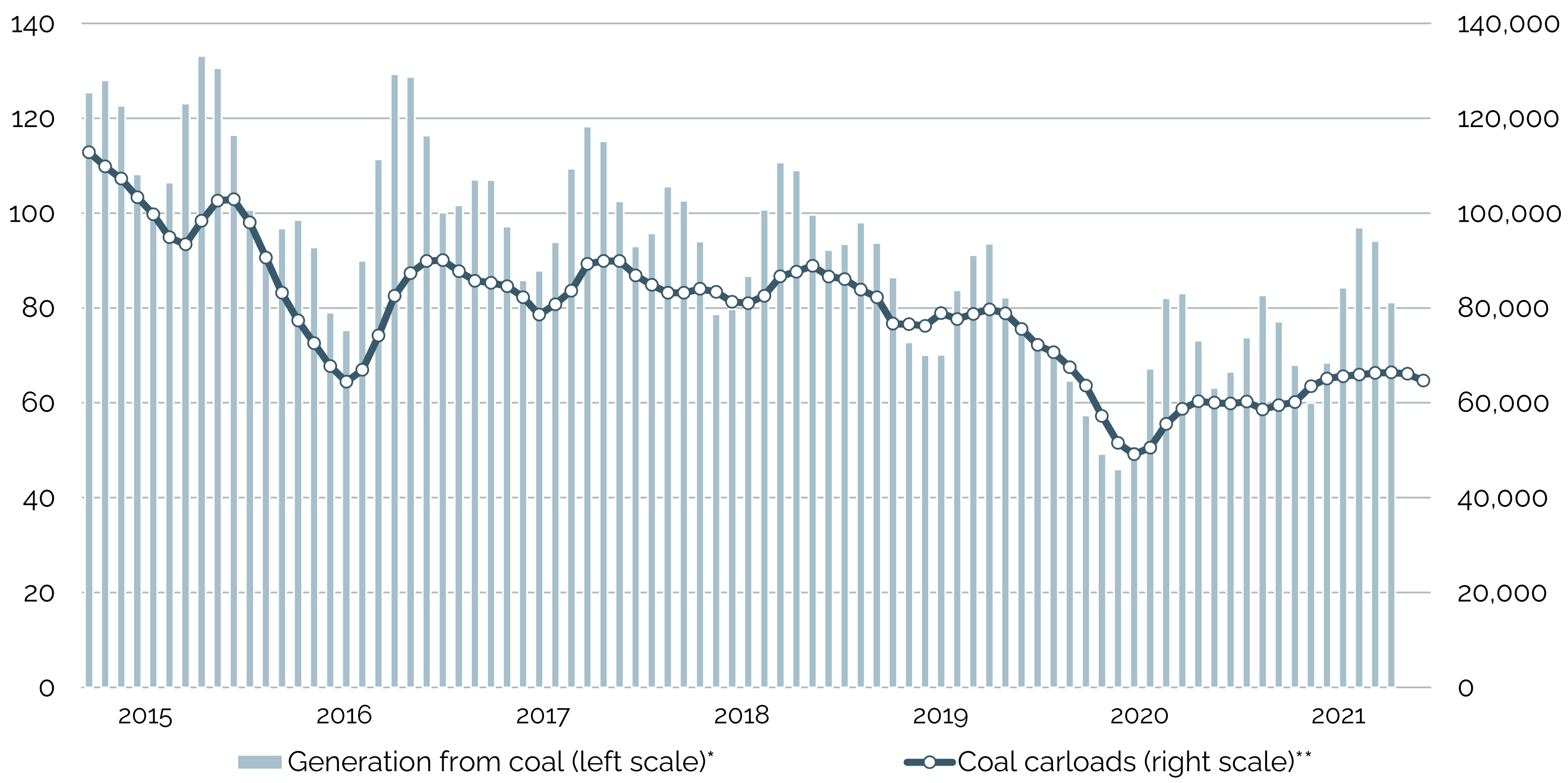
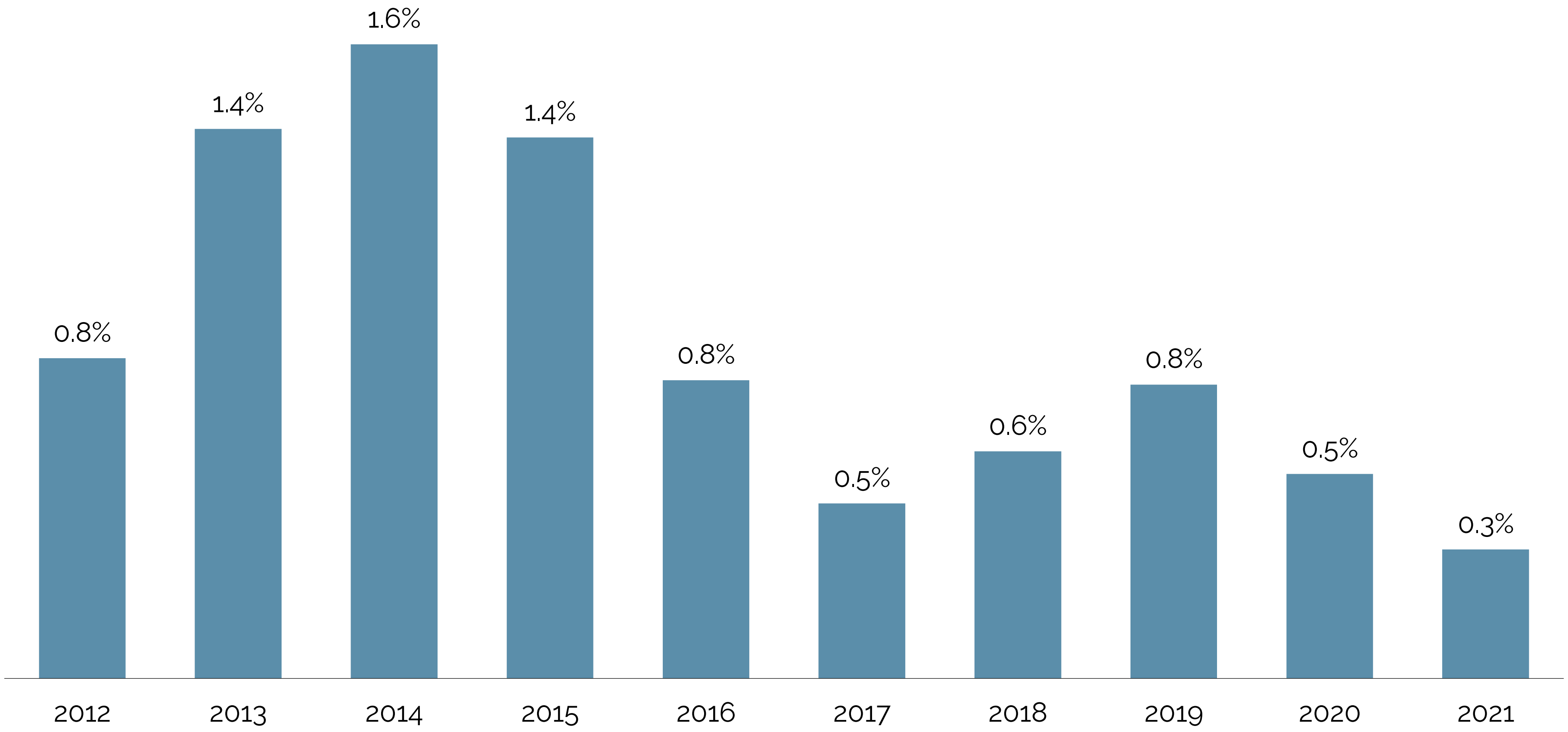
U.S. Rail Carloads of Coal vs. U.S. Electricity From Coal



