THE RAILROAD WEEK IN REVIEW

April 24, 2015

"We feel these are positive trends and about 60% of our total portfolio of business will drive revenue and volume improvements for the rest of the year." — Pat Ottensmeyer, KCS President

The first quarter 2015 railroad earnings season continued this week. Both CN and CP reported double-digit revenue gains year-over-year; KCS and Union Pacific roughly matched what they did a year ago. The same pattern holds for total revenue-unit deltas. In merch carloads, including auto and crude oil, CN and KCS tied at nine percent gains; the other three were within a point or two of where they were a year ago. CN and CP posted ten and nine percent merch carload RPU gains with the others essentially unchanged.

CP once again stands out in the operating ratio department, down 872 basis points year-over-year to a stunning 63.2, beating out UP's second-place 64.8. However, UP's year-over-year delta was only 233 basis points, which says they're on a steady roll while CP is still playing catch-up. I'm betting, however, that CP will widen the OR point spread between itself and the other class Is, if only because I'm convinced the CP focus is getting better returns from present customers than beating the bushes for new incremental business. It's what CEO Hunter Harrison did during his CN tenure and before that the IC.

Three of the four roads reporting this week have revenues and expenses both in US dollars and non-US currency and they go to great pains to report "constant currency," or FX-adjusted, results. I'll do no such thing. The numbers you'll see here are exactly what was presented on the calls, the reason being that doing business in non-US dollars has its costs and that's part of doing business.

Moreover, carriers back out certain one-time expenses to provide "non-GAAP" earnings that supposedly present fairer comps. Not for me, they don't. Once again, "extraordinary" items go with the territory and must be considered, especially in the WIR context where we're more concerned with how the railroad is running and adding value to the transportation service than we are with year-over-year comps. In order of appearance:

Canadian National posted double-digit revenue gains in everything but coal, and respectable volume gains in five of its seven commodity groups. Total revenues increased 15 percent to C$3.1 billion on 1.4 million revenue units, up nine percent; even though fuel expense was down 22 percent, total ops expense increased nine percent, producing a 65.7 ops ratio.

Below the line, net income was C$704 million, up 13 percent. Market cap increased by C$7.7 billion and retained earnings increased by C$917 million, suggesting that every dollar in retained earnings generated C$8 in market cap. Cash from operations increased 54 percent to $992

million, 141 percent of net income. Free cash flow after capex and dividends was C$272 million, up 42 percent.

Six key operating metrics all showed significant improvement: GTMs per train-mile, cars switched per yard hour, terminal dwell, trailing GTMs per available horsepower, car-miles per day, and train velocity. CN generated 10 percent more GTMs on seven percent more fuel burn, increased GTMs per gallon by three percent and achieