A Very Sandhouse Christmas2022

After Renaissance, Retreat – Now What?

NUTC

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RailsTop10 (Approaching Year End 2022)

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 form the pandemic? JIC? Near or Re-shoring?

Railroads Today (Fall 2022)

- ***<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?
- <u>Tailwinds</u>:
  - Pent up 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)
  - Fuel Surcharge Lag
  - 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”

- This was business-as-usual – the every 5 year three years-plus-back pay negotiations – NORMAL NEGOTIATIONS exacerbated by timing, pandemic, politics, etc
- 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
- Paid Sick Leave never negotiated for
- 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
- What was truly unusual was media reaction to the “*Impending Economic Crisis*” – see Time Magazine (??), WashPo, etc
- 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 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)[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

- <u>New short line spinoffs by Class 1's</u> – *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 <u>is</u> 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? 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?*

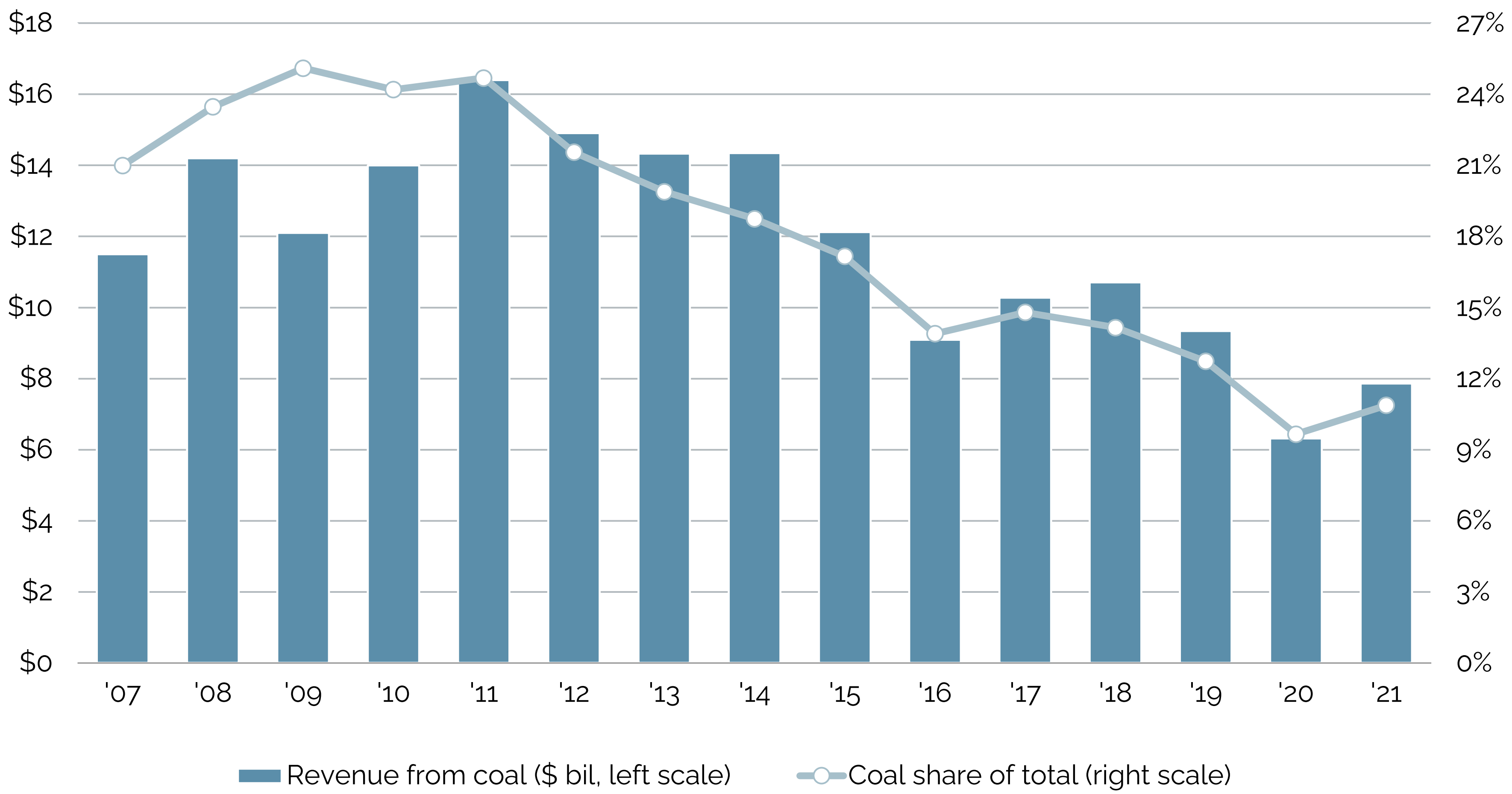
Rail Themes Emerging from Q3/22 Webcasts, etc

- Rail financial results once again solid, beating estimates – despite service woes, volume weakness – to the irritation oif DC!
- Supply chain and labor issues remain But sequential improvement is seen; politics a headwind
- Rails promise *growth pivot ("Talking the Talk")* but the year starts poorly to say the least….Rails miss H2/22 deadline for improvement
- Capex budgets are up (BUT so is inflation)
- Split on *coal* outlook (CSX vs NSC) for '23 after starring in '21-22 – future decline unchallenged, strength of the DCB lasts longer than expected . Still no investment in coal supply chain- would you?
- STB grabbing headlines (Pan Am/Amtrak/Access Hearings/Service/CPKC); conflating pricing power (reciprocal switching) with service
- Rails tout benefits of *single-line* service (CSX-PAR, CPKC)!
- Rail-Rail competition heating up (BNSFvUP; CPKC plans) as truck gains IM share
- Labor wins in bargaining (assuming ratification) but rails can handle it even if they didn't *account* for it so well
- Rail cars set for (modest?) recovery
- New leadership transitions, one big succession plan only now & surprisingly resolved (CSX), one resolved in favor of a growth focus (CN)
- NS INVESTOR DAY SUGGESTS L/T THINKING

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. Rail Revenue From Coal



Source: AAR Freight Commodity Statistics

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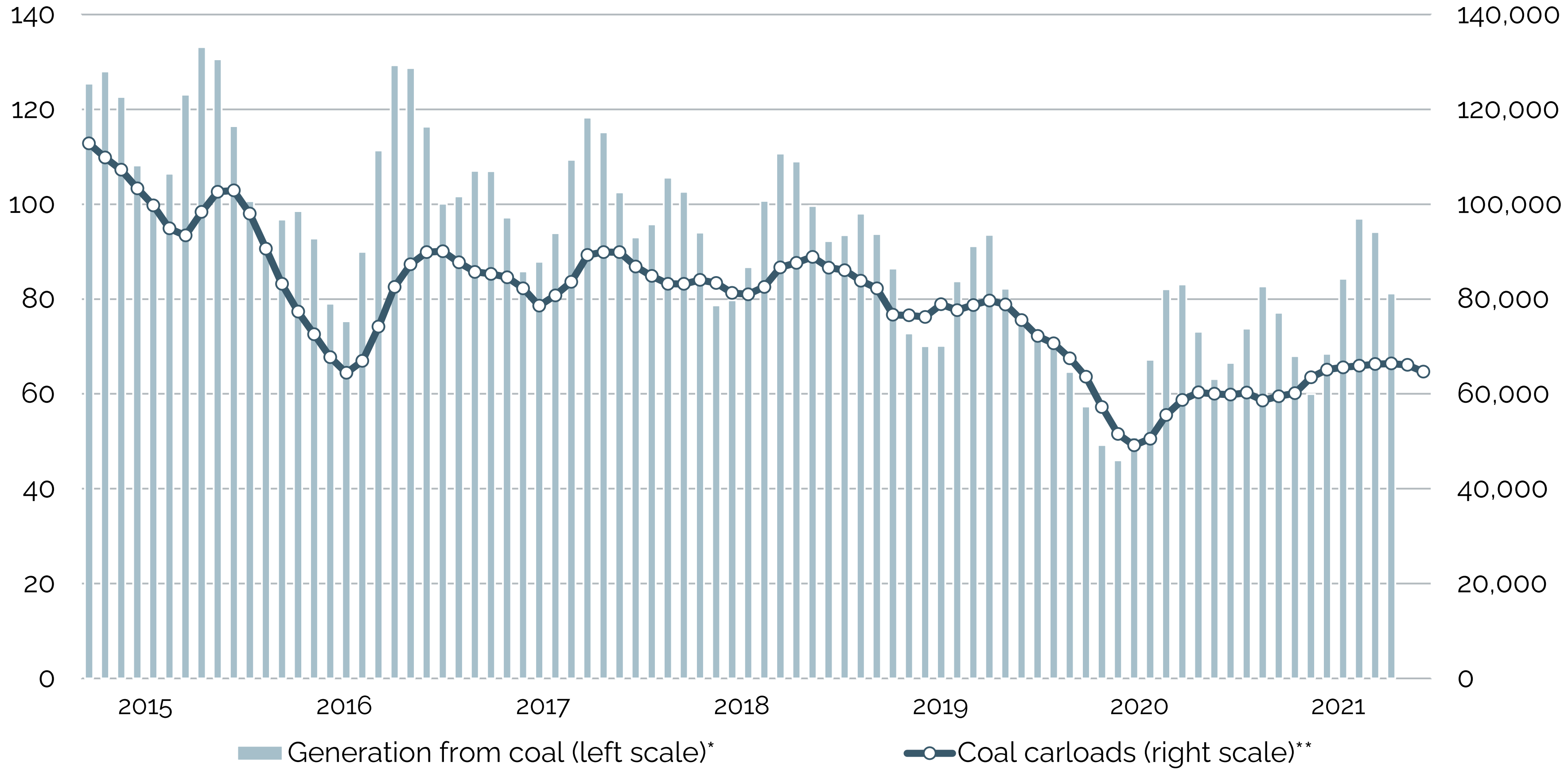
Rail Coal Volumes Are Closely Tied to Electricity Generation From Coal

(2000 = 100)

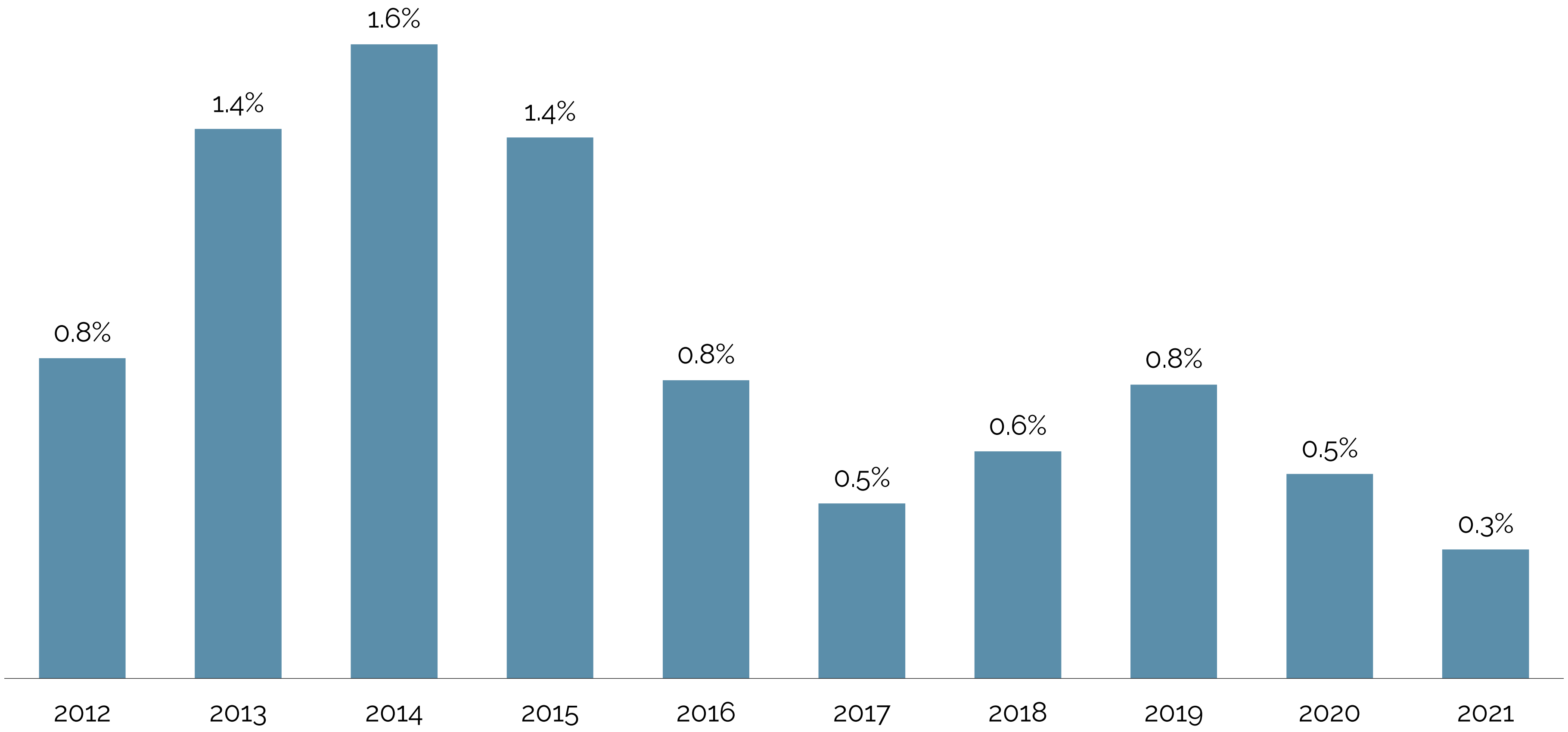
Coal tonnage based on originated tons by U.S. Class I railroads.
Sources: Energy Information Administration, Association of American Railroads