*3-month moving average, million megawatthours.
**3-month moving average based on weekly originations. Source: EIA, AAR

Crude Oil’s Share of U.S. Rail Carloads



Source: AAR Freight Commodity Statistics

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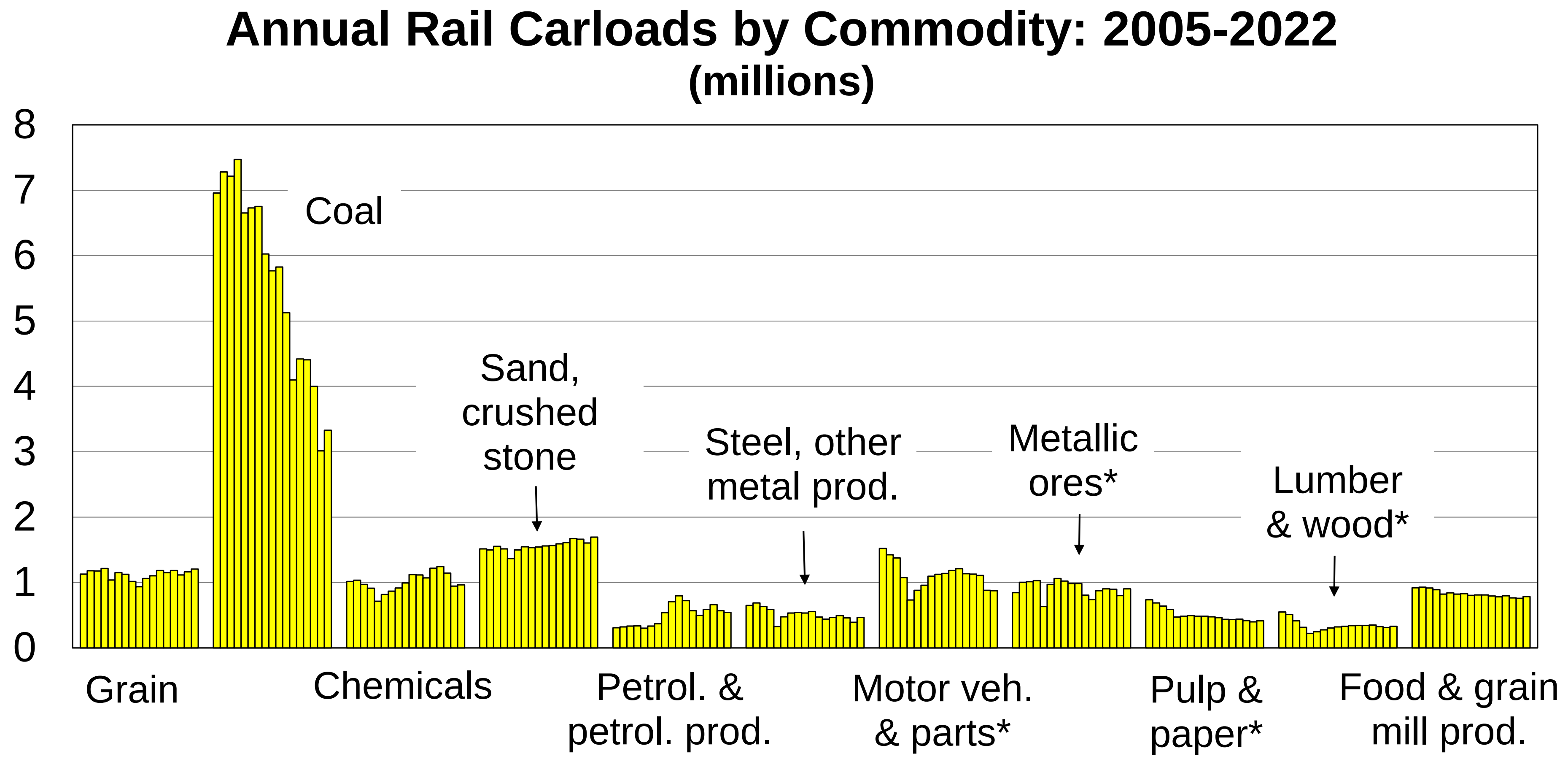
Constantly Changing Markets



*Combined U.S. + Canadian carloads. If intermodal were shown on this chart, it would rise from 11.5 million units in 2005 to 14.5 million in 2018 then down to 14.1 million in 2021. Source: AAR *Rail Time Indicators*

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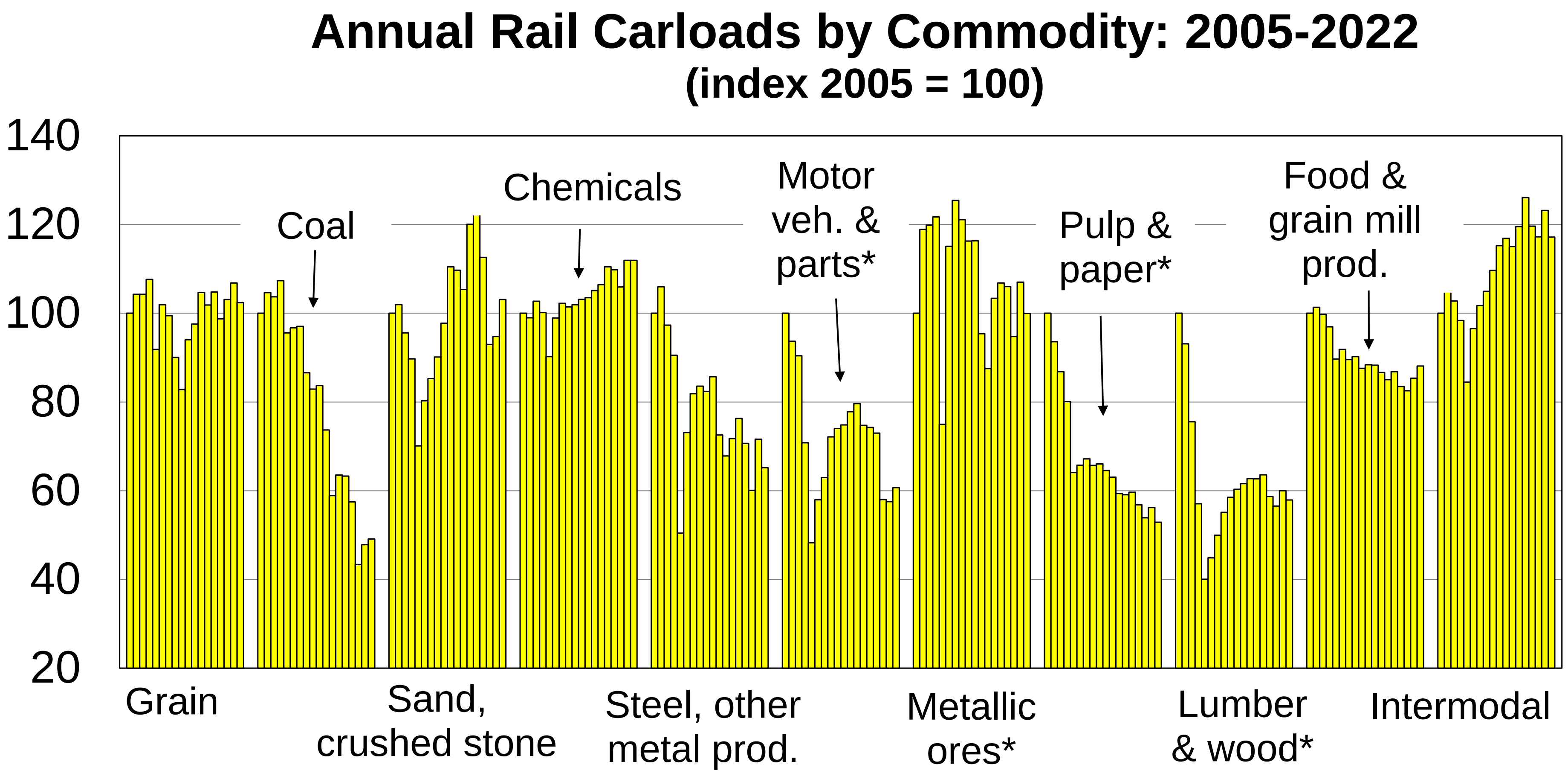
Rail Markets Are Constantly Changing



