RAILROAD WEEK IN REVIEW

January 29, 2016

"Canadian National's solid earnings execution is a testament to the company's strong operating model and superior network." — Walter Spracklin, RBC Capital Markets

Canadian National fourth quarter results easily blew the competition for the earnings brass ring completely out of the tub. I urge you to go to the slides at *www.cn.ca/investors* and sing along. Of the ten operating measures I track (changes in total revenue units, merchandise carloads, RTMs, etc.), CN took first place in seven.

I can sum up why they do so well in one word: execution. Turn to Jim Vena's slide 6. Every measure is heading in the right direction. Four of the six metrics have to do with over-the-road performance; two deal with yards. The relationship is easy to see: the better cars get through the yards, the better the road performance. The better the road jobs do, the better the yard guys can do keeping departures on time, giving road crews the consistency they need for on-time arrivals.

Operating performance in turn supports commercial results. Chief Marketing Officer JJ Ruest shows on slide 9 how flat-to-down carloads are still generating positive RTMs in some commodity groups. System-wide, fourth quarter RTMs were down five percent vs. cars down eight percent. Moving the same or more tons in fewer cars not only increases margins but also revenue per RTM: up eight percent. Tells me cost per RTM is going down. Better yet, freight revenue per RTM increased five percent.

Ruest says he expects 2016 carload numbers to come down a bit. But if RTMs are the same or better, who cares? You get paid for moving stuff, and if you can use fewer assets to do it, you net more cash. One carload of plastics moving 10 miles in leased equipment nets you more money than 10 cars of wood chips moving one mile in RR-owned cars, e.g.

Here's how CN does it. Total revenue, C$3.2 billion, slipping one percent, despite gains in forest products (lumber, mainly), ag products, automotive and intermodal; declines in energy products from crude to frac sand and metals more than offset.

Revenue units slipped eight percent, with gains in automotive and intermodal not enough to offset negative numbers everywhere else. The eight percent average RPU increase — true value pricing, based on service quality as perceived by the customer — kept revenue declines to a minimum, in spite of the significant volume decline.

Operating expense dropped seven percent, largely on fuel (down 32 percent), to C$1.8 billion, pushing operating income to C$1.4 billion, a seven percent gain, and taking the OR down 3.5

points to 57.2, lowest in the biz. Below the line, net earnings increased 11 percent to C$941 million. And clearly CN has sold the story to the Street. RBC Capital's Walter Spracklin:

> While we have built conservatism into our volume estimates, we note that the reduction pales in comparison to those made for CN's peers. This is due to CN's relatively low coal exposure and high merchandise and consumer-driven exposure. Combined with foreign exchange tailwinds, we expect CN to outperform on a volume basis.

On a personal note, I was particularly delighted to hear CEO Claude Mongeau presiding. He's recovered successfully from some health issues late last year. Though he remained engaged with the CN business at hand throughout the proceedings, CFO Luc Jobin ran the railroad during his recovery. Whew. A nasty bullet dodged. Well done, Claude.

Norfolk Southern fourth quarter operating income declined 28 percent to $642 million as total revenue sank 12 percent, revenue units skidded seven percent, and RPU lost six percent year-over-year. Operating expenses came down only five percent as the $150 million lower fuel bill offset double-digit jumps in depreciation and materials/other. The operating ratio took on 5.5 points, to an unhealthy 74.5, hardly what we'd come to expect of NS in days of yore. Below the line, net income was $361 million, down 29 percent.

The spreadsheets are red with negatives. Not one commodity group posted a revenue increase, with metals/construction, chemicals, coal, and intermodal down double-digits. Commodity carloads declined across the board, though only metals/construction and coal dropped by double digits. Metals/construction alone posted a double-digit drop in RPU; all others shed single-digits.

Fuel surcharges (FSC) only made things worse. A year ago NS collected Q4 FSC to the tune of $308 million; this year it was $82 million, roughly a quarter of what it was.Thus the decline in adjusted revenues (without FSC) was just five percent, operating income slipped just four points, and the OR actually *shed* 23 basis points, to a still-unhealthy 77.0.

