THE RAILROAD WEEK IN REVIEW
October 24, 2014

"We are going to see strong single-digit, low double-digit RTM growth for next year, more than it will be on the carload side." — Keith Creel, President and COO, CanadianPacific

This was the Earnings Week from Hell. Not only did we have five roads reporting third-quarter results but also there was the 2014 BNSF shortline gathering in downtown Fort Worth. As a result, I got to listen only to the CP call plus the Hunter Harrison solo event, so what follows is what I gleaned from the individual road financials, slide-sets, and transcripts. I'll do the BNSF meeting summary next week along with GWR results to be reported Halloween.

Having all the reports in a lump lets me offer some common themes before getting to the individual names. Revenue gains rose handsomely across the board, from 7 percent (NS) to 16 percent (CN). Revenue units were up from 2 percent (CP) to 11 percent (CN). Merchandise carloads were up double-digits everywhere, system RPUs averaged 3 percent across the board and the merchandise carload sector averaged 64 percent of revenues.

Crude oil and frac sand are the elephants in the merchandise carload living room, though only CP and KCS deign to break out crude-oil numbers in the financials and only KCS provides frac sand carloads. You can get both breakouts by drilling down into the 5-digit STCCs in the Quarterly Carloads Statistics (QCS) the STB provides, but that's always a quarter behind times so it's only good as a guideline, though a good orders-of magnitude guideline at that.

Intermodal dominates across the board, garnering 20-25 percent of the total revenue pie while coal is falling behind at 19 percent and sinking. However, the BNSF coal guys are saying the 3 percent drop they saw in Q3 was more a function of velocity than demand and their PRB coal is still a strong market contender, especially when gas gets north of $4.00. Track space once occupied by coal trains is being freed up for intermodal and merchandise traffic, the latter up 9 percent among all class Is (using BNSF Week 39 QTD as repotted to the AAR).

Canadian Pacific led off Earnings Week Two on Tuesday with a double-header: Earnings at 11:00 followed closely at 1:00 by CEO Hunter Harrison's M&A Q&A. Third quarter earnings first. Revenue is up 9 percent to C$1.7 billion on 687,000 cars and containers, up 2 percent (the smallest delta of the group). Crude oil was the big gainers, up 63 percent to 31,000 units, though, put in context, it's only 5 percent of total volume. Grain, aggregates/metals, coal and intermodal are still 75 percent of the CP franchise. Even if crude hits the vaunted 200,000 car level, it's still in the sub-10 percent range.

All-in, CP is a strong carload contender, with 69 percent of total revenues, up 3 points year-over-year. The merch carload sector generates 69 percent of RTMs to coal's 15 percent and

intermodal's 16 percent. System RPU gained 7 percent as US grain, potash, chemicals, crude and domestic intermodal (CP helpfully splits out domestic and international) all posted RPU gains in the six percent-plus range. Operating expense rose just 4 percent, leveraging a 19 percent ops income increase to C$621 million and taking the ops ratio down three points to 62.8. Net income rose 23 percent to C$400 million.

Little was said about the fourth quarter or 2015 outlook; however, in the Q&A it came out that CP wants to emphasize RTM deltas over carloads, which says to short lines, "Give me heavier cars going longer distances at higher revenues per ton-mile." GWR's new Rapid City, Pierre & Eastern gets high marks for "doing a solid job moving product," and CP is delivering better metrics outside Chicago, suggesting they might do a better job forwarding trains. [*A friend who does business daily with both says Class I delays getting in is causing power shortages for the outbounds, exacerbating dwells — rhb*]

Hunter Harrison took to the air waves, as it were, to hold forth on his views on North American transportation policy and to clarify some aspects of the CP-CSX conversation. No offers were made, nobody rebuffed anybody, and at the end of the day they concluded each party has a different view of the railroad world. He remains convinced that "some type of transaction" is out there that will add value for all stakeholders and increase competition.