*Combined U.S. + Canadian carloads. Source: AAR *Rail Time Indicators*

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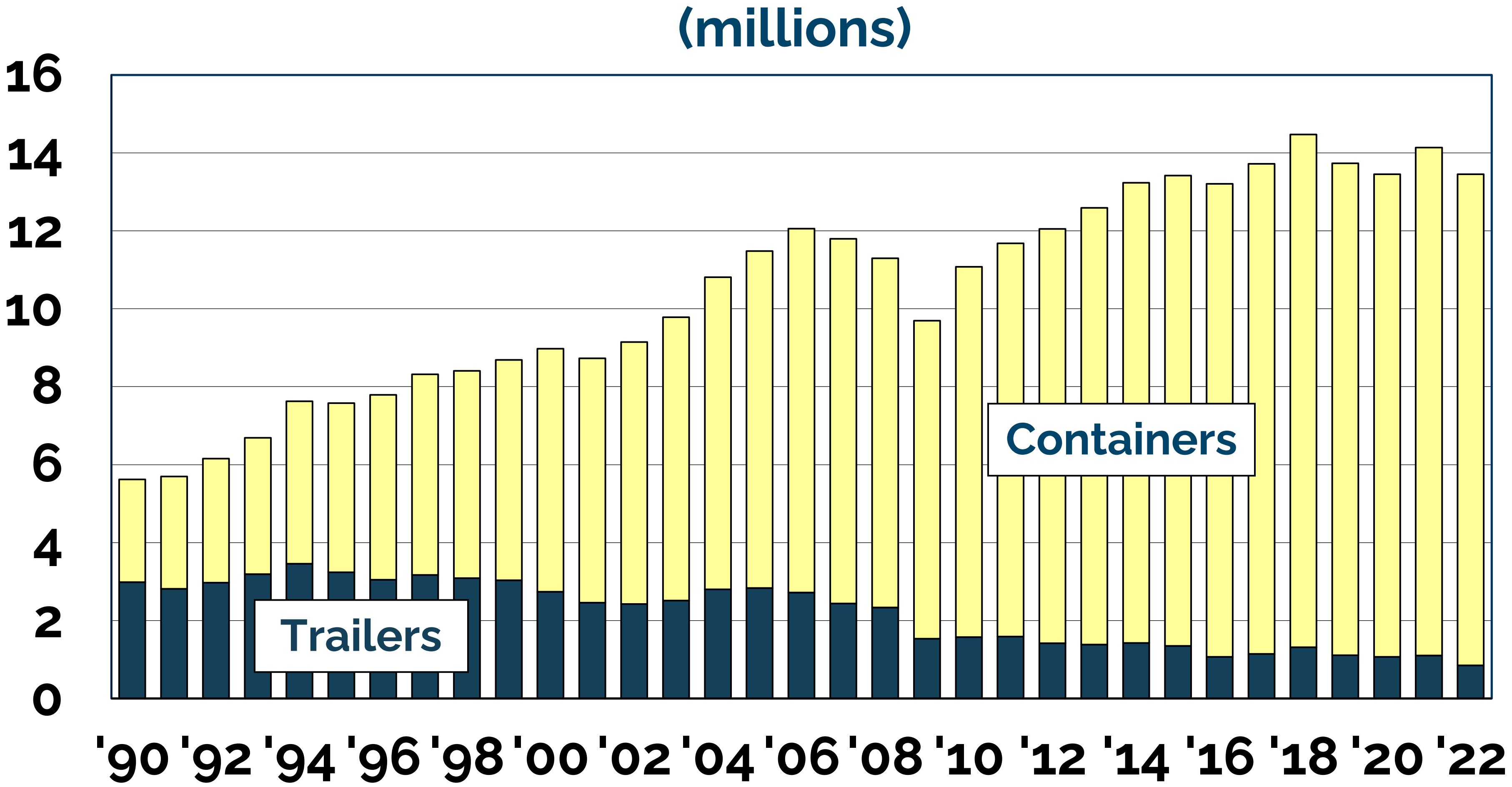
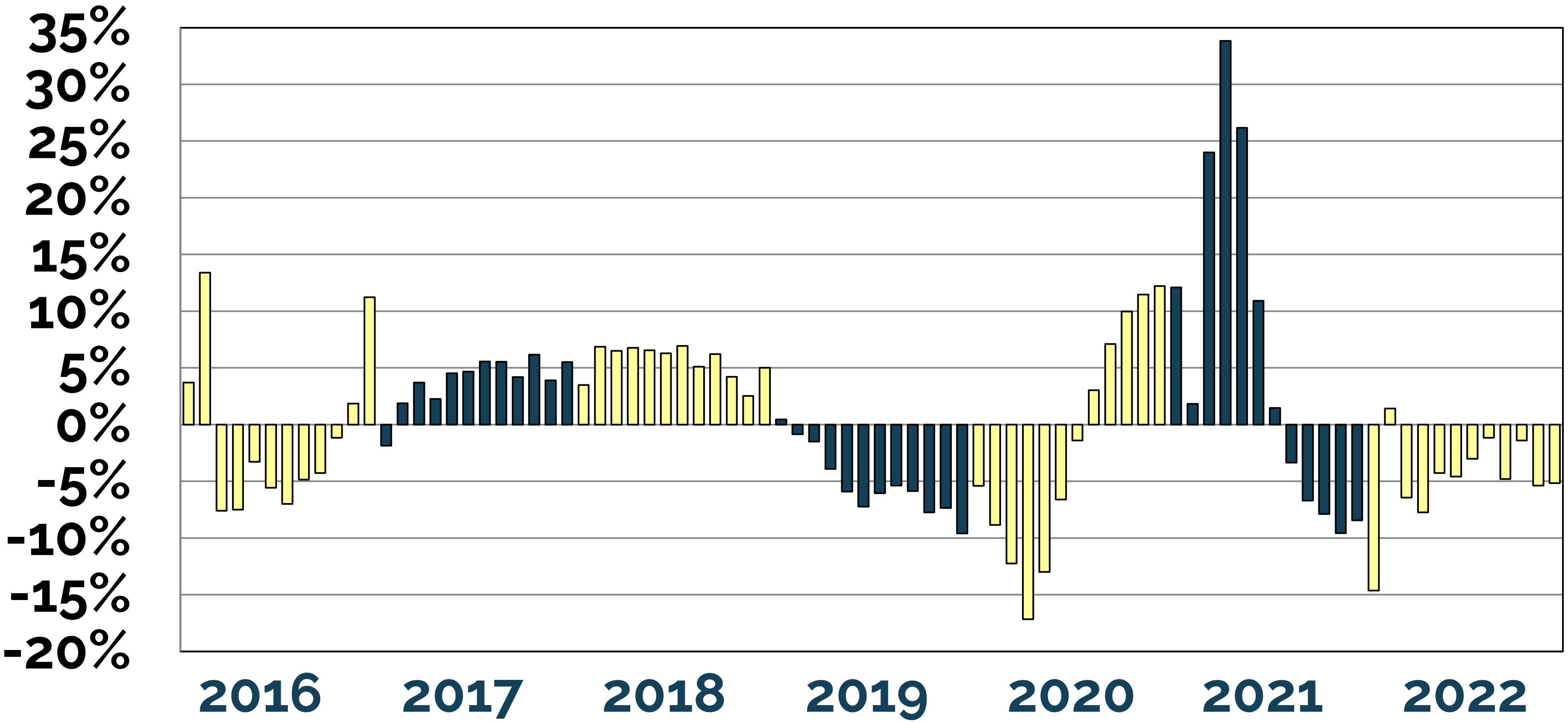
Rapid Intermodal Growth



