RAILROAD WEEK IN REVIEW
January 25, 2019

"We are executing our strategic playbooks utilizing the principles of PSR and, frankly, the results speak for themselves." — John Brooks, Chief Commercial Officer, CP

"Kenny [Rocker]has talked over and over about being in front of the customer, making sure they know what we're up to. That doesn't mean that the conversation goes smoothly and comfortably, but it means that they know." — Lance Fritz, UP Chairman, President & CEO

"We are continuing to drive improvement in all of our productivity initiatives. Record GTMs combined with our ongoing locomotive strategy resulted in record locomotive productivity for 2018." — NS Chief Operating Officer Mike Wheeler

Canadian Pacific kicked off Week Two of earnings season. It was an energetic and entertaining call. Right out of the box CEO Keith Creel said, "As you can see from the release, by every financial measure, literally, every financial measure, this has been a record year, both on the quarterly basis as well as a yearly basis."

Canadian Pacific reported fourth quarter revenue of C$2 billion, up 18% on a 5% increase in revenue units; system RPU gained 13% to C$2,767. Operating expense was up 10%, ops income jumped 28% to a quarterly record C$864 million, and the OR shed nearly four points to 56.4, down 376 basis points. Net income after backing out the effects of last year's tax windfall rose 38% to C$648 million; adjusted diluted EPS increased 41% to C$4.55.

CP posted quarterly revenue increases in all commodity groups, with only grain and mets/mins/consumer slipping ever so slightly in revenue units. It was a record fourth quarter and full year for energy, chemicals and plastics; there was sustained growth in forest products while building on strength on transloads and superior service. There was growth in autos in spite of cyclical weakness, and steady construction demand supported aggregates and steel, though the fall-off in white fracking sand put a dent in this sector.

RTMs increased 9% on GTMs up 12% and only 9% more fuel burned. CP maintains its leadership on gallons burned per KGTM: 0.956. Cash from operations increased 24% to C$2.7 billion, free cash flow after capex was C$1.2 billion, up 38%, FCF after dividends was +53%, and ROE was 18.5%.

In sum, this was a very robust call and I think CP's approach to running a railroad bodes particularly well for the merchandise carload sector. Early in the call, Chief Marketing Officer John Brooks said, "2018 was a tremendous year for CP, as we executed our disciplined strategy to deliver sustainable, profitable growth. We had a plan, we picked our partners, and we executed with precision in the marketplace."

Union Pacific freight revenue increased 6% to $5.4 billion on 2.2 million revenue units, up 3%; system RPU gained 2% to $2403 (IP was $3260 and Ag $3087). Total revenue was $5.8 billion, also up 6%. Ops expense gained 11%, pushing ops income down 2 points to $2.2 billion. The OR was 61.6, up 280 basis points. Net income adjusted for last year's tax follies was $1.4 billion, up 29%. Full year cash flow from ops was $8.7 billion, up 2%. FCF after capex (remaining at 15% of revs) was $5.2 billion, up 32%. FCF after divs was $3.0 billion, up 47%.

To get a handle on commodities, the AAR carload reports are essential. UP puts coal, petrol products/crude oil, and frac sand in the Energy bucket. Premium is intermodal and finished vehicles. (I can't tell where parts go. QCS says UP does some 70,000 loads of parts every quarter. UP reports 115K finished vehicles for the Q; AAR says 467K auto loads for the year, roughly 4x the Q4 finished vehicle total. Could it be parts in boxcars are in the IP group?)

Industrial contains all the usual suspects -- building materials, aggregates ex-frac sand, forest products, metals, and chems, etc. Ag includes the STCC 01 grains, grain mill products, processed foods, and ferts. For 2019, UP commodities will be up pretty much everywhere, with some soft spots in grains, frac sand, coal.

Unified Plan 2020 (PSR rollout) started on the MOP and Minn/Wisc in October. It's starting on the Sunset and LA-Chi segments now; west coast planning gets under way in two weeks; and the whole thing will be in place by midyear. Results to date include better car-cycle times, moving more goods with fewer assets, and reduced terminal dwell.

(On the call Jim Vena said in response to a Q on terminals, "Everything is on the table — flat yards, hump yards -- there is nothing that's not on the table. I'd be remiss to say, listen, we're going to shut down x amount of yards, but we're going to spend a lot of time to make sure we get the plant set up to handle the business as efficiently as possible with great service. So that's where we're headed." Kinda makes you wonder about Brazos, eh?)

Listening to the call, I came away thinking short lines can make some significant contributions to the effort and reap real benefits in the bargain. You have to make the traffic fit the plan, working with customers to find the fits. There are going to be fewer but bigger trains, meaning cars spending less time in class yards and fewer unit trains as those commodities are rolled into manifest jobs. Color me encouraged.

The Norfolk Southern earnings call yesterday was loaded with superlatives: records in Q and FY ops income, lowest FY OR, merch revs and RPU, IM volume and revs, FY fuel usage and train length. Railroad revenue gained 9% to $2.9 billion on 2.0 million revenue units with a 5% RPU gain. Ops income was up 27% to $1.1 billion and the OR dropped to 62.8, down 5+ points. Net income adjusted for the 2017 tax games increased 44%; adjusted EPS jumped 52% to $2.57.

Merchandise revenue units were unchanged due to the declines in metals/construction and auto. Said Chief Commercial Officer Alan Shaw, "Robust economic growth, pricing improvement, and tight truck capacity drove revenue growth in 2018. Favorable crude-oil price differentials and increased demand produced revenue gains in most chemicals markets, while the ethanol market growth boosted agriculture revenue."

Asked about customer service and the PSR roll-out, Shaw said, "Our approach with customers has been highly collaborative. They want a supply chain partner that can support their growth and so their goals are aligned with ours. We're focused on improving service and also putting a product out there that lets them compete." This is essentially the same message customers are getting from the likes of CP, CSX, and UP: We can't be all things to all people but let's work on fitting what we do best to what you need done.

The income statement is odd in that they show $145 million in gains for property sales and rental income as a credit to the MS&O line. (The more usual practice is to put it below the line as other income.) Doing so reduced operating expense to the reported 62.8 whereas, absent the credit, the OR would've been a not-so-hot 67.8.

Cash from ops increased 15% to $3.7 billion; FCF after capex and dividends was $931 million, up 13%. BUT... share buy-back expense jumped nearly 3x to $2.8 billion from $1.0 billion. This made me look more closely at the balance sheet. Current assets are less than current liabilities, debt is 70% of equity, retained earnings declined YOY, and there is negative working capital. Hardly what we've come to expect from NS.

CFO Cynthia Earhart showed compensation up 4% on "higher pay rates, incentive compensation, and overtime and re-crews," and purchased services up 7% partly on car hire "reflecting slower network velocity and the cost of additional short-term locomotive resources." Yet just a few minutes earlier COO Mike Wheeler had said, "We are pleased that the velocity of our railroad accelerated at the end of the fourth quarter and we drove further improvements in the first quarter of 2019. This has been achieved by the healthier T&E crew-base, the full implementation of our network operations center, and intense energy and execution by the field."

Still, I was comforted to hear all the superlatives, and the means are definitely there to keep the momentum going.

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