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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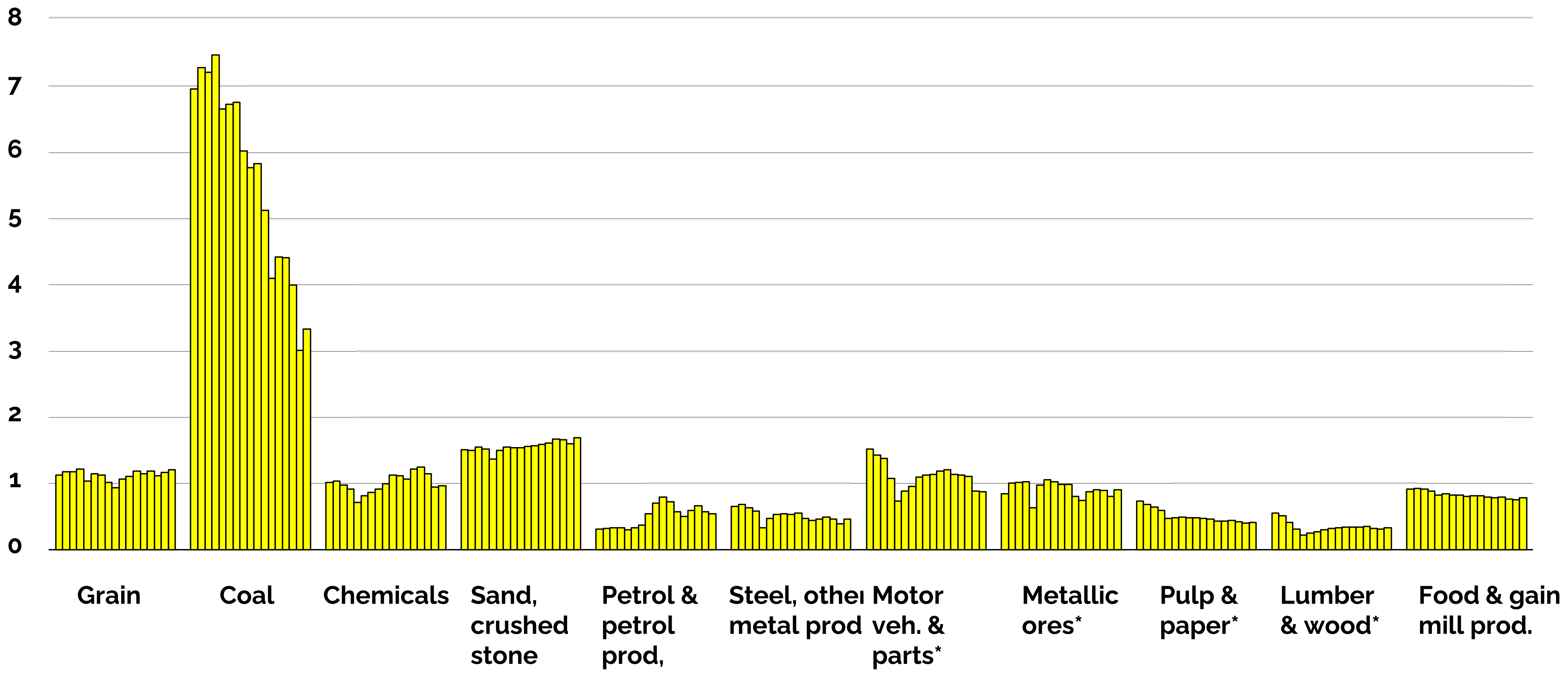
Constantly Changing Markets

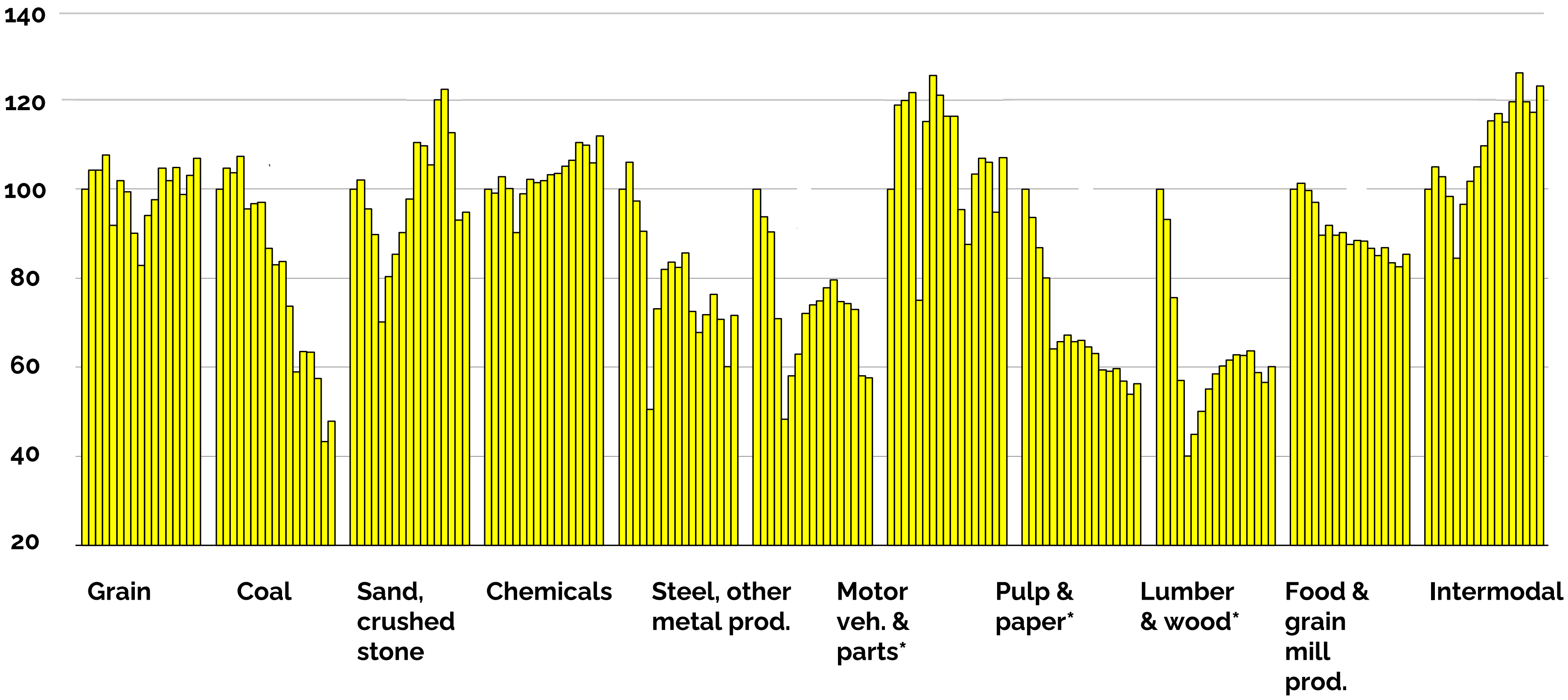
Annual Rail Carloads by Commodity: 2005–2020
(millions)



*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 millions in 2018 then down to 14.1 millions in 2021.
Source: AAR Rail Time Indicators

Constantly Changing Markets

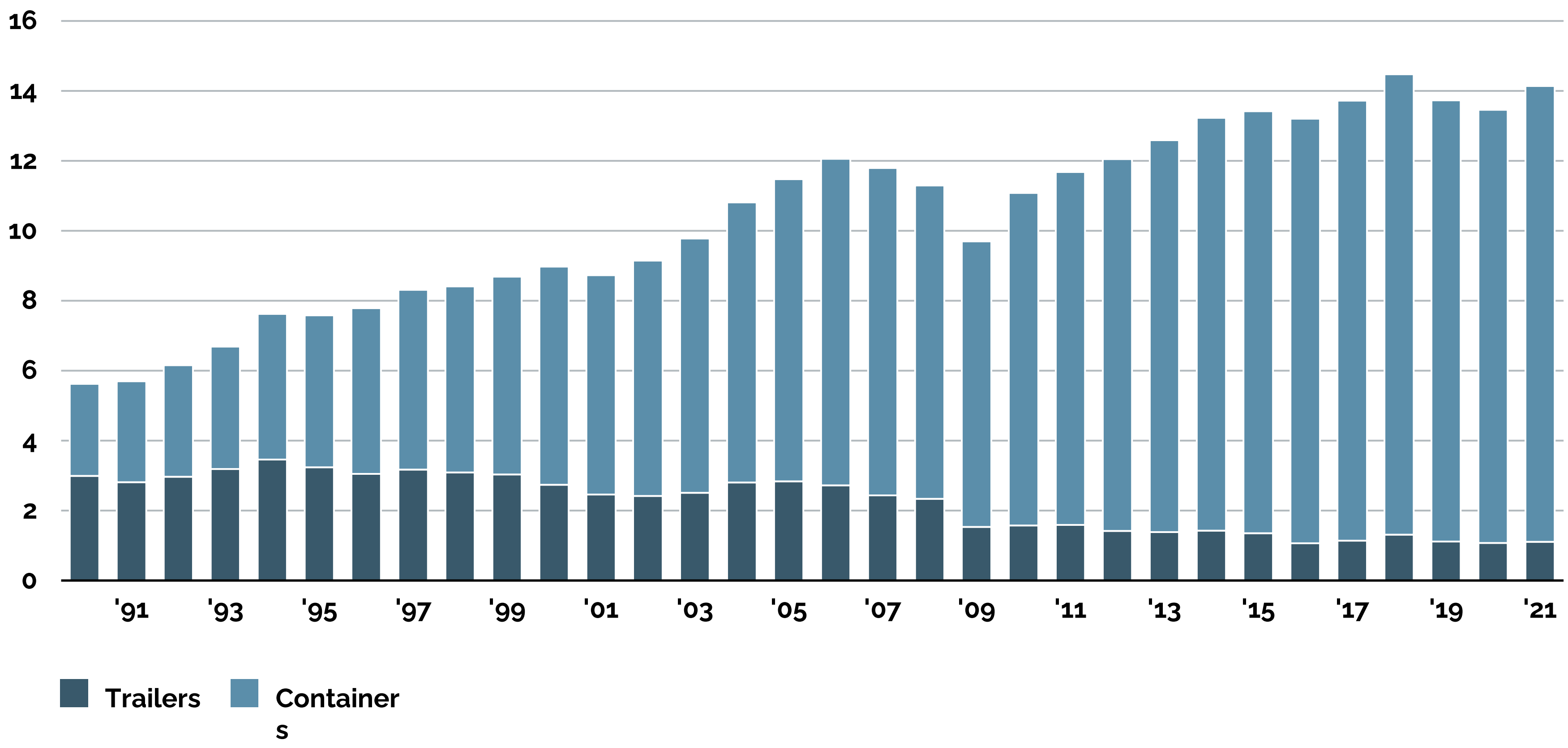
Annual Rail Carloads by Commodity: 2005–2020
(index 2005 = 100)