Source: AAR *Rail Time Indicators*

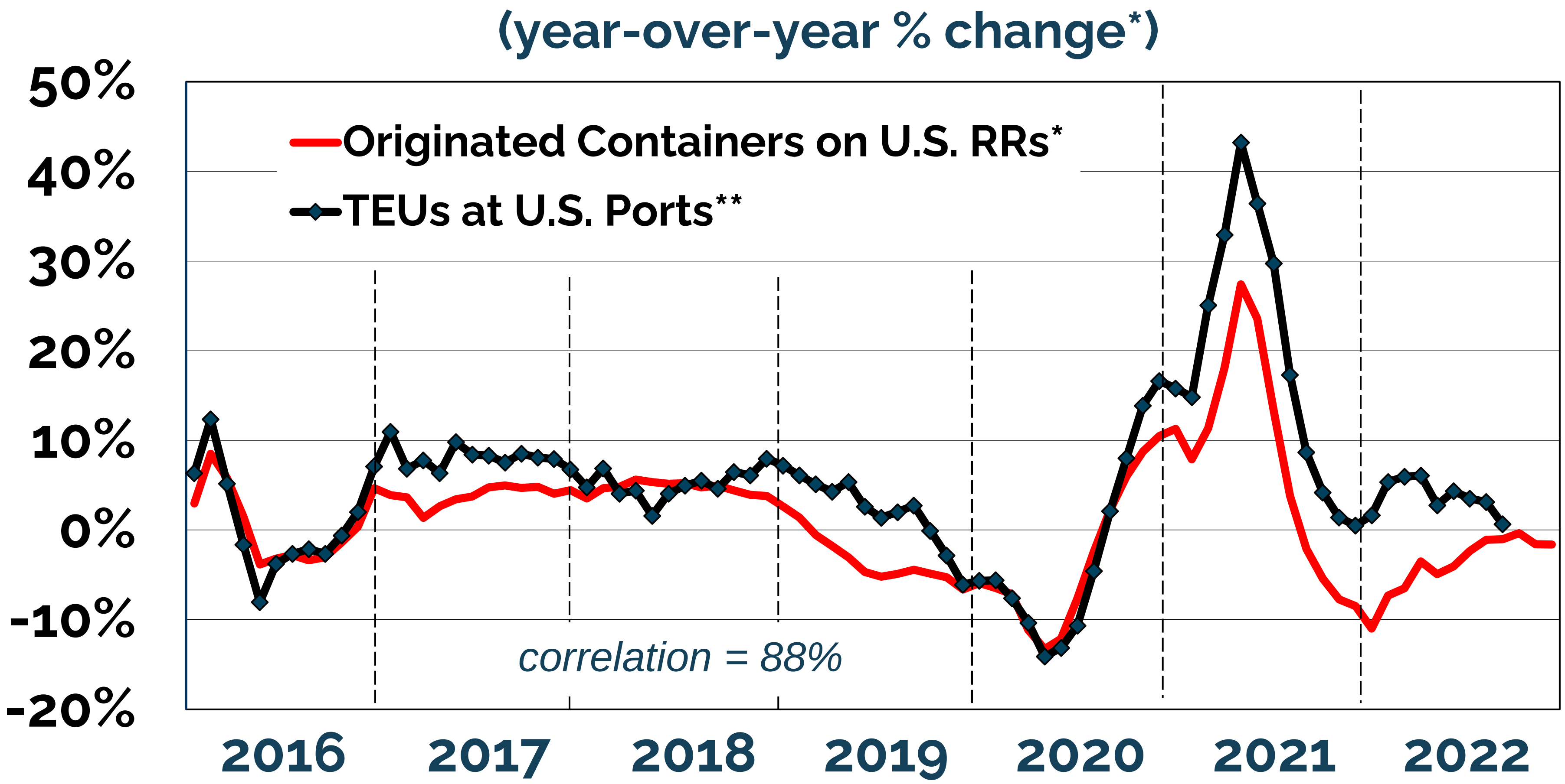
U.S. Rail Intermodal

(% change from same month previous year)



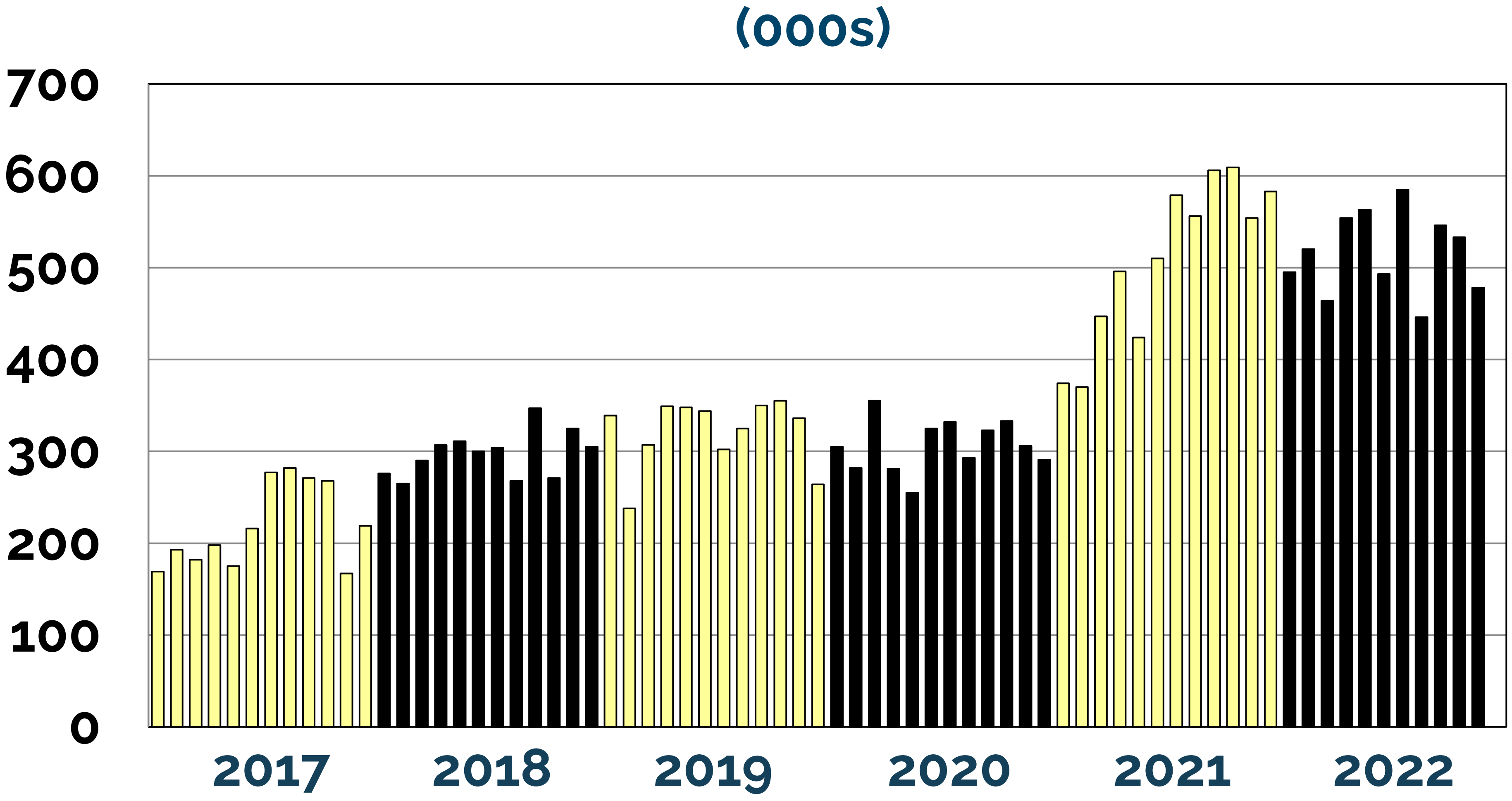
Data are based on originations, are not seasonally adjusted, don't include intermodal, and don't include the U.S. operations of CN, CP, and GMXT. Source: AAR *Rail Time Indicators*

