THE RAILROAD WEEK IN REVIEW
October 25, 2013

"Merchandise and intermodal revenues rose by $153 million and $38 million, respectively, while coal revenues declined by $60 million compared with last year." -- Wick Moorman, CEO, Norfolk Southern

The Norfolk Southern third quarter earnings call conveyed concisely the railroad's strength in executing to plan. Total railroad revenue increased five percent to $2.8 billion on four percent more revenue units, the latter measure besting the other Big Six Class Is. Merch carload revenues increased 11 percent, again a Class I first place. Chemicals, including Petroleum Products, was the big volume winner, up 14 percent. However, a third of STCC 28 chems go into the Ag group, so some adjustments must be made to get at the non-ag chems short lines are most likely to see.

The Week 39 quarter-to-date carload break from nscorp.com shows STCC 28 chems up three percent, petroleum products up 35 percent, and chems all-in up ten percent. After backing out the NS Commodity Map's 34 percent ag products allocation, combined chems and petroleum are up 13 percent, roughly in line with the 14 percent chems gain noted above. Moreover, the Week 39 gain in units is more than enough to offset the coal loss.

Elsewhere, carloads in the ag/consumer/government commodity group were off three percent (corn and beans for drought, weak ethanol), metals/construction increased nine percent (frack sand, pipe), paper/clay/forest up four percent (export pulp, pulpboard), and auto was up nine percent (higher production). Intermodal units gained five percent as highway conversions more than offset a sight international volume dip.

Operating expense inched up a mere 70 basis points, propelling a 16 percent ops income gain and taking the OR down three points to 69.9. NS is running bigger trains farther and with better power-to-weight ratios: revenue units up 4.0 percent, GTMs up 4.6 percent, RTMs up 5.0 percent, fuel burn up 2.1 percent, GTMs/gallon up 2.4 percent, operating expense ex-fuel up 0.1 percent. Below the line, net income gained 20 percent to $482 million while diluted EPS was up 23 percent to $1.53 on a three percent decline in share count.

The message to local and regional connecting rails is simply this: find the traffic that pays its own way and turn the cars. Team Norfolk Southern is there to back you up with efficient service at competitive pricing. Truly an outstanding three months of work. A read of the transcript with the slides at hand is highly recommended.

Canadian Pacific turned in an impressive third quarter. Total revenues increased six percent to C$1.5 billion even though revenue units slipped two percent to 675,000. System RPU jumped eight percent to C$2,215 (I always said CP wasn't charging enough) with double-digit gains in forest products, grain, and industrial/consumer generating a ten percent gain in merch sector RPUs. Unfortunately, CP vols were off in grain, forest products, auto and even intermodal (Chief Commercial Officer Jane O'Hagan says they let some lanes go where RVCs weren't up to snuff).

Ops expense saw year-over-year declines in comp & benefits, fuel, materials, rents (15 percent!), and purchased services for a six percent drop over all. Ops income leapt 39 percent to C$524 million and the OR dropped a jaw-dropping eight points to a highly respectable 65.9 from 74.1 a year ago. GTMs were essentially unchanged (CP didn't give a real number; I had to guess it from their gallons-per-GTM number) and RTMs were up 2 percent. CP President Keith Kreel says both train weights and lengths increased by double-digits in the Q, which explains the RTM/GTM relationship. GTMs/gallon increased seven percent.

Net income was up 45 percent to C$324 million; diluted eps was C$1.84, up 41 percent as the diluted-share count came up a point. On the call CEO Hunter Harrison said they're a year ahead of plan, Kreel said they've taken 11,000 cars out of the fleet, O'Hagan said the 13 percent transit time improvement yielded that commodity's best-ever quarterly volumes and longer hauls, and CFO Brian Grassby said headcount is now down by 4,200 souls.

An impressive quarter, to say the least. However, as any retailer knows, the best way to make more money is to sell more things, and things -- on the railroad, at least -- are revenue ton miles. CP may have won a two percent RTM increase on a two percent decrease in revenue units, but it's still going to take more revenue units to generate more RTMs. Flat merch carloads year-over-year is not a winning game.

Canadian National third quarter 2013 revenues increased eight percent to C$2.7 billion on 1.3 million revenue units, up three percent, with a six percent RPU increase. Merch carload revenue increased eight percent including auto, itself up eight percent, on flat vols. Petrol/chems vols were unchanged, even though the annualized run-rate for crude oil is now about 70,000 loads, 80 percent of which is heavy crude. Mets/mins vols increased eight percent, led by frac sand out of Wisconsin.

Forest products vols were up three percent on lumber and panel to the US and Asia exports; the paper group was essentially unchanged. Grains/ferts vols dropped 13 percent thanks to a very slow start July/Aug which dragged down a more robust Sep. Auto vols were flat, even though CN has a 50-percent share in new finished vehicles in Canada. Coal, a mere seven percent of the CN business book, dropped seven percent in vols on thermal coal deltas. Intermodal boxes moved up eight percent -- international 13 percent and domestic eight percent.

Ops expense increased nearly seven percent as the railroad handled more cars with the same number of hours and people. The rate of terminal throughput is up five percent; GTMs/train-mile, cars switched per yard hour, trailing-tons/HP, car-miles per day, and system train velocity all posted better numbers sequentially and year-over-year. Ops income is up ten percent and the OR broke below 60, down 73 basis points to an industry-leading 59.8.

Let me point out that CN runs a higher percentage of merch carloads -- 69 percent -- than any other Class I. We often hear how hard it is to run a single-car network efficiently, yet here we have CN with 65 percent of RTMs in merch service generating 69 percent of revs and the highest revenue/RTM of the three main groups: coal, intermodal and merch.

Net income was C$705 million, up six percent; EPS was up C$1.67, up ten percent on three percent fewer shares. Cash from operations increased to 124 percent of net income from 113 percent; free cash flow after dividends was C$720 million and the dividend payout was 28 percent of income vs 23 percent a year ago.

Conclusions. With six of seven class Is reporting, total revenues were up by comfortable mid-single digit percentages; only CP and UP were down -- and only slightly -- in total revenue units; RPMs were generally up more than units. NS was the clear winner in merch carload gains, up six percent, while CP took the honor in ops expense reduction, down six percent. All but CSX posted ops income gains in the ten percent range. CN posted the lowest OR (59.8); CP posted the biggest year-over-year OR improvement (8.2 points).

What this tells me is the trend is still toward running faster, smarter railroads with greater attention to detail and running to plan. The rails are measuring *everything* and taking steps promptly to fix those areas not up to scratch. This is good. Volume gains will be stuck in the low single-digit percentages for the foreseeable future and the only way to generate the cash flow needed to keep the doors open is to run what you have as well as you can. This quarter's results are reassuring.

Next Week: Observations of and lessons learned at the BNSF annual shortline meeting.