*Combined U.S. + Canadian carloads. If petroleum products were shown on this chart, its index would rise from 108.1 in 2010 to 259.4 in 2014 down to 161.9 in 2017 and up to 214.73 in 2019.
Source: AAR Rail Time Indicators

Rapid Intermodal Growth

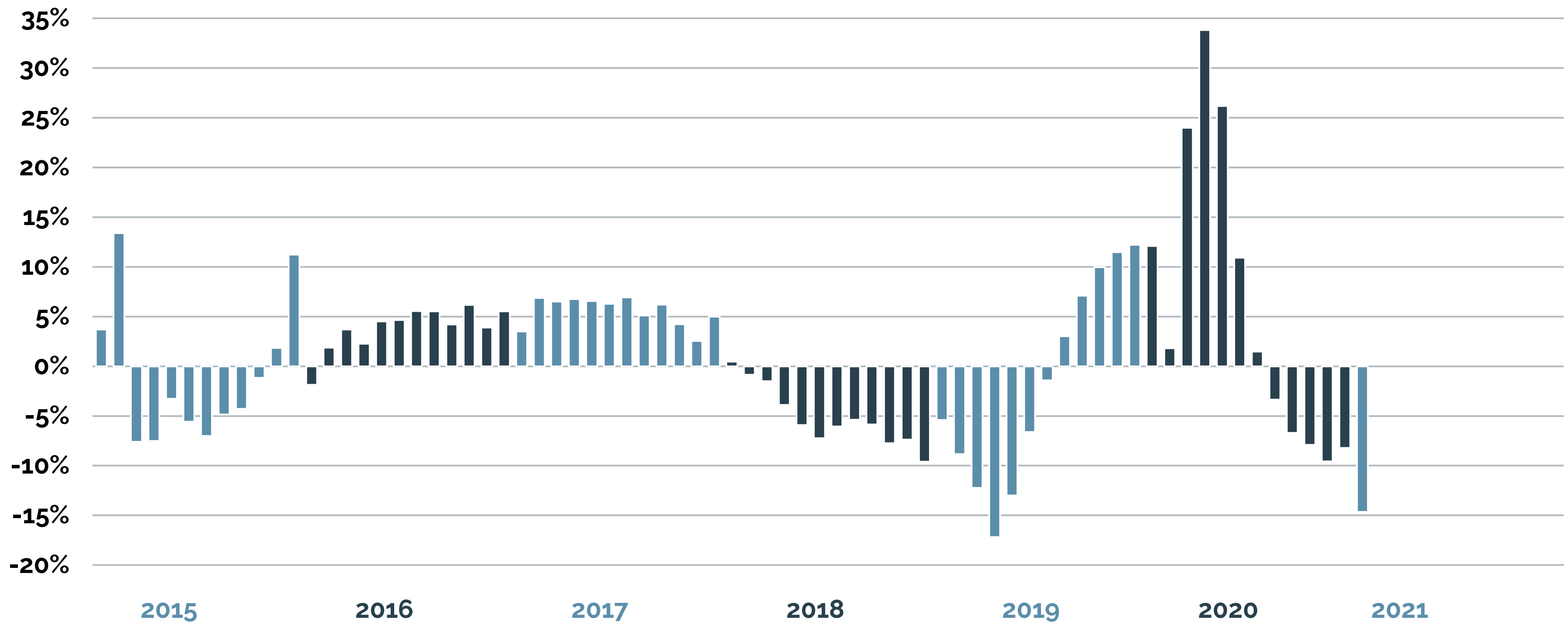
(millions)



Source: AAR Rail Time Indicators

U.S. Rail Intermodal

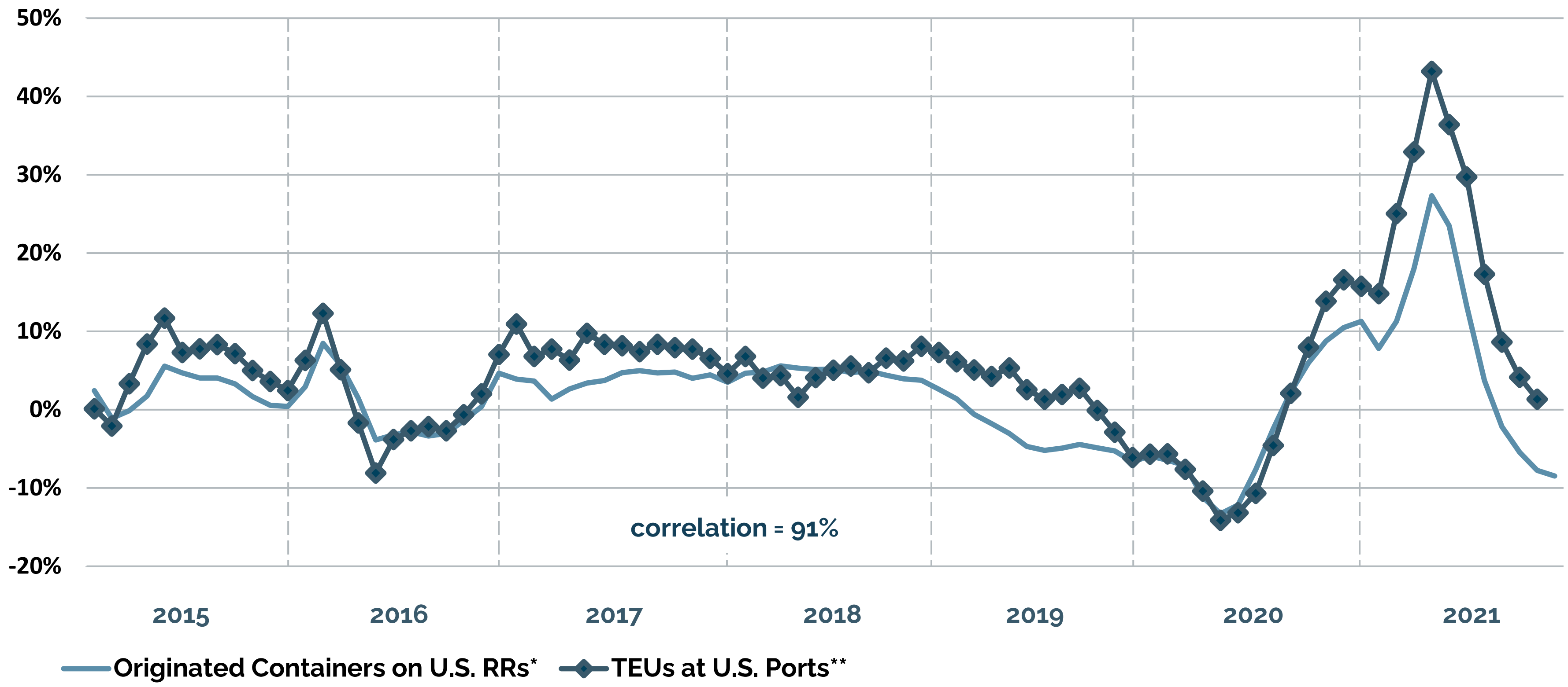
(% change from same month previous year)