As Ports Go, So Goes Intermodal



*BNSF, CSX, KCS, NS and UP combined. **Combined loaded + empty TEUs at Baltimore, Charleston, Houston, Long Beach, Los Angeles, New York/New Jersey, Oakland, and Savannah, Seattle/Tacoma, and Virginia. Data are based on 3-month averages. Source: AAR, individual ports

Job Openings: Transportation, Warehousing, & Utilities



Figures are not seasonally adjusted. Source: Bureau of Labor Statistics

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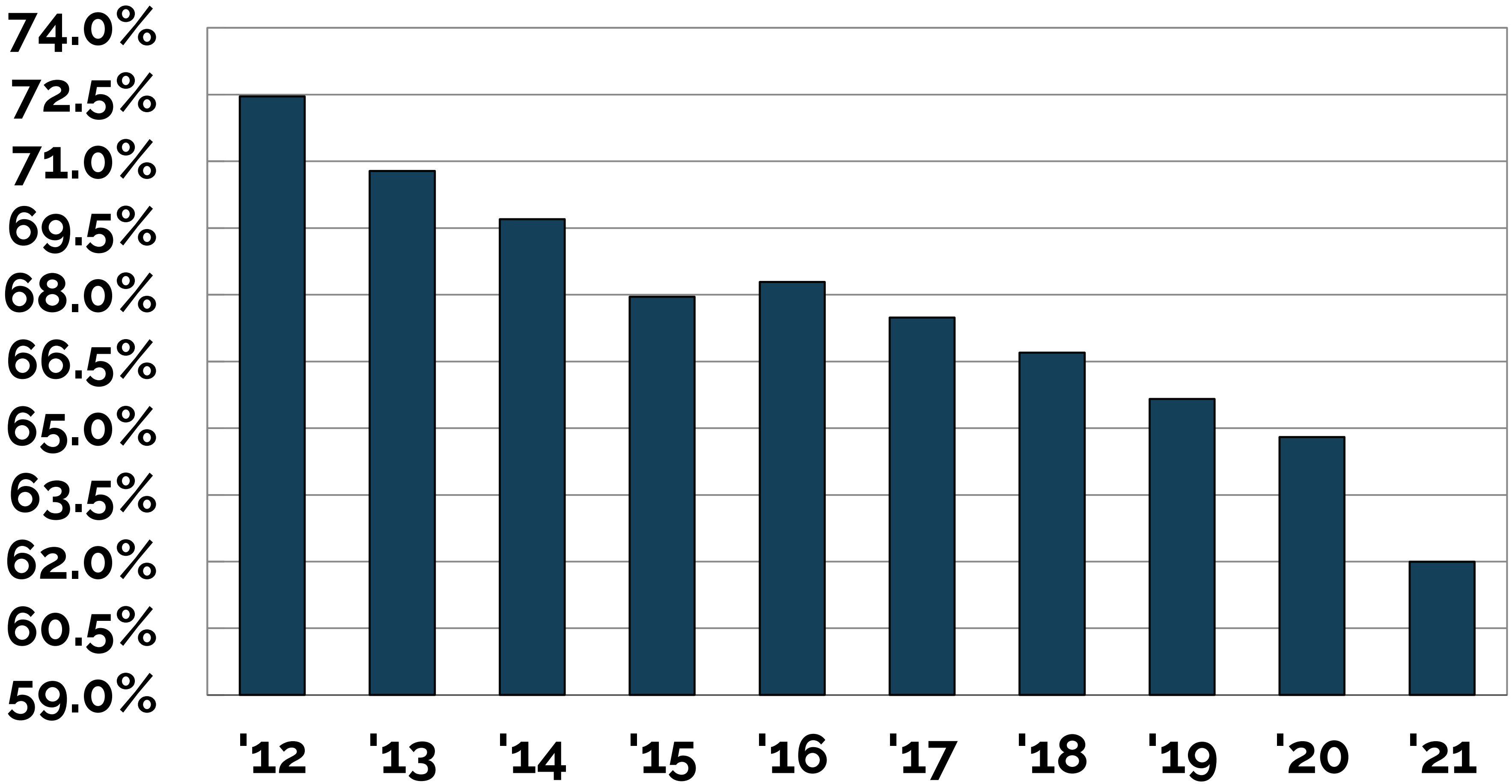
CULT - Class I Railroad Operating Ratio*