Says he, past mergers didn't work especially well because of service issues that arose partly through poor execution. "A merger won't fix what was bad service to begin with," but if everybody agrees up front where they want to be at the end of the day, and execute to plan, it'll work. He's all for sharing access to facilities as long as there's a quid-pro-quo that creates a better bilateral agreement than anything the government might impose.

At the end of the call I concluded that HH made many valid points, and having been part of the Conrail-NS-CSX transaction, I could identify with most. However, my feeling is that with shared power-by-the hour, with through trains from me-to-you re-routed around Chicago (touched on this with Some BNSF ops folks this week), and with adult agreements about access, we can send the NIT League and a boatload of politicians packing, and get on with the business of railroading without any corporate marriages.

Canadian National walks away with the honors in six of my seven key results measures ranging from gains in revenue, revenue units, RTMs, and carload revenues to the lowest operating ratio. Total revenue increased 16 percent to C$2.9 billion on 1.5 million revenue units, up 11 percent. The revenue mix is 53 percent merch carload — including crude oil, frac sand, grains & ferts, and automotive — 38 percent intermodal and 9 percent coal.

Operating expense grew 14 percent thanks in part to an 11 percent yard-dwell increase, car velocity off 6 percent and train velocity off 5 percent. Fuel burn improved with a 3 percent gain in GTMs per gallon and a slight improvement in gallons per thousand GTM, though it remains north of 1.8, an industry high. Operating income rose 19 percent to C$1.3 billion, net income

gained 21 percent to C$853 million, and the operating ratio came down another point to 58.8, lowest in the business.

CN remains my favorite rail from a financial standpoint. I've borrowed from Buffett a metric comparing year-over-year changes in market cap to changes in retained earnings over the same period. The rule is a dollar change in retained earnings ought to generate more than a dollar in market cap. CN excels here: $18.60 in market cap gain for every dollar in retained earnings.

I see no reason for the momentum to slow. On the call CN said they envision merch carload numbers growing in energy (crude oil, frac sand, pipes), lumber and panels for housing, and automotive. Bulk products look strong in ag, thermal and export coal, and coke. International intermodal appears to be on the mend and domestic shows promise in balancing price and volume growth, which I assume to mean weeding out the poorer performers to leave more room out on the railroad for those that earn their keep.

Norfolk Southern started their call as I was lifting off for DFW on Wednesday. Reading the transcript, I have to say the call was encouraging, to say the least. CEO Wick Moorman opened the proceedings saying, "Continued high demand in most of our business groups drove an overall volumes increase of 8 percent, with double-digit increases in merchandise and intermodal, offset by a slight decline in coal." The operating 67.0 operating ratio is a third quarter best.

Total revenue was $3 billion, up 7 percent, on two million revenue units, up 8 percent: the merchandise carload group, including automotive, as well as intermodal gained 10 percent in volume, offsetting a 2 percent decline in coal. Three out of five merchandise categories posted double-digit volume gains: chemicals, automotive, and metals/construction. Chief Marketing Officer Don Seale describes the commercial aspects thus:

> The five merchandise carload business groups also set a new quarterly record with $1.7 billion in revenue, an increase of $152 million or 10 percent versus third quarter of 2013. Our merchandise markets also faced negative mix effects as strong volume growth within our metals, construction, and bilevel automotive segments offset gains in higher revenue per unit, agricultural, and chemical commodities. Overall merchandise RPU was flat for the quarter.
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> With respect to volumes, growth was led by strong increases in crude by rail and natural gas liquids, which increased our chemicals volume by 17 percent. Automotive volumes were up 12 percent versus last year, propelled by significant increases as we took advantage of the auto manufacturer summer shutdown period in July to reduce finished vehicle inventory backlogs that were a result of national rail car supply issues incurred earlier in the year. And growth in frac sand aggregates and steel increased our metals and construction carloads by a strong 12 percent.
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> The excellent 2013 corn crop continued to provide growth opportunities in our agricultural market, helping to generate a volume gain of 6 percent in the quarter. Finally, paper and

forest products volumes were flat in the quarter, with double-digit gains in lumber offsetting declines in kaolin clay and waste shipments.

