THE RAILROAD WEEK IN REVIEW
January 24, 2014

"We achieved fourth quarter record highs in revenues, income from operations, net income and earnings per share." - Wick Moorman, CEO, Norfolk Southern

Norfolk Southern astounds. Operating income $881 million, up 23 percent, operating ratio 69.4, down 398 basis points. Net income up 24 percent to $513 million. Share price gain over 12 months 27 percent to $92.83; market cap up $5.6 billion; retained earnings up $696 million, so every dollar in RE gained $8.04 in market cap. Revenues $2.9 billion, up seven percent on 1.9 million revenue units; up four percent.

Merchandise revenues including auto and crude oil up 12 percent; coal revenue down two percent, making good on Wick's promise at the shortline meeting last summer to replace lost coal revs with new merch revs. Carloads not quite: merch units up 7.6 precent; coal units off 8.5 percent. Intermodal posed no surprises - revs up six percent on six percent more units. System RPU increased three percent to $1,547 with carload up five percent to $2,625 and coal up seven percent to $1,989 on favorable export coal mix and a $15 million volume shortfall settlement with a utility customer.

Metals & Construction vols were up one percent due primarily to increased shipments of iron, steel, frac sand, and miscellaneous construction materials. Ag vols increased six percent as corn shipments grew 23 percent: more short haul carloads to Midwestern processors, and longer haul volume to ethanol producers. A favorable export market also drove increased shipments of soybeans over Gulf and Atlantic ports.

As for chems, most readers know, NS combines straight STCC 28 chems with STCC 291 petroleum products (asphalt, LPG, etc.) and STCC 13 crude oil. NS reported 116,100 chems units, up 22 percent, the largest gain among all commodity groups, so a closer look is in order.

Using AAR Week 52 data and the NS "commodity map" that shows what commodities go under what headings, one can get a sense of how much crude oil affected total chemical vols. Combined Q4 to Week 52 STCC 28 chems and petroleum products (291+13) were 136,733 units with chems up five percent and petrol products up 61 percent. Fertilizers take 34 percent of the STCC 28 allowance, leaving net chems at 104,627 units, up 22 percent, same as the Q report.

Fuel expense increased two percent against an eight percent jump in burn and seven percent price reduction. Gross ton-miles and revenue ton-miles both increased five percent. Crew-starts came down one percent, there were five percent fewer re-crews, and carloads per active locomotive unit increased four percent.

Finally, cash flow. Full year net income as $1.9 billion, up nine percent, and cash from operations was $3 billion, unchanged. Free cash flow after capex was $1.1 billion, up 34 percent, and free cash flow after dividends was $470 million, up 135 percent.

Like I said, NS astounds. The coal shortfall has been all but brushed aside with new strengths in the carload franchise. Operating expense control once again levers double-digit percentage gains in operating income. Every dollar in retained earnings is returning multiple dollars in market cap expansion and free cash flow is nicely positive after capex and divs. Well done.

Union Pacific chalked up yet another stellar quarter rife with records: quarterly bests in operating revenues, operating income, and earnings per share. UP had full-year records in operating revenues, operating income, operating ratio and earnings-per share. Quarterly revenues reached $5.6 billion, up seven percent, on 2.3 million revenue units, up two percent. Merchandise carloads including crude oil and automotive increased 7.3 percent, nearly offsetting coal's 9.5 percent decline. Intermodal was the laggard, up only two percent. System average RPU gained six percent with gains in all commodity groups but intermodal, down two percent.

Operating income was $1,973 million, up 14 percent, as ops expense increased by less than four percent. The operating ratio broke 65 at 64.96, a 219 basis-point improvement. On the call COO Lance Fritz said the system's "agility and resiliency" and "surge recovery resources" let UP achieve a Q4 record 95.5 percent completion of industry spot & pull commitments made. Loco GTMs per horsepower-day increased two percent; the number of non-unit train carloads switched increased four percent.

Below the line, net income increased 13 percent (I like it when there is little spread between ops income and net income gains - it shows little noise below the line) to $1.2 billion; eps increased 16 percent to $2.55 on yet another two percent reduction in diluted shares. Net debt to cap was 31 percent, unchanged. Return on Invested Capital calculates out at 14.2 percent and return on equity is a handsome 20.7 percent. Free cash flow after capex and dividends was pennies shy of $2 billion, up 56 percent.

What we're seeing here yet once again how keeping tabs on service delivery expense and quality in the eye of the customer drives strong financial results. Pricing for equipment reinvestibility continues to be a major factor in 2014, as is using the franchise strengths to increase shareholder returns. The combination propelled share prices up 34 percent in 2013. Looks to me a repeat would not be out of the question for this year.