*Operating expenses as a percentage of operating revenue. Source: AAR

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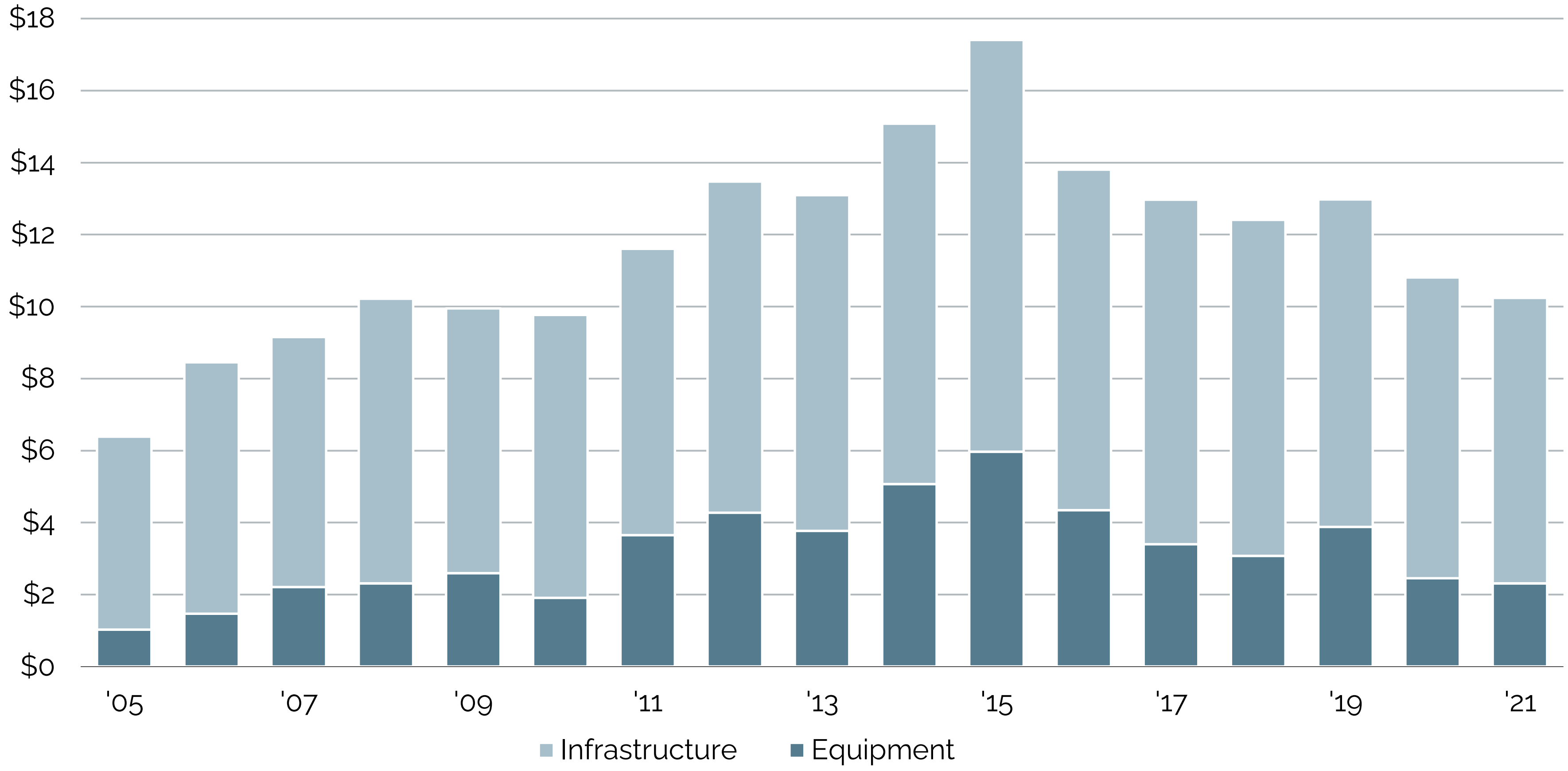
Railroad Capital Spending

($ billions, current dollars)



Data are for Class I railroads. Source: AAR

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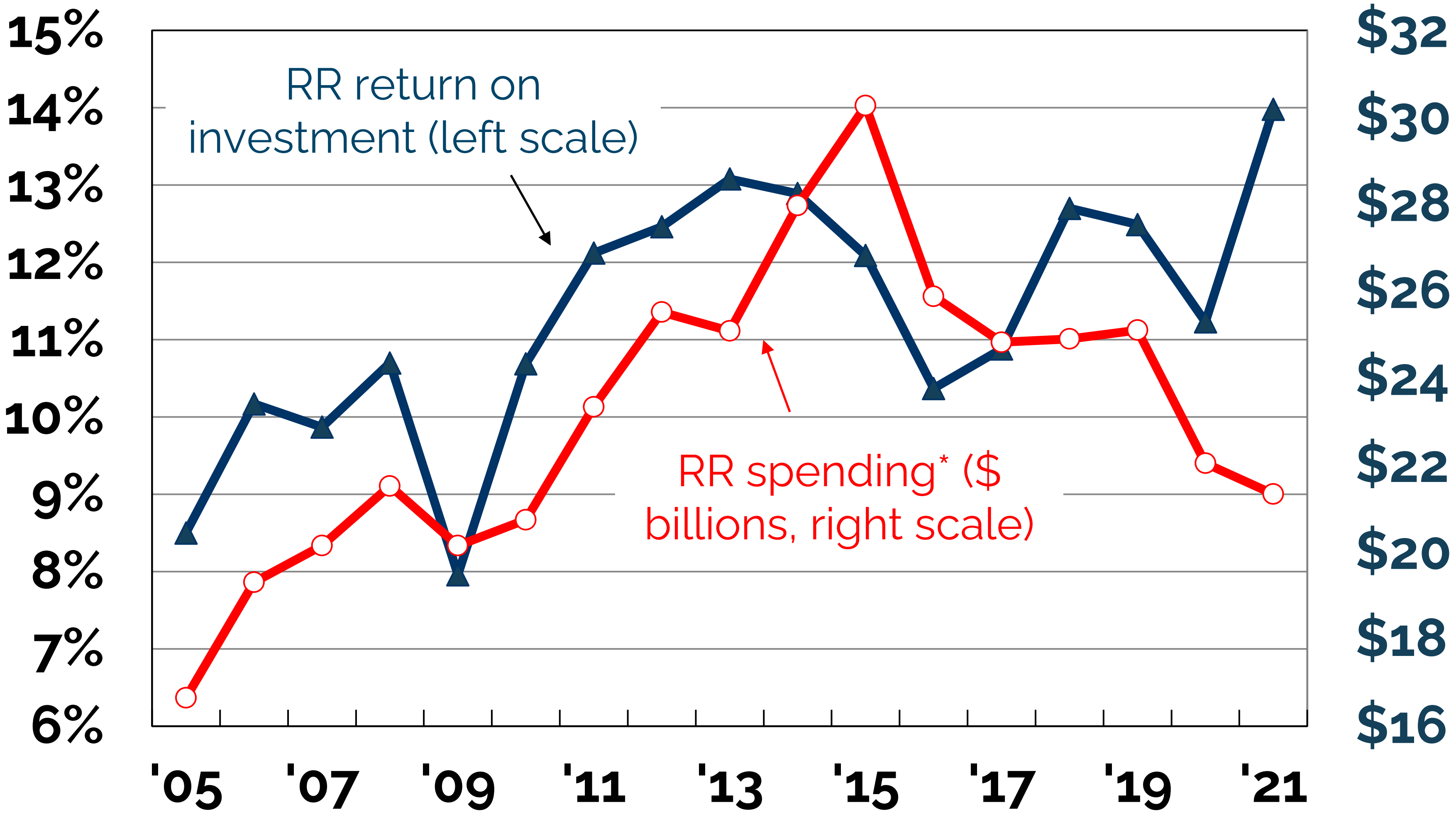
Historically, a Strong Positive Correlation Between RR ROI and Spending



