THE RAILROAD WEEK IN REVIEW
January 30, 2015

"The large, integrated energy companies are investing to create supply chains that give them resiliency, redundancy and competitive advantages." CEO Claude Mongeau, CN

Canadian National is a financial powerhouse masquerading as a railroad. Fourth quarter revenues (all dollars Canadian in this section) increased 17 percent to $3 billion on 11 percent more rev units with RPU gaining six percent. Operating expense grew but six percent as comp & benefits charges remained unchanged. Operating income jumped 30 percent to $1.3 billion and the operating ratio came down to 60.7, a 406 basis-point improvement.

Fuel expense increased six percent in spite of a five percent drop in price-per-gallon, but the payoff was 12 percent more GTMs for 11 percent more fuel burn. GTMs per gallon increased one percent and CN broke the holy grail of one gallon of fuel per 1000 ton-miles to the down side: 0.98 v 0.99 last year. Below the line, net income was up 33 percent to $844 million and diluted GAAP eps gained 36 percent on two percent fewer shares.

Operating cash flow increased 24 percent to $4.4 billion, handily covering capex and dividends, leaving free cash flow of $1.3 billion, up nearly 50 percent. Long-term debt was up a $billion, two-thirds of the share repurchase expense, leaving FCF after capex, divs, and share buy-backs a negative $239 million. But… retained earnings increased $932 million as market cap leapt $8.5 billion on the 21 percent year-over-year share price gain. Thus every dollar in retained earnings increase produced nine dollars in market cap (Buffett only looks for a buck).

Out on the railroad, manifest carloads including auto and crude oil increased nine percent, coal was up an astonishing 27 percent (though loss of an export coal contract pushed RTMs down three percent) mainly on US utility demand, and intermodal vols gained ten percent chiefly on the international business equally split between and among the Port of Vancouver, Port of Montreal, and the Port of Prince Rupert.

The petrol/chems commodity group increased vols only four percent — 7,000 units — though crude itself did 34,000 units, indicating weakness elsewhere in the single-carload chems franchise. The good news is the mix is 60-40 heavy to light crude and trending to the former; 75 percent of all crude originates in Canada, sparing CN the Bakken-related ups and downs. The metals/minerals group increased carloads by 20 percent, 50,000 units, of which frac sand was more than half. Lumber increased nine percent on US housing starts.

The 2015 outlook is generally positive. The shortage of heavy-haul truck drivers is pushing more boxes to rail in spite of lower highway diesel fuel prices. The auto outlook for Canada manufacturers is better than for their US counterparts, export potash is looking up, CN has put more cars in its lumber and panel fleet, grain is still on the mend.

In the oilfields, CN sees 75,000 new carloads on top of 2014's 217,000 carloads, a 35 percent increase, in combined energy-related products from frac sand to pipe to crude. On the call, Chief Commercial Officer J.J. Ruest said growth will come regardless of crude oil price swings as customers are investing for long-term grown in spite of short term price volatility. Pipe and sand inputs could be more volatile, however.

FY 2015 revenue units are expected to grow at a three-to-four percent rate year-over-year; rates will increase at about the same rate on what JJ calls "selective upscaling." Capex will run $2.6 billion, roughly half repair-and-replace, a fifth on equipment, and the rest to stay ahead of the curve, adding capacity to bring on incremental carloads at lower variable cost per unit. As CEO Mongeau said on the call, "Our first priority is on cash capital investment back into our business. The rest is for a consistent marathon-runner type distribution of our excess cash to our shareholders." Like I said, a financial powerhouse.

Norfolk Southern, on the other hand, is just now finding its feet after starting 2014 in the slow lane. Total quarterly revenue stayed at $2.9 billion year-over-year. Revenue units increased four percent but revenue per unit slid four percent. Operating income, $891 million, was up one mere percent, thanks mainly to significant negative deltas in compensation and fuel. The quarterly OR was 69.0, breaking below 70 for the first time.

Below the line, net income was virtually unchanged at $511 million; eps was even at $1.64. Cash from operations drifted south by seven percent; free cash flow after capex and divs was a tenth of what it was a year ago, $47 million. Return on invested capital came in at 9.8 percent. Retained earnings increased a $billion as market cap grew by ten times that.

Lower fuel surcharges hurt freight revenue across the board. The Manifest Carload group including auto and crude increased carloads by five percent and revenues by four percent while taking a one percent hit in RPU. Intermodal was up five percent and four percent respectively in revs and vols, with RPU up a point. Coal took the big hit, down 15 percent in revs, six percent in vols, and ten percent in RPU.

Merch carloads increased double-digits in metals/construction (frac sand, coiled steel, and pipe live here) and chems (where crude oil and NGLs live). Ag/consumer/govt and paper/clay/forest posted negative carload deltas year-over-year. Ag downers included beans and bean products somewhat offset by corn; PCF losses in paper and MSW could not offset limited lumber gains.

The 2015 outlook is for more of the same: crude oil strong (though in the last week we've seen oil trains parked as the east coast Brent/WTI spread favors the former); NGLs and drilling inputs continue apace; housing starts (more in the south say other sources) draw more stick lumber, panel, cement and aggregates; and healthier auto sales put fewer, bigger vehicles on each auto rack and builders buy more slab and coiled steel; corn and beans carloads expand to feed more chickens as beef and pork prices rise. There is good news in highway conversions for intermodal; there is no good news in coal.

But there is hope for the railroad. COO Mark Manion's slides show how the operational improvements made earlier in the year started to pay off in December. T&E hires from April hit the road in Nov; Bellevue is on-line; Chicago's Metra fly-over has been completed, more locos — used as well as new — are available for pulling freight, and so on. The NS franchise is unequalled in density: peerless intermodal lanes, access to the re-emerging industrial heartland, and routes reaching 70 percent of the US population. Surely shares can do better than the low hundreds. The five-year eps CAGR plus dividends suggests at least $120 and I'm long.

Crude-by-rail volumes are slowing. The Jan 29 UBS *Morning Espresso* tells all:

> The UBS revised price deck for WTI suggests lower for longer is the probable outcome for oil prices ($49 for 2015E, $62.50 for 2016E, $75 for 2017E)1. Our analysts believe that, unlike prior sell-offs in oil, which were primarily driven by weaker demand, the current oil collapse has been driven by higher than expected supply and weaker demand. This suggests the current selloff could take longer to play out and the eventual recovery could be muted.
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> The best historical context for the current downturn is the 1998 cycle, in their view, when oil fell over 50% due to slowing demand and increased production. The mid-1980s collapse was different, because demand was actually contracting (i.e. rather than just slowing) and OPEC's spare capacity was much greater.

I can see operating benefits accruing to the rails as crude oil shipments slow. East coast spreads between delivered Bakken crude and Brent crude at the dock now disadvantage the former. With the whole non-coal energy side of the house drawing in maybe five percent of revs and a smaller percent of revenue units — not to mention the huge liability when Something Goes Wrong — stepping back from unit trains of crude oil may not be all bad. Anything to improve the bread-and-butter manifest train performance.