RAILROAD WEEK IN REVIEW

January 24, 2020

"To date, we have operated over 3,000 trains with international crews and we will expand our international crew base in 2020 which should allow the majority of KCS trains to operate with international crews over the Laredo gateway. Additional improvements with customs processing and joint U.S.-Mexico customs efforts will continue into 2020." — Jeff Songer, COO, KCS

"A lot of this junk debt, the really low quality stuff, your low quality B, CCC bonds, don't earn their yields. You may be getting a 12% yield on this CCC bond but the default rates are so high that owning CCCs or even low quality Bs get you worse returns. We call this fools' yield." — Dan Rasmussen, Verdad Advisors, Real Vision Jan 22.

KCS Q4 revenue increased five percent year-over-year led by strength in the Chemicals & Petroleum and Industrial & Consumer Products sectors, up 13 and 11 percent respectively. Metals & Scrap revenue gained 12 percent, while the Ag & Minerals group slipped three percent. Revenue units dipped one percent on frac sand, down 13 percent, and crude oil, down 17 percent.

KCS posted volume gains in Chems & Pet (seven percent), Metals & Scrap (nine percent), and Ores & Minerals (26 percent). Revenue per unit grew six percent, helped by double-digit gains in Coal & Pet Coke and Automotive. Revenue related to the Mexico Energy Reform process grew 43 percent on a 37 percent increase in volume. Chief Marketing Officer Mike Naatz notes that this business has remained relatively flat sequentially and says that the quarter's increase was largely due to the seasonality of LPG volumes.

The 2020 outlook calls for low-single-digit volume growth and mid-single-digit revenue growth. KCS sees uptrends in some 70 percent of the commodity book, with the remaining 30 percent expected to be neutral. Chemical & Petroleum will see strong growth in refined product exports to Mexico, and in plastics from the new Sasol Lake Charles facility. Ag/minerals are expected be up due to increased demand and better cycle times. The Industrial & Consumer business unit will benefit from changes in metal-sourcing patterns as well as easy 2019 comps in forest products.

Intermodal revenue is expected to be neutral with continued growth in the cross-border franchise segment being somewhat offset by U.S. and Mexico domestic volumes. Pricing and truck availability pressures persist, although Naatz believes that they've bottomed out. Finally, there's been an uptick in Canadian crude shipments; their continuing depends on favorable spreads.

Total operating expense increased 13 percent on a strict GAAP basis, though a non-GAAP adjustment for recent restructuring charges and a gain in insurance recoveries relating to hurricane damage a year ago bring the ops expense increase down to a respectable two percent. Non-adjusted ops income was down eight percent to $236 million and the reported OR increased to 67.6, up 459 basis points.

Among the US Class Is going through the throes of adjusting to the PSR model, KCS' progress is remarkable — through 2020 savings are expected to be in the $125 million range. To show exactly how it works and where the saving lie, Sameh Fahmy, EVP for Precision Scheduled Railroading, devoted more than a few minutes on the call walking listeners through an impressive list of accomplishments and goals.

The process got rolling in 2019 as KCS zeroed in on key performance operating metrics: velocity, dwell, hold-outs, locomotive failure frequency, and trip plan compliance. Then they looked at the non-moving elements: mechanical shop work flows, number of locomotives out of service for how long and why, loco shop staffing and work flow-through, what out-sourced work could be brought inside. KCS also engaged with suppliers and customers, finding, for example, 600 cars in Monterrey yard waiting for the the customer to accept them. Fahmey:

> As a result of all this, we took out a lot of assets — 16 percent of locomotives and 12 percent of cars. Fuel efficiency improved five percent because of the longer, heavier trains and the tonnage on them. We reduced the cars-on-line by 17 percent, particularly foreign cars, and that affected things like car hire, which went down by $12 million in 2019.
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> We also improved the locomotive fleet, taking out some 200 older units. As a result, locomotive failures are reduced by about 54 percent. We consolidated mechanical repair facilities to match our reduced asset levels.
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> We also put a lot of emphasis on crew efficiencies, reducing overtime, re-crews, deadheads, taxis and lodging, for example, with double-digit savings across the board. We also improved train length in Mexico, increasing train size by six percent while reducing crew starts by seven percent. All of this activity improved service.

I go into this in detail, not that KCS is the only one out there doing stuff better via the PSR model, but because the amount of detail in the KCS remarks provides oodles of guidance for short lines and regional rails wanting to provide a better service that's worth a premium price, and lower operating expenses in the bargain. Attention must be paid.

Union Pacific wound up the 4Q reporting week with two million revenue units, down 11 percent, and total revenue of $5.2 million, down nine percent. RPU gained a point to $2,425. Operating expense declined 12 percent, for ops income of $2.1 billion, off five percent. Net income was off ten percent to $1.4 billion. Free cash flow after capex and divs was $2.6 billion, down 13 percent.

Of the 20 commodity groups in the UP weekly carload report to the AAR, 15 posted declines. But, as you look across the quarterly summary UP provides (the only Class I to do so), you'll see Q4 was the worst of the year with quarterly freight revenue hovering in the five billion dollar range. Thus I am inclined to look at full year carload volumes to weed out quarterly swings.

Backing out coal/coke, intermodal and auto, merch carloads in the commodities key to short lines declined only two percent and represented 39 percent of UP's total revenue unit volume. Looking only at the merch commodities ex-auto with more than 250,000 annual carloads, only grain — 3.7 percent of total merch carloads — was off, and that by five percent. The rest of the industrial and agricultural carload franchise pretty much held its own.

Key operating performance measures such as car-miles per day, terminal dwell, crew-starts, trip plan compliance, and touches per car all showed improvement. Hump yards at Fort Worth and KC are closed. Core train length is up; local way freight operations are being adjusted to align with customer demand, which I guess means getting away from "train time is any time."

The UP closes the year with Q4 results falling well short of what UP is capable of doing. I think the full-year picture is more representative — revenue down only five percent on six percent fewer revenue units, operating income unchanged, the OR down 210 basis points to 60.6.

Last week's CSX earnings commentary was very much centered on operating improvements and what benefits CSX expected to accrue from them. On the other hand, there was little said about the commercial results in terms of attracting new customers and creating new revenue streams from existing customers. And so it was I sent out inquiries to a number of short lines and regional railroads asking for comments on operating improvements and commercial support.

I thought the response from the owner of several short lines in several states, a chap I've known for 20+ years, was particularly revealing, He writes that CSX has reduced car-cycle and transit times so much that a significant customer who traditionally used railroad equipment is shifting to a leased car fleet. Moreover, interchange times are more consistent meaning better asset utilization for the short line.

On the commercial side, he writes that he's seen little signs of CSX "seriously wanting to grow their carload business." He confirms my contention that sales and marketing force personnel losses over the past two years are "simply staggering;" the good guys who remain are being "spread impossibly thin." As a result, the short line's new business success has been largely "home grown," with CSX only rarely taking part in attracting new carloads. Worse, my correspondent says the pressure is on at CSX to increase rates everywhere.

This is unfortunate as CSX 2019 revenue units are down four percent from the 2016 full-year number. Yes, revenue is up on higher RPUs, with coal and intermodal taking the biggest volume hits. Merch carloads were actually up 30 basis points and I'm willing to bet non-Class I "partners" have been significant contributors.

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