*Capital spending + maintenance expenses. Source: AAR

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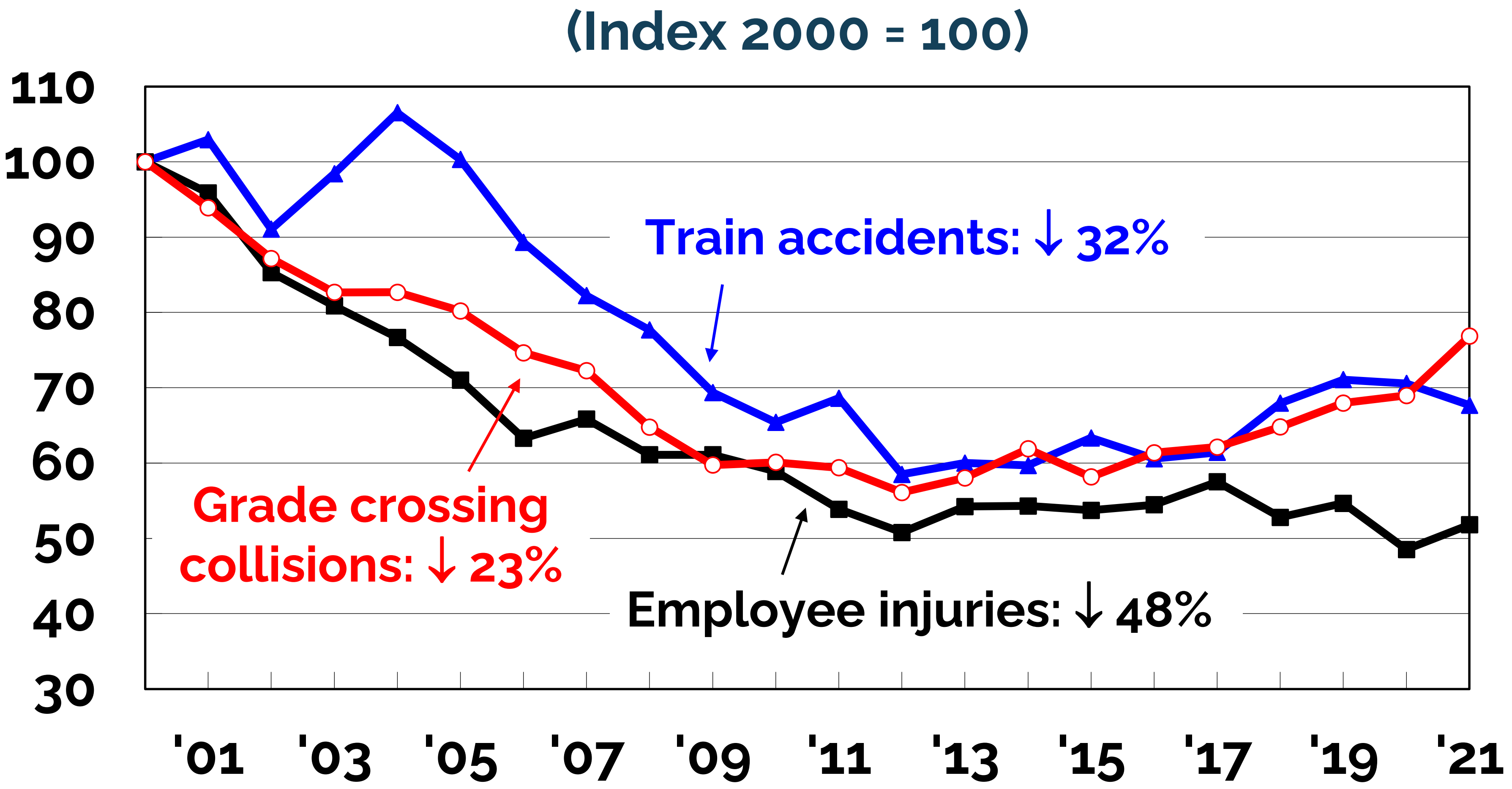
Recent Decade Was Safest Ever



% = change in rate from 2000-2021. 2021 is preliminary. Source: FRA

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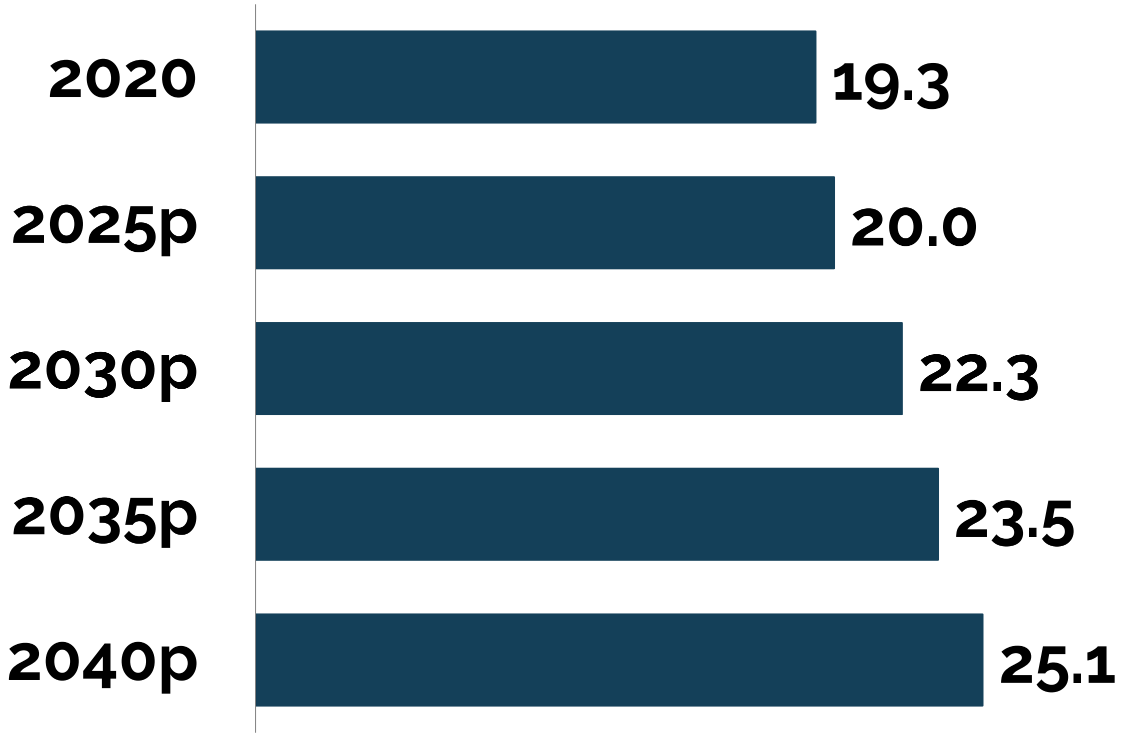
Long-Term Demand for Freight Transportation Will Grow

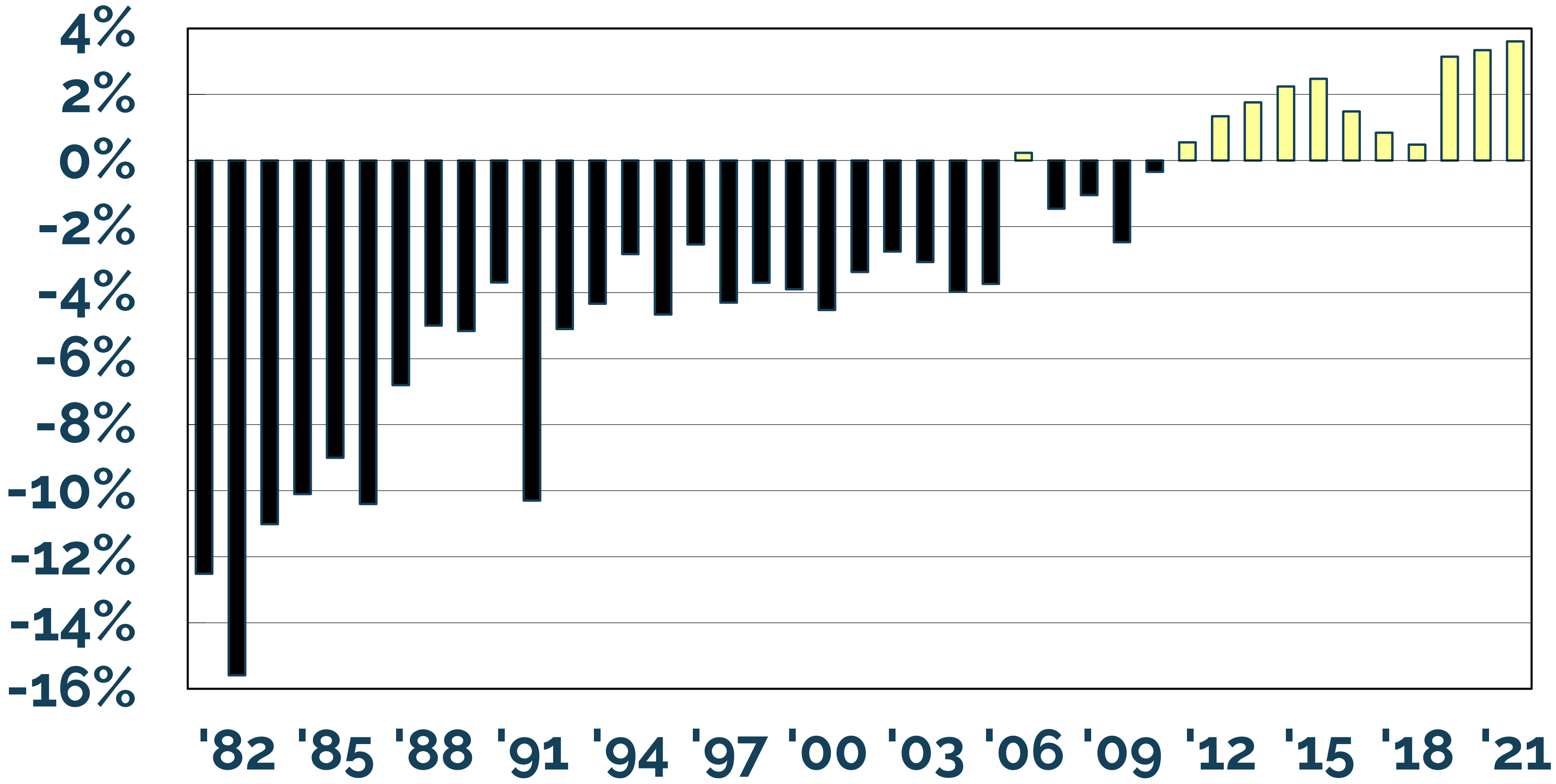
Billions of Tons of Freight Transported in the U.S.



