RAILROAD WEEK IN REVIEW

January 26, 2018

"Oil companies have a backlog of almost 7,000 wells that have been drilled but not fracked—30 percent more than in January 2017. Having already spent money to drill last year, operators can save money and boost production by fracking the backlog." — Wall Street Journal, January 22

The *Journal's* argument is that U.S shale companies "are poised to earn real money this year for the first time during the fracking boom." Crude oil prices have surged almost 40 percent since June and, even though the majors have announced plans to cut back on new down-holes, production continues to increase because of past and continuing investment.

In fact, federal forecasters expect that drillers will soon push U.S. oil output past the monthly record — 10 million barrels a day — set in 1970. As a result, even as the players vow to cut back on new E& P money, 2018 promises to be the year U.S. oil companies will generate more cash than they spend, a first in the age of shale.

Given the number of un-fracked wells, the market for frac sand, pipe, cement and other ingredients will hardly suffer. And among smaller operators, where the short lines do a lot of business, spending is expected to rise about eight percent in 2018, about a fifth of last year's new money. Thus the italicized quote above.

Canadian National kicked off Week Two of the 4Q2017 earnings season. Adjusted (before the tax benefits — See WIR Jan 19) earnings were C$897 million, down six percent, on operating income of C$1.3 billion, down seven percent, and an adjusted OR of 60.4, up nearly four points. Freight revenue increased two percent to C$3.1 billion on seven percent more revenue units against a four percent drop in system RPU.

The merch group car count including auto was unchanged, while coal dropped 17 percent and intermodal boomed with a 20 percent gain. On the call, Chief Marketing Officer JJ Ruest commented on the decline in grain thanks to global competition, and the gains in metals and frac sand (half again what it was a year ago; Wisconsin origins up by nearly a fifth). The revenue mix is now intermodal 26 percent, up from 24 percent; carload drifted south to 69 percent from 72 percent; coal remains a relatively minuscule five percent of revs.

The railroad slowed slowed down considerably as shipper demand outstripped capacity. Confirming the official remarks on the call, a friend who knows this railroad well writes that CN is "jammed to the gills." He notes that east of Winnipeg, it is OK, even "with 12-14,000 foot trains in a land of 6,500 foot sidings." Winnipeg to Edmonton is not so good, with 14,000 sidings and some double track — just too many trains. And that goes to JJ's comment that they're seeing "new record volumes" running to and from the West Coast.

You can see it in the stats. Terminal dwell was up eight percent, car velocity in car-miles per day slipped six percent, and train velocity between terminals dipped four percent. GTMs gained three percent but it took four percent more fuel and cut GTMs/gallon by two percent. Ops expense ex-fuel gained six percent, but KGTM/s gallon remain at that holy grail of less than one.

Looking ahead, JJ sees yet more demand next year with CN reaping the rewards in terms of North American drilling activity being positive for frac sand, pipes and steel coils. Domestic and export grain vols will improve. Auto sales may be stuck in the 17 million SAR range, though numbers of bi-levels of SUVs remain respectable. Growth in U.S. housing starts and renovations helps lumber, panel and construction materials. Added capacity will allow CN to re-enter the crude by rail market on a take-or-pay basis, which I see as the most reasonable approach — JJ said during the Q&A that the history of crude by rail "is a bit like a yo-yo."

Norfolk Southern was up next. Pretty solid results here. On the call, CEO Jim Squires, Chief Commercial Officer Alan Shaw, and even COO Mike Wheeler invoked the need to create happy customers. That's key. Channel checks with short lines indicate a continued NS aversion to low RVC commodities. This is what helped drive CSX vols down 11 percent and revs down eight percent in Q4. I suspect part of the NS aversion may lie in having to take shortline allowances off the top, reducing the R part of the RVC ratio.

As an aside, I'm pleased to see NS is taking an aggressive approach to easier and faster carload rate quotes. The new pricing process can be run from an iPhone and is a great step in the right direction for being more responsive to rate requests. After all, the whole world is doing business on their iPhones; why not the railroads? A big help is the benchmarking capability to compare proposed rates against market rates.

Getting back to the earnings topic at hand, the NS slides and supporting material present clean results with and without the tax event effects. The NS revenue numbers I'm using include fuel surcharges; ops income and net income are both affected. I'm using the non-GAAP pre-tax numbers to get better comps.

In the merch carload sector, all commodities ex-ag were up — global competition in beans, for example. Total revenue was up seven percent, ops income gained 13 percent, net before tax games was up 18 percent, the OR was 67.7, down 177 basis points. Improving share prices pushed the market cap up $2.85 for every dollar delta in retained earnings. (Buffett's rule is market cap must go up at least a dollar for every dollar delta in retained earnings.)

Fuel expense rose 23 percent, yet consumption grew by a measly onepoint to generate GTMs up three percent. GTMs/gallon was up a point and a half, KGTM/gallon came down an equal amount, though still north of one. Free cash flow before divs and share repos was up third. Net debt came down a point, net debt/equity down 25 percent, invested capital up 25 percent. Capex was 16 percent of revenue vs. 19 percent a year ago. *Pas mal*.

Union Pacific brought up the earnings week markers. One of the things I like best about UP's quarterly presentations is the commodity volume breakout and the cleanest financials in the land. To set the scene, UP total revenue increased five percent to $5.4 billion on 2.2 million revenue units, up a point, helped by a four percent gain for system RPU. Operating income before the tax benefit increased four percent to $2 billion and the adjusted OR was 62.6, up 60 basis points. Adjusted net income gained five percent to $1.2 billion.

Merchandise revenue units including auto gained three percent, propelled by a 17 percent gain in the industrial sector. Revenue increased 28 percent on RPU up ten percent, thanks in part to a doubling of frac sand carloads, aggregates, waste, and military moves. Automotive vols were down four points on mix shift, offset by hurricane replacements; parts were off a point.

Ag products vols slipped seven percent on exports, though RPU gained four percent; processed food and beverages gained. Chemicals volume gained five percent with STCC 29 gains on Mex propane and crude oil. Potash demand pushed ferts vols up 11 percent. Coal was off three percent in total, though Colorado and Utah export coal vols held. Intermodal revenue units were essentially unchanged year-over-year; price per box was up four percent.

The 2018 volume outlook calls for growth in packaged foods and export ethanol, though grain is a toss-up. Frac sand should continue strong, though "local sand" (read Brady Brown sand, an opportunity for OmniTRAX) may offset past patterns. Plastics push chems while construction materials and general industrial recovery will keep that sector humming.

Out on the railroad, COO Cameron Scott said that while derailment frequency decreased, upticks in personal injuries and public crossing incidents cast a bit of a cloud. Dwell and system train speed trend are not heading in the right direction, though today's WSJ reports PTC implementation has caused some service degradation by making trains stop where they shouldn't. Train size is up, as is terminal productivity in terms of throughput and cars switched per employee.

Meanwhile, UP began construction this month on its new Brazos Yard in Herne, Texas. The $550 million rail yard represents the largest capital investment in a single facility in UP history. The railroad expects to decrease car handlings and improve cycle times, switching as many as 1,300 rail cars per day. Once again, as in Santa Teresa, NM, UP is giving more trains some plane to go, mitigating yard congestion. Expect ribbon-cutting in 2020.

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