Coal revenue was down 2 percent year-over-year. RPU was unchanged on export/southern steam coal mix. Utility coal vols slipped 3 percent due to a mild summer and lower nat gas prices. Domestic met coal vols gained 8 percent mainly on coke to steel makers. Industrial coal leapt 32 percent due to new business and organic growth with industrial customers as the economy continues to improve. [*Unfortunately, channel checks reveal lost industrial coal opportunities where circuitous routings drive up car cost and drive down yields. — rhb*]

Operating expense gained a mere 3 percent, leveraging an 18 percent ops income gain. Fuel expense was about even as price per gallon dipped 6 percent and the 4 percent greater fuel burn produced 9 percent more GTMs. GTMs per gallon increased 4 percent and gallons per thousand GTMs came down 4 percent to a respectable 1.19, even though the slower network caused deterioration in both train speed and terminal dwell. On-going track work and PTC projects in the Northern Region don't help. Yet.

Even with all these moving parts, customer surveys and market intelligence suggest that increasing demand for rail transportation will push vols higher in Q3 and beyond. The energy sector will produce gains in crude oil, frac sand and drilling pipe while the housing market supports gains in aggregates, lumber and construction materials. Automotive sector volumes are expected to move higher, with increased vehicle production and with new models coming online at several NS-served assembly plants. The expected record 2014 corn and soybean harvest will lead to both domestic and export growth.

Domestic intermodal growth continues to be a function of tightening capacity and rising cost in the trucking industry. Organic growth for the international intermodal segment appears to be limited as NS guidance tends toward the beneficial owners, third parties, and steamship lines. But all truckload conversion doesn't have to be intermodal. Tight truck markets create carload pricing opportunities for anything that moves in a boxcar from paper products to consumer products to manufactured components — business that is directly competitive to boxcar. Looks like a great time for short lines to tee up their local service competitive advantage.

Union Pacific brought up the markers Thursday, reporting best-ever revenue, operating income, operating ratio and earnings. Total revenue was $6.2 billion, up 11 percent, best percentage gain of the US Class Is. Revenue units increased to 2.5 million, up 7 percent with intermodal up 10 percent, ag products up 14 percent and industrial products up 12 percent. Within industrial products, non-met minerals increased 30 percent on frac sand, lumber grew 15 percent on housing starts, and construction materials were up 11 percent on aggregates and cement.

The strength in the agricultural sector came mainly from export grain with modest gains in grain products plus food and refrigerated. The chemicals group fared less well. Car-counts increased

just 2 percent as industrial chems grew 7 percent, LPG gained 12 percent and crude oil lost ten percent. Not being an originating presence in the Bakken is part of it; however, increased production in Texas and other areas partially offset the Bakken declines.

Operating expense increased 7 percent. Fuel was up 2 percent on a seven percent burn increase against a 5 percent decline in fuel price per gallon. GTMs grew 8 percent and GTMs per gallon improved by one percent. UP burned 1.09 gallons per thousand GTMs, down one percent and approaching the Holy Grail of one gallon per KGTM. The operating ratio was 62.3, down 248 basis points. Net income was up 19 percent to $1.4 billion.

Union Pacific's Unique Selling Point for short lines and regional railroads lies in the fact that it handles more merchandise carloads than any other North American Class I: 40 percent more than second-place CN and 50 percent more than arch-competitor BNSF (using Week 39 numbers for BNSF as the Q won't be out for another week). Moreover, the UP carload franchise is evenly balanced among the ag, chems and industrial commodity groups, ranging between 10 and 14 percent of total UP revenue units.

The commodity outlook is for record 2014 crops of beans and corn (good for the rails, not so much for growers and users as the former get less for their crops and the latter pay higher transport costs as demand for grain cars exceeds supply). The outlook for industrial chems is "solid," though crude oil remains a challenge for lack of high-production origins. I sense no barn-burners here and with the GDP outlook for Q4 in the sub-three percent range and UP's balanced carload franchise, there is little opportunity for market-beating performance. But three percent up is better than flat or down any day.

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