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

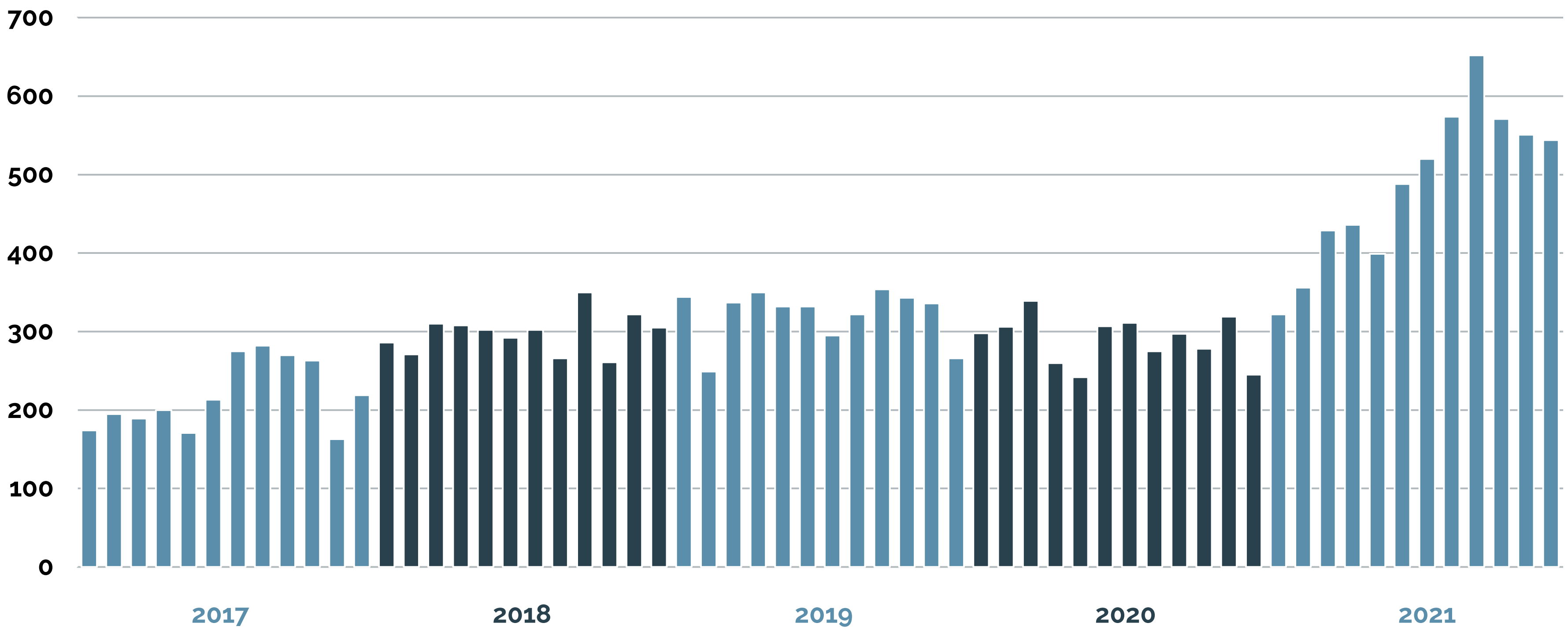
(year-over-year % change*)



*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

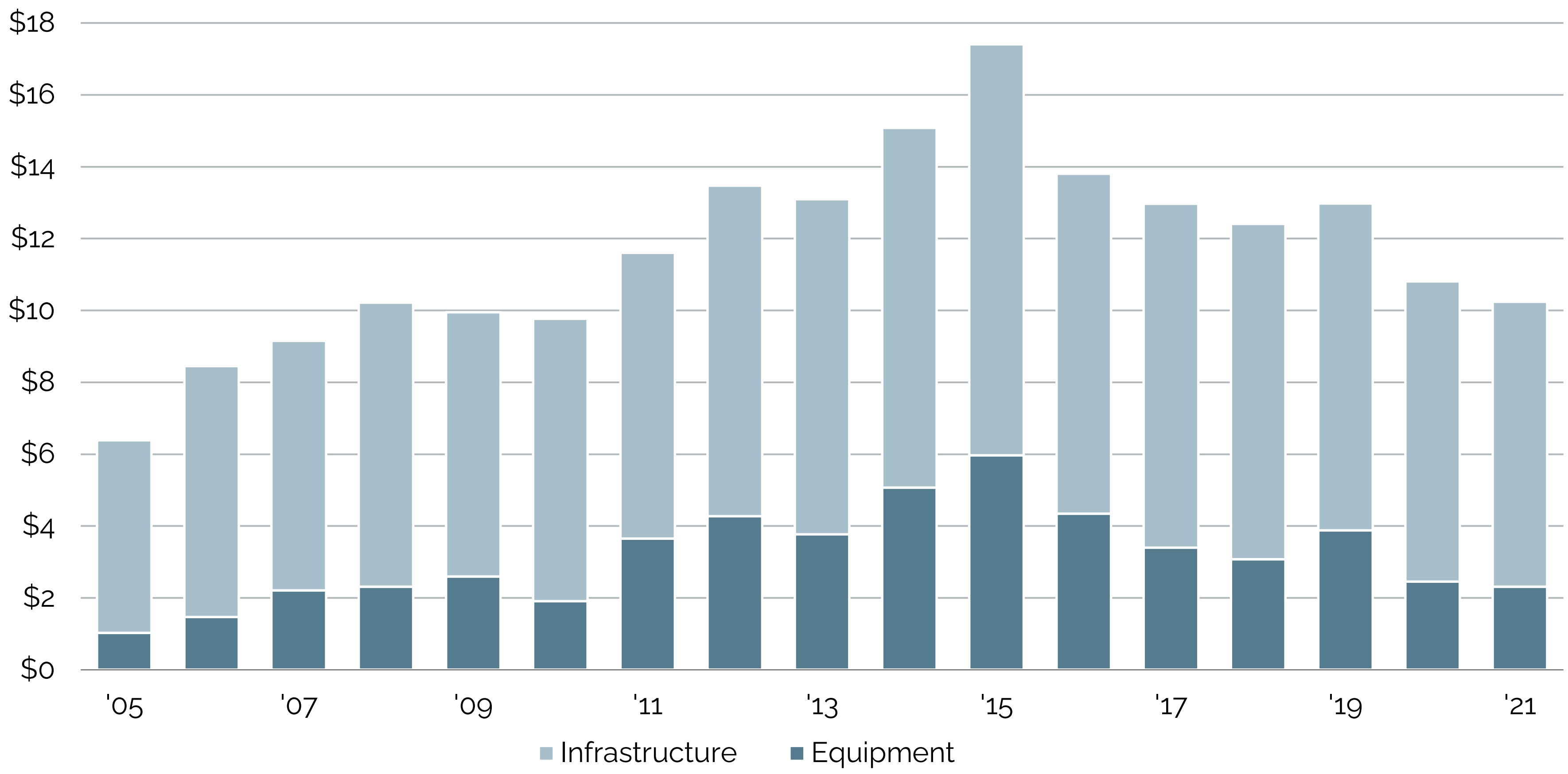
(000s)