Kansas City Southern rang up an eight percent year-over-year gain in fourth quarter revenue on Friday. Total freight plus "other" sales amounted to $616 million on 543,600 units. Volume winners include grain, up 37%, on recovery from last year's drought, and frac sand up 17 percent. Crude oil, a mere one percent of loads, came down nine percent as refiners shifted sources away from KCS routes. Utility cutbacks in Oklahoma and Texas contributed to a 19 percent dip in coal vols; gains in merch units were double the coal unit shortfall.

Operating expense increased just six percent, leveraging a 13 percent operating income gain to $196 million. Diesel fuel expense increased nine percent on a three percent price-per-gallon increase (UNP and NSC reported lower fuel prices) and five percent more fuel burn to support an eight percent boost in revenue ton-miles.

Below the line, it gets complicated as always. But with all the puts and takes for equity earnings, foreign exchange, debt retirement, and non-controlling interest, net income was up 24 percent, nearly double the ops income gain, and that's good. Not so good is the fact that eps was a dollar-three against a $1.10 Street estimate. As a result KSU shares got hammered at the open, down ten percent to $92.5 at the open. (And creating a tremendous buying opportunity for those of us waiting on the sidelines for the opportune moment. Shares had recovered about half the loss by thee PM.)

To my mind, Marketing EVP Ottensmeyer is probably the best in the business when it comes to explaining what's up, what's down and why. Chems and STCC 291 petroleum products drifted south four percent on pullbacks from two customers in Mexico. Ag vols jumped 37 percent largely on cross-border grain. Industrial & Consumer Products vols were up one percent yet generated a nine percent revenue gain. Forest products vols were off three percent as decreased paper vols offset gains in housing-related lumber.

The big full-year story is what Ottensmeyer calls his Strategic Growth Areas: crude oil, cross-border intermodal, frac sand, the port at Lazaro Cardenas, and automotive. Collectively, these five categories grew revenues by 22 percent and represented 10 percent of total KSC revenues for the year. As for 2014, Ottensmeyer says

> Our guidance for 2014 is for mid single-digit volume growth, pricing above inflation and high single-digit revenue growth. The ramp-up in production at the new auto plants in Mexico will take longer than expected and that will have a ripple effect on other products like steel and plastics. We've adjusted our crude-oil outlook to reflect the permitting issues and capacity constraints that relate to handling heavy Canadian crude in the Gulf region.
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> We're taking a more conservative view of coal and grain, where unexpected events are outside our control. Our core merchandise business will grow in the single-digit range as we see strength continuing in steel, plastics, petroleum and housing-related products like appliances and lumber. Our paper customers say they don't see the downturn lasting the year. Grain will have very easy comps into the first eight months, but we expect it to flatten out.
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> Our energy business unit will return positive single-digit revenue growth as frac sand, pet coke and crude oil will more than offset the lower coal revenues. The new auto plants in Mexico will start producing in the second quarter and ramp up over a two to three year period. Intermodal growth will be driven primarily by truck-to-rail conversion in our cross-border business, which we feel has a lot of runway to grow for a very long-term horizon.

Looks like Fortress has won the MMA auction. An item in the Jan 21 *Portland Press Herald* says Fortress affiliate Rail Acquisition Holdings has won the auction with a "stalking horse" [see WIR Dec 20] bid of $14.25 million for the entire 500-mile railroad between Montreal and northern Maine. It was still not a done deal, though. RAH ownership is subject to a final judgement scheduled for Jan 23 in both the U.S. District Court in Bangor and the Superior Court of Quebec in Sherbrook.

Today's *Bangor Daily News* reports that yesterday the U.S. court approved a $15.85 million tentative sale agreement that will allow RAH to take ownership. The decision came simultaneously with a Canadian bankruptcy court proceeding. The transaction is expected to close in about two months, according to Trustee Robert Keach.

BDN says MMA had laid off 79 employees, including 60 US citizens, in the wake of the Lac-Megantic incident. Of these, some 30 were hired back thanks partly to a loan the company secured that would allow it to run through February. Keach said the sale is proceeding with the understanding that the company would hire to fill most of the positions vacated by the layoffs.

The 28th annual Railroad Equipment Finance conference will be at La Quinta, Calif. this coming March 2-5. If you've never been, you owe it to yourself to go. And if you're a regular, you won't be disappointed this trip. Sponsor and fellow *Railway Age* Tony Kruglinski columnist assures me that he has once again a superb lineup of some 50 name-brand presenters will be on tap to go over such timely topics as equipment lease rates, what car types are long and short, new-build trends in car and locos, what's happening in crude-oil tank cars and small-cube covered hoppers for frac sand, PTC, and more.

Once armed with the information, what to do with it? Speakers will identify where the dangers are and where to find the best risk/reward transactions. You'll get to meet the most important players in the NA lease market, learn what they think and why, their likely actions, and where the money's coming from. And you'll hear how the various players are coping with bottlenecks caused by everything from slow transit times, shoddy unloading practices and general railroad operating practices.

See http://www.railequipmentfinance.com for further information and registration materials. Hope to see you there.

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