RAILROAD WEEK IN REVIEW
July 29, 2016

"Our goal is always to minimize train starts and move cars as fast as we can. Those are basic fundamental rules we live by." — Mike Cory, Chief Operating Officer, Canadian National

Canadian National's mostly-new senior management team delivered as-good-as-can-be-expected results in a positive and upbeat presentation, loaded with tidbits about effective railroad management. Among the Big Six Class Is reporting thus far, in percentage terms, CN saw revenue down the least, took the system RPU delta positive to everybody else being down, posted the highest percent of revenue coming from merchandise and intermodal (and the lowest from coal), took total ops expense down the most, had the smallest negative operating income change, and posted the lowest OR by 6.8 points.

Total Q2 revenue units declined 11.7 percent to 1.2 mm units; freight revenue was C$2.6 billion, off 9.6 percent, and RPU increased 2.3 percent. Operating expense came down 12.1 percent, producing ops income of C$1.3 billion, off 5.1 percent; the OR was 54.5, down 1.91 points and best in class (again). Net income was C$858 mm, down a mere 3.2 percent. Cash flow from ops was 142 percent of net, up four points; free cash flow after capex but before divs increased 12 percent to C$1.2 billion; after divs but before share repos up 8.3 percent.

Carload vols in every single merchandise carload commodity line but one were down (auto was flat and the only exception), with double-digit declines in petroleum/chems, metals/minerals, and grains/fertilizers, bringing the merch class down 12.9 percent. In revenue, petroleum/chems dropped 16 percent due to pipeline competition for crude, the Alberta wildfires (adversely impacting sulfur vols as well), partly offset by higher volumes of refined petroleum products including gasoline, diesel, and propane. Metals/mining revs came down 17 percent on decreased shipments of energy-related commodities such as frac sand, drilling pipe, and semi-finished steel products.

Forest products revs gained four percent thanks to an improved US housing market, partially offset by decreased shipments of paper products. Q revs dropped 12 percent in the grains/fertilizers commodity group on lower volumes of Canadian wheat to North American and export markets, lower export volumes of barley and lentils, decreased volumes of oats to US markets, and reduced volumes of US corn and soybean meal exports via the Gulf of Mexico. Increased volumes of Canadian canola meal and oil and increased offshore exports of Canadian canola and soybeans provided partial offsets.

Operating expense for Q2 took decreases in every line item but D&A and rents, chiefly the result of decreased traffic volumes, lower fuel prices, lower pension expense and cost-management initiatives. As usual, CN posted improvements in all six operating productivity measures such as

GTMs per train-mile, yard dwell, cars moved per yard- switching hour, terminal dwell, car-miles per day, and trailing GTMs per available horsepower. (COO Mike Cory is running longer trains wherever he can, hitting 200+ cars in some service lanes). CN burned 12 percent fewer gallons on 10 percent fewer GTMs, boosting GTMs/gallon by two percent to an industry best. Gallons/KGTM did not fare so well in the Q, yet broke below 1.0 in the first half.

Looking ahead, JJ Ruest calls for continued growth in the US housing market, improving steel and iron ore markets, and a bottoming of frac sand vols — now geared more to nat gas than crude (spreads and the pipelines are the villains; JJ will take what he can get). CN is facing a bumper crop in grain, with some moves starting directly. US grain as well is encouraging. Global prices for potash have hit their lows, so vols will be up.

Looks to me like CN has taken advantage of the YTD lull in traffic vols to get ready for the inevitable higher vols, even it we have to wait till 1Q2017 for that really to start.

Norfolk Southern handled 1.8 mm revenue units in Q2, down 7 percent. Coal was again the culprit, down 24 percent, and intermodal was no help, down five percent. Merch carloads were off just three percent. Quarterly revenue dropped 10 percent to $2.5 billion, while system RPU was off three percent. Backing out the $69 mm drop in Fuel Surcharge (FSC) fees takes adjusted revs to $2.4 billion vs. $2.6 billion a year ago, down seven percent.

Operating expense declined 11 percent; operating income was off five percent to $770 million and the OR was a record low 68.6, down by 137 basis points. Net income slipped seven percent to $405 mm, though for the six months actually increased by seven percent to $792 mm. (I'm ignoring eps because share repos artificially inflate results). Cash from operations was off five percent to 1.4 billion, capex increased five percent to $992 mm, and free cash flow after capex and dividends was $150 mm vs $255 mm a year ago.

Alan Shaw's slide 7 is the best snapshot yet of the revenue splits. Note how the published RPU decline becomes *No Change* after backing out FSC and Triple Crown. Regarding merch revenue slide 8, the chems group was off the most, yet, based on STCC patterns in the QCS, most of the downdraft was crude oil, suggesting industrial chems, ferts and the STCC 29 group were relatively unscathed. Shaw said during the Q&A on the call that local corn availability and low spot truck rates combined to affect grain numbers and trucks were grabbing paper shares in the southeast. But I think that's temporary. The merch group as a whole delivers 64 percent of revs on 62 percent of RTMs, supporting what CFO Marta Stewart said about that group being "the most incrementally positive."

As for the rest of the year, Shaw projects improved results in steel, lumber, plastics, and export beans. COO Wheeler says they have room to increase carloads per train start, and CEO Jim Squires sees the path to better earnings growth and a lower OR running through growing vols irrespective of market conditions.

The shortline take-away from the call is that the NS focus is on controlling what it can control through marketing, operations and finance. Shortline partners are in a great position to contribute, given their proximity to the customer, efficient first-mile/last mile operations, and ability to control cost by building trains by destination and blocking for the distant node.

Pennsylvania's North Shore Railroad Company promotes three. Todd Hunter, who's been heading up the company's business development and sales efforts as Director of Marketing, is now Chief Marketing Officer. I first met Todd when he signed on with NSHR in 1996 as a customer service rep, and I've always admired his energy and attention to detail. It has played no small part in helping the company grow its customer base and industry presence over the years.

Joseph Kantz moves up to Business & Development manager from Marketing Representative. His nimble "out of the box" thinking has been particularly helpful in re-introducing outbound anthracite coal business on the Shamokin Valley Railroad as well as creating several new transload customers for the NSHR family of railroads.

Loni Martz Briner steps up to Public Relations and Media Manager. She joined the NSHR Customer Service team eight years ago and has kept the company in the public eye through internet, social media, pamphlets, the quarterly newsletter, and enhancing the company calendar tradition. A seasoned presenter, Loni will continue representing NSHR with area chambers of commerce and economic development entities. etc.

Watco will start operating Norfolk Southern's new Thoroughbred Bulk Terminal (TBT) in Sandusky, Ohio effective this month. This former Triple Crown facility becomes Watco's 58th terminal location within its proprietary Watco Transloading, LLC. The goal is to expand the area TBT presence and create new transload customers. No stranger to the area, Watco currently operates three other existing TBT Terminals in the greater Ohio Region: Columbus, Ohio; Euclid, Ohio; and Willis, Michigan.

Watco/Sandusky operations will include both origin and destination transloading. There will be outside storage for various break-bulk products, 30 fully-paved railcar spots, ample parking space for customer-related products, and room for eventual expansion. The facility will serve a broad commodity base, including but not limited to chemicals, plastics, forest products, steel products, and various agricultural products. The whole idea of filling every inch of space with customer-related activities fits well the the NS stated goal of controlling what they can.