Source: Bureau of Labor Statistics

Railroad Capital Spending

($ billions, current dollars)



Data are for Class I railroads. Source: AAR

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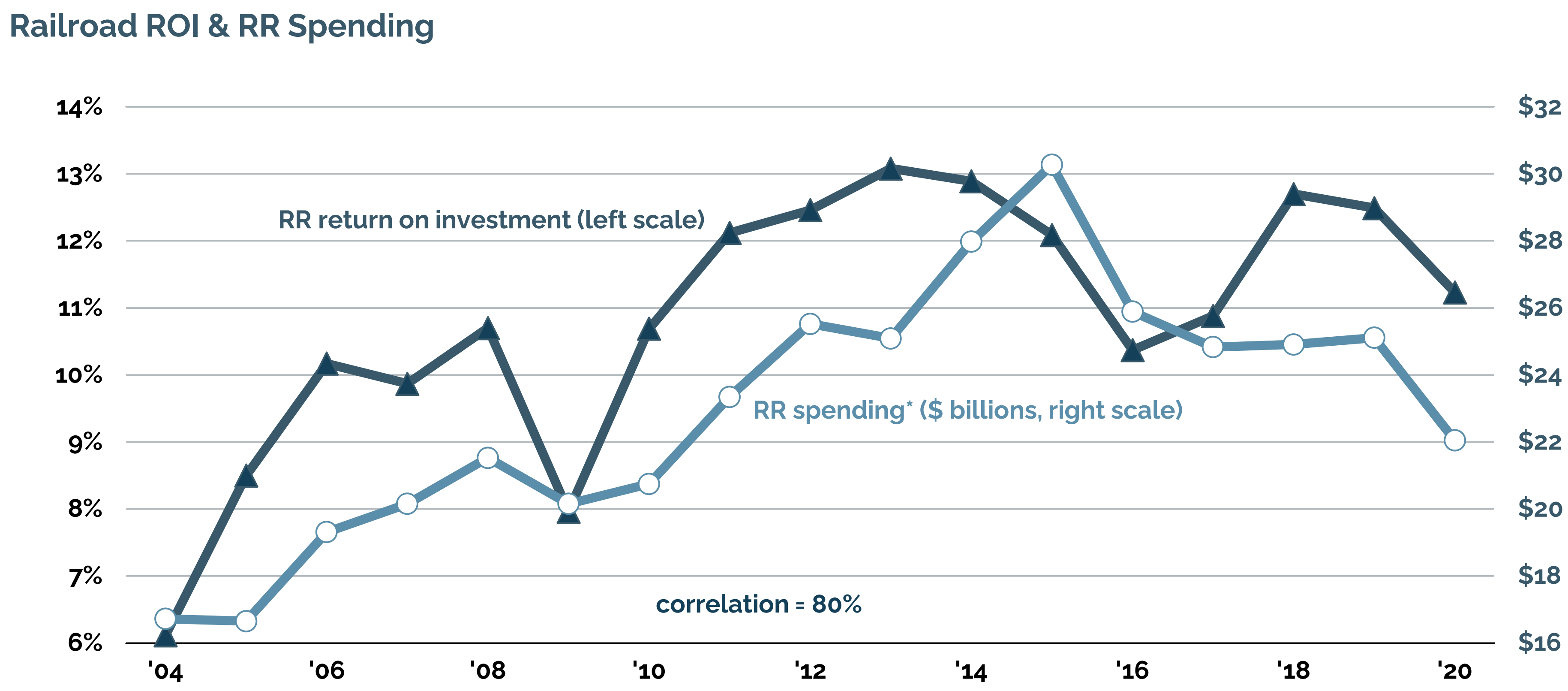
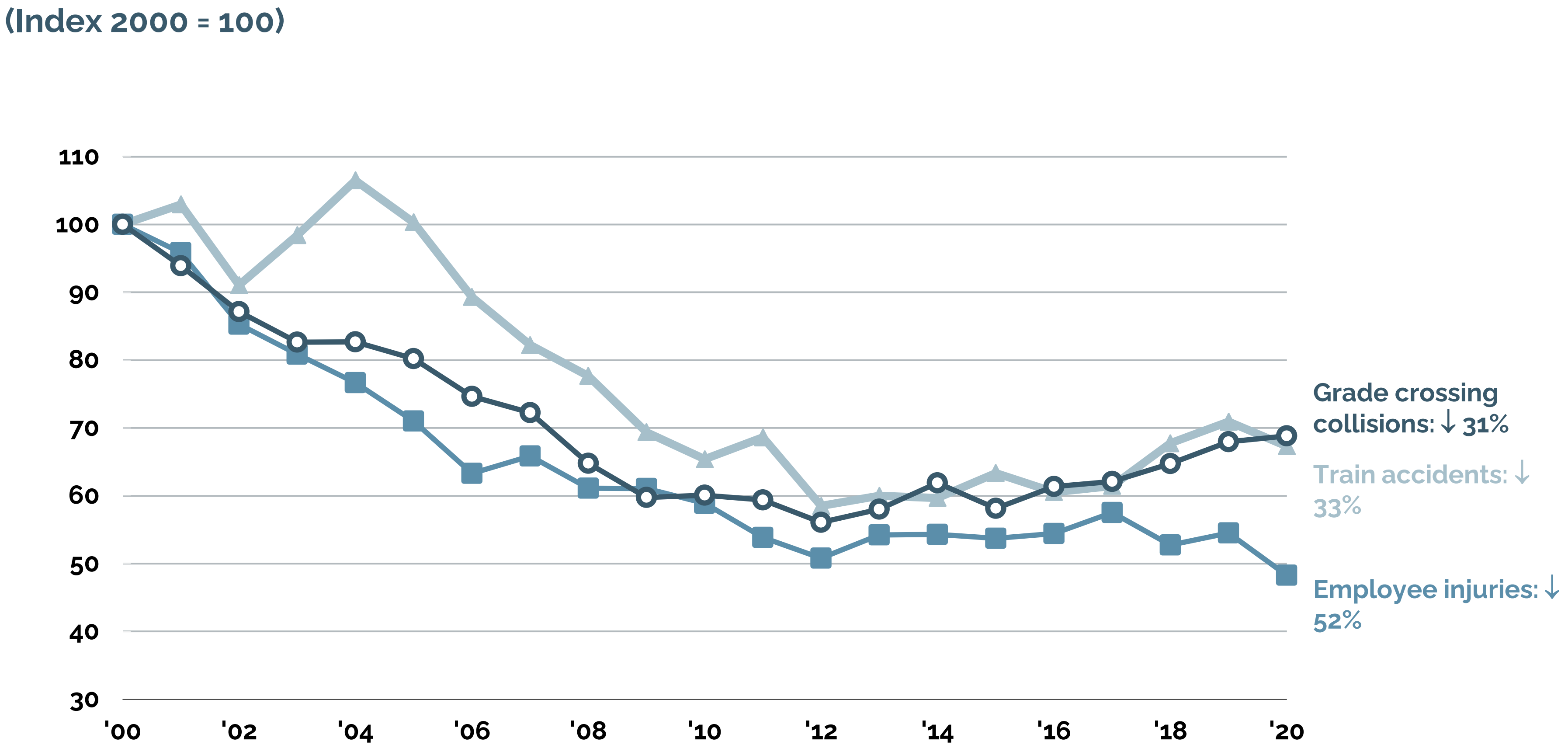
There's a Strong Positive Correlation Between Railroad ROI and Spending