But wait. There's more. Net debt increased 11.1 percent to $8.8 billion, and is now 77 percent of equity. ROIC has slipped to 7.4 percent, and return on equity is 12.8 percent. Working capital is half what it was a year ago and retained earnings shed $157 million. Full-year cash from operations is about where it was a year ago, yet, with dividends up four percent and share repos up by a factor of three. Operating free cash flow after capex, divs and repos sank to negative $1.3 billon, a hole five times deeper than it was at the end of 2014.

The real story is in four CAGR numbers. First, 4Q2015 operating revenue, down 6.5 percent from the 2013 number. Second, 4Q2015 operating expenses, down only 3.2 percent since 2013. As a result, 4Q2015 operating income declined at a 14.6 percent CAGR over the two years. And the quarterly OR increased to 74.5 from 69.4 in the same period, a 3.6 percent CAGR.

So what is NS going to do? CEO Jim Squires opened the call with a 14-slide deck detailing the steps to a 65 OR by 2020. The plan has two parts: improved service levels and pricing for "service-sensitive markets," and "productivity savings" of $650 million over the next five years. As for the revenue side, NS targets an "extensive review of customer expectations, plant-level forecasts and market expectations," and short lines have much to contribute here.

On the expense slide, $420 million comes out of comp and benefits in terms of right-sizing the work force, more yard closures, and trimming the branch-line network. Another $70 million comes from purchased services and rents: car hire, third-party services and trackage/haulage fees. The remaining $160 million comes equally from materials and fuel.

Squires says the faster railroad provides better service in the eyes of the customer and costs less to run, in the eyes of NS. Is it enough, especially with CP saying they see $1.2 billion in savings, twice what's in the slide set? Perhaps. The performance metrics are on the mend and we're told to expect savings to be front-end weighted. We'll want to see quantum leaps this quarter.

Shares of all four freight car builders plus Wabtec were on the uptick Tuesday morning, led by Greenbrier (GBX), up three percent. By way of review, the GBX Manufacturing segment produces double-stack intermodal railcars, conventional railcars, tank cars and marine vessels. The Wheel Services, Refurbishment & Parts segment performs wheel, axle and bearing servicing; railcar repair, refurbishment and maintenance activities, and production and reconditioning of a range of parts for the railroad industry in North America.

The Leasing & Services segment owns approximately 11,000 railcars and provides management services for approximately 219,000 railcars for railroads, shippers, carriers, institutional investors and other leasing and transportation companies in North America. In fact, I saw a train of GBRX tank cars en route to the Point Breeze refinery here in Phila just the other day.

Unfortunately, share prices for the whole railcar building and leasing sector have followed the rail carriers in a downward spiral going back to last summer. The global downturn in commodities and consumer durables hasn't helped, as so many of the new car orders are usually for stuff like crude oil, frac sand, plastics, and NGLs, plus intermodal platforms.

As to why, one must look to China. John Mauldin writes in his *Thoughts from the Front Line* for January 24, "China doesn't simply extract resources from the ground and export them. China imports raw materials, transforms them into finished goods in its factories, and then exports those goods. Their gain lies in the value added in the manufacturing process." So with the pull-back in China, raw material imports slow. And, as Maudlin notes, "China banks seem to be doing whatever they can to avoid paying anyone in dollars." So much for carloads of export stuff here.

Car storage is getting to be a major problem. Iowa Pacific's Ed Ellis found this group of cars in Del Norte, Colorado. He posted the photo to Facebook and wrote, "One reason coal cars are

going into storage is because velocity has improved on the railroads, which means fewer cars are needed to move the same amount of coal."

Among the comments: "Since the UP lost the Central Tennessee River & Navigation (CTRN) contract, coal traffic on the Moffat line has dried up. Very quiet up there!" And, "AEP (and others) shutting down several coal-fired power plants has also contributed to this." To which one wag added, "Load them with snow." He must be from DC.

So not only do we have tank cars built for crude oil in storage, but also whole fleets of open-top hoppers once used to feed coal-fired generating stations are looking for homes. Short lines with space are reaping the benefits of not ripping up idled track-feet.

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