U.S. DOT estimates that total U.S. freight movements will rise from around 19.3 billion tons in 2020 to around 25.1 billion tons in 2040 – a 30% increase.

p – projected   Source: FHWA - *Freight Analysis Framework*, version 5.4.1

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

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Long-Term Demand for Freight Transportation Will Grow

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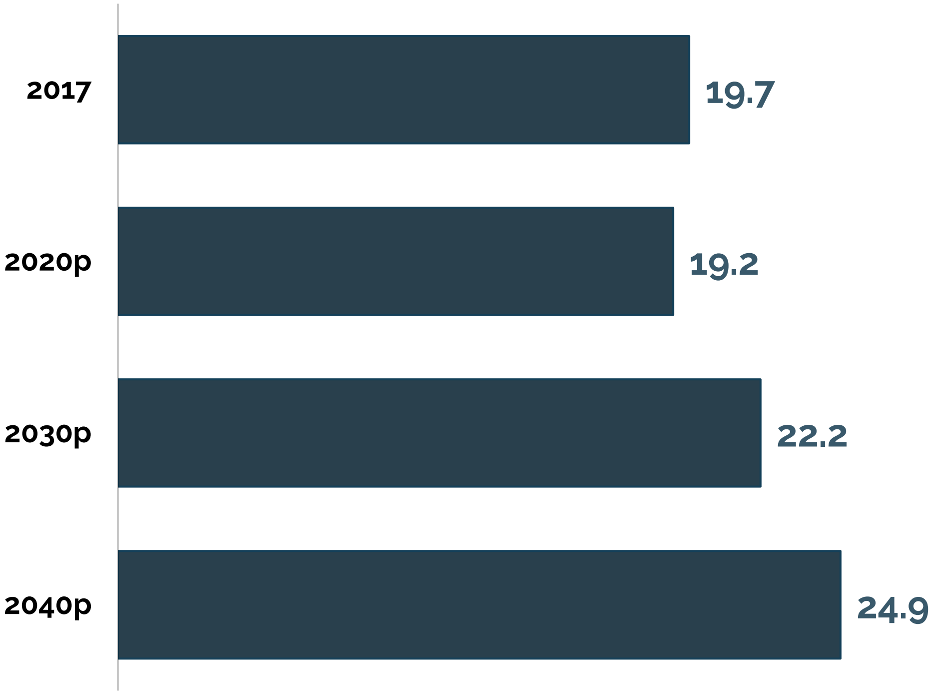
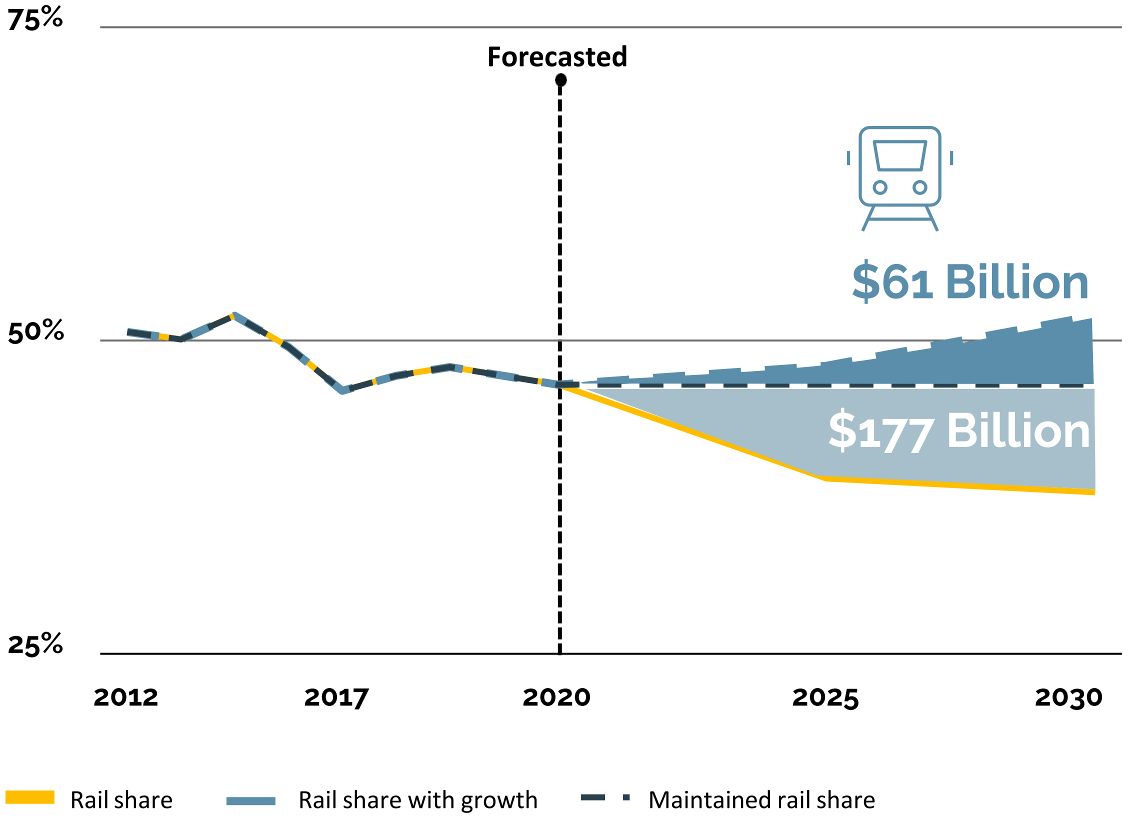


U.S. DOT estimates that total U.S. freight movements **will rise from around 19.2 billion tons in 2020 to around 2.49 billion tons in 2040** – a 30% increase.

p – projected
Source: FHWA - Freight Analysis Framework, version 5.0

By using available capacity, railroads could add $61BN 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

Source: © Oliver Wyman

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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