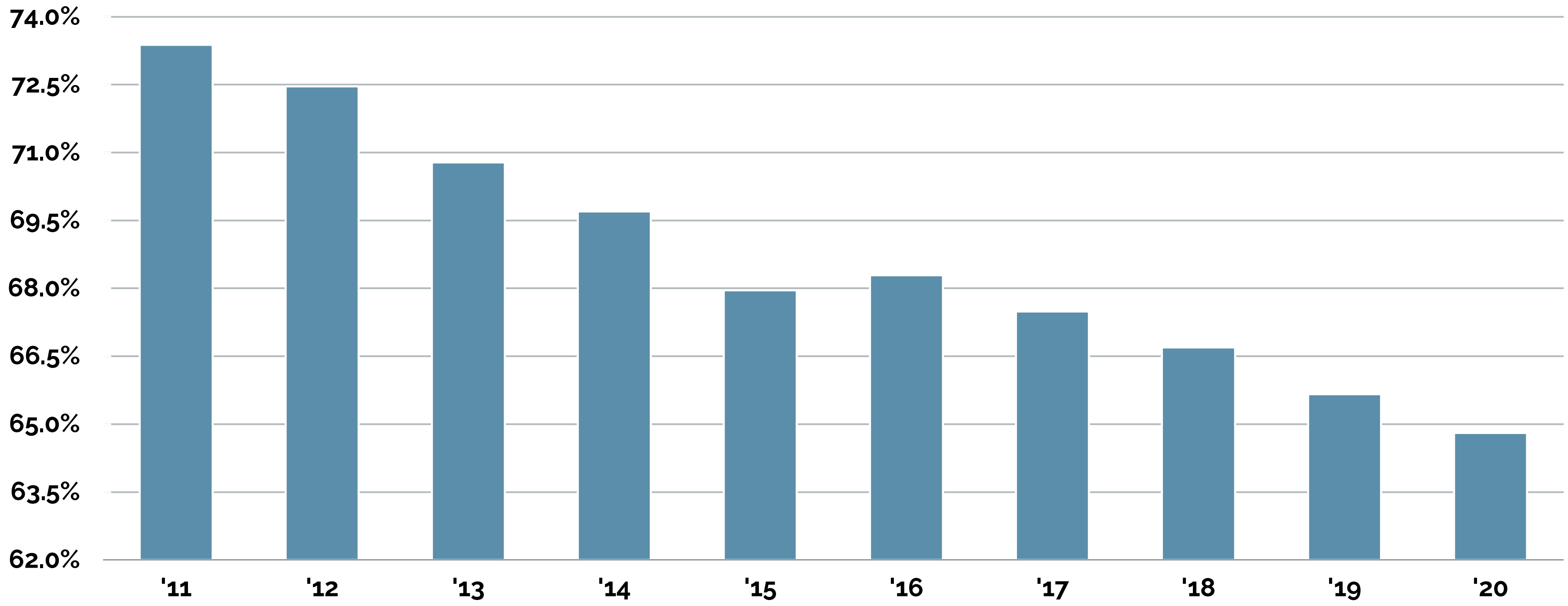
*Capital spending + maintenance expenses.
Source: AAR

Recent Decade Was Safest Ever



% = change in rate from 2000-2020. 2020 is preliminary.
Source: FRA

RR OR – Worthy of "Cult" Status?



*OR – US-ONLY - Operating expenses as a percentage of operating revenue.
Source: AAR

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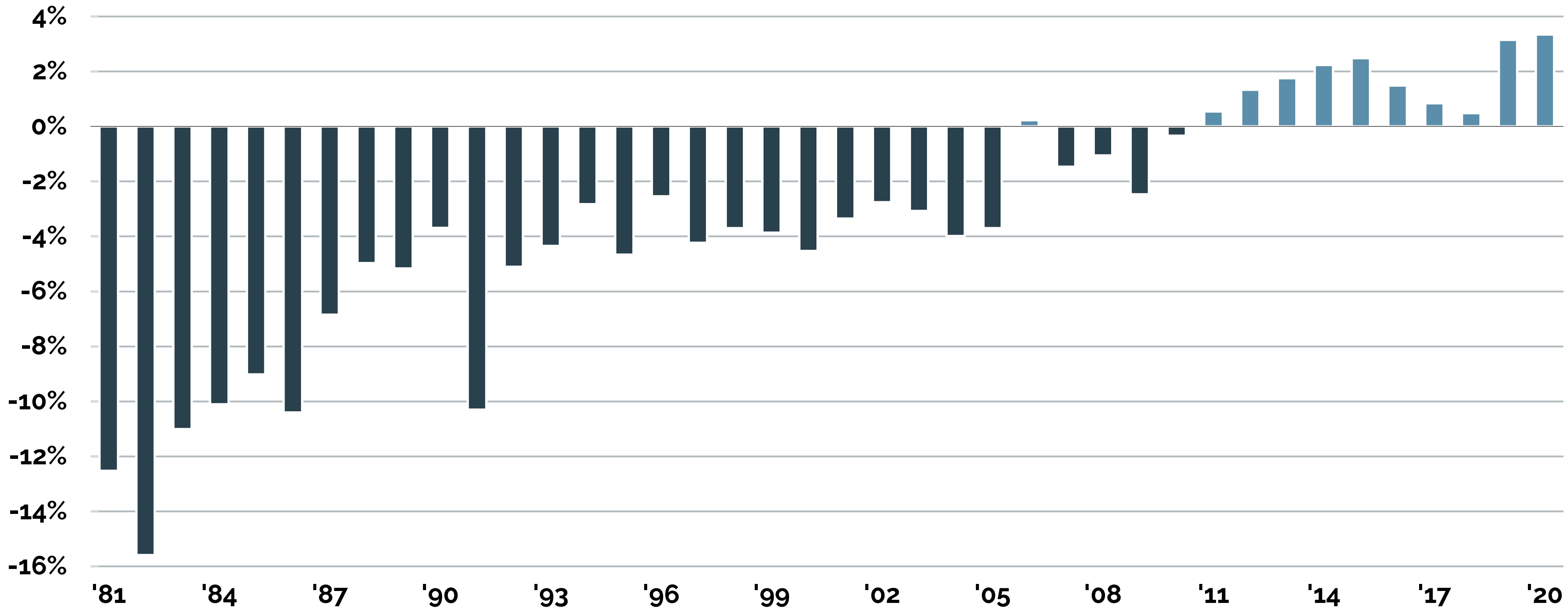
Spread Between RR's RPIC and WACC

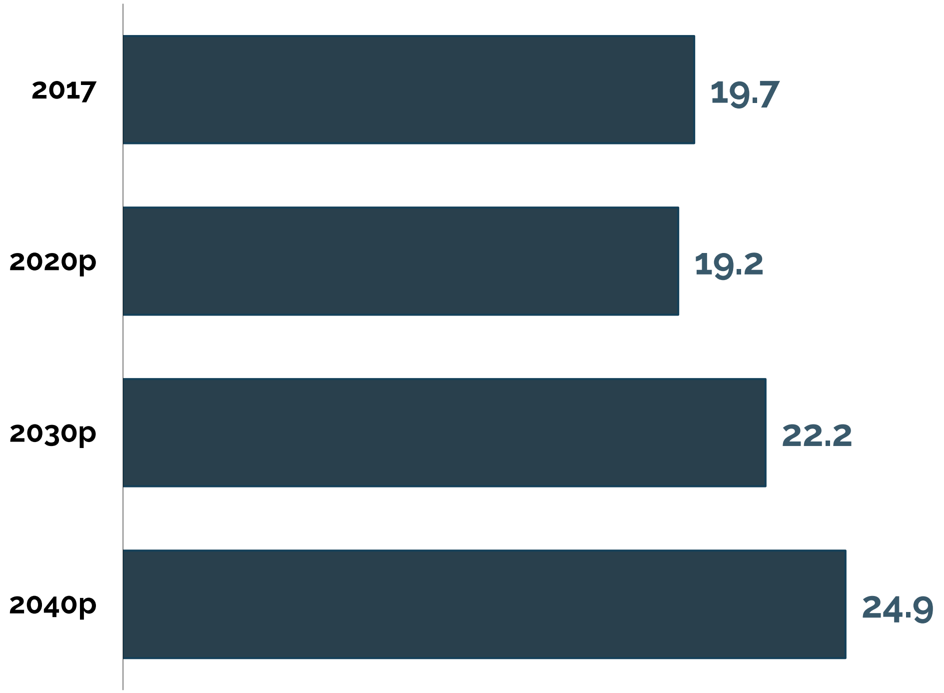
Using STB Data, US ONLY



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

Long-Term Demand for Freight Transportation Will Grow

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

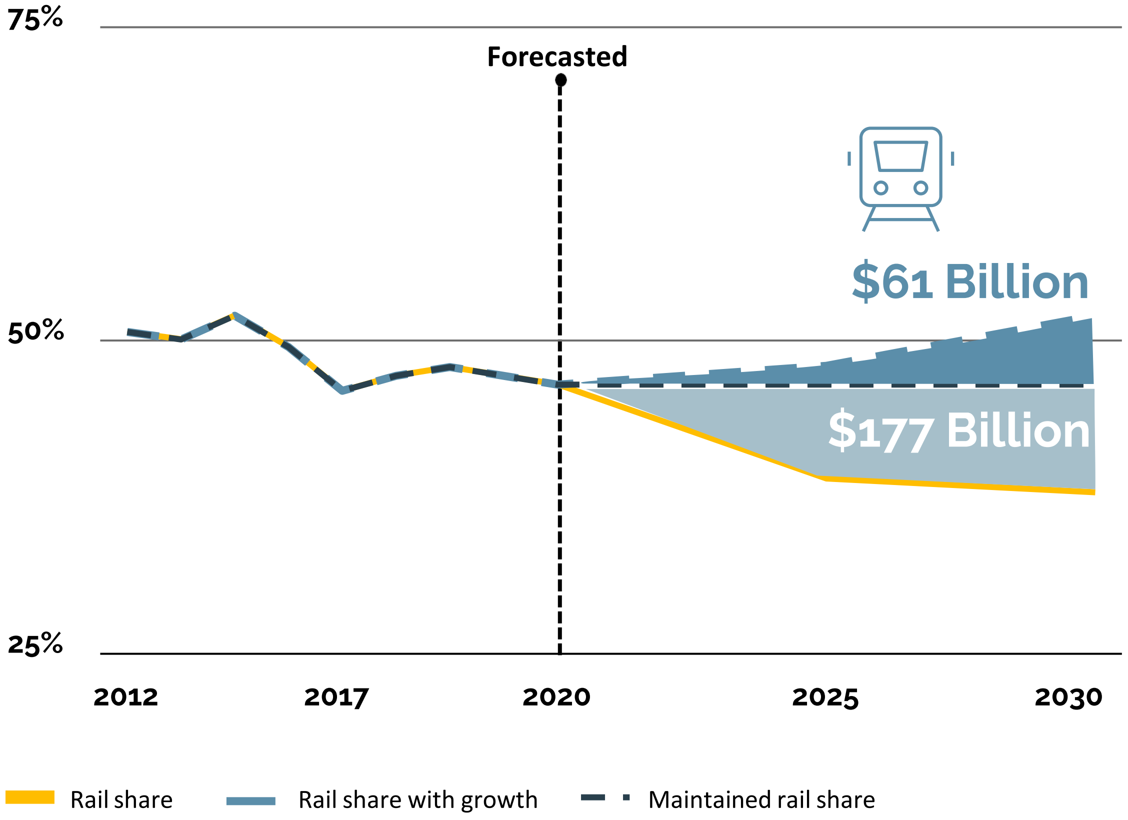


U.S. DOT estimates that total U.S. freight movements **will rise from around 19.2 billion tons in 2020 to around 2.49 billion tons in 2040** – a 30% increase.

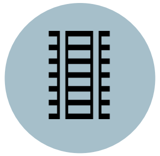
p – projected
Source: FHWA - Freight Analysis Framework, version 5.0

By using available capacity, railroads could add $61BN more in growth revenue – with limited capex

Freight market share analysis and forecast by ton-mile

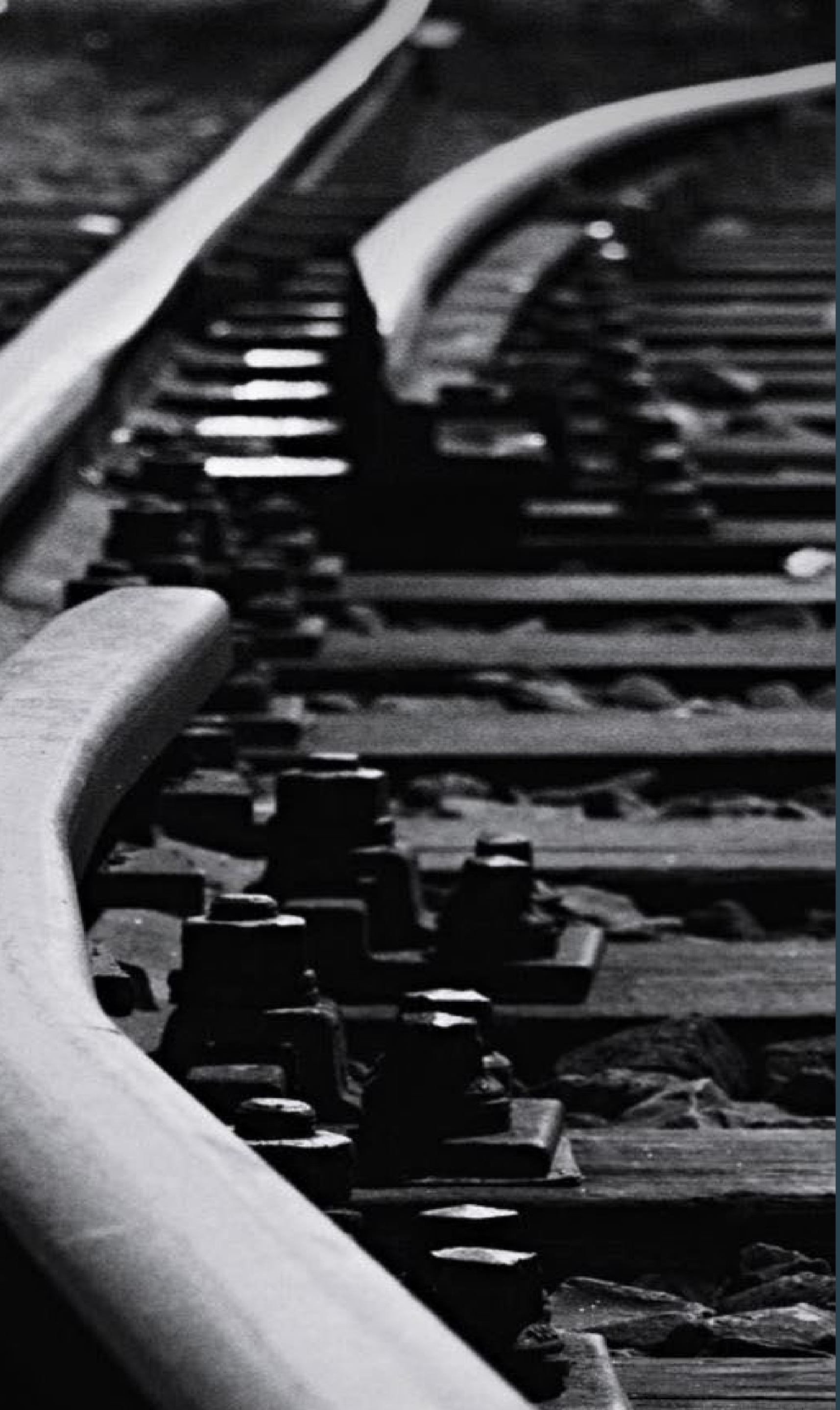


Source: © Oliver Wyman



Gaining a half point of share per year delivers growth that by year ten fills current available capacity

Assumes no material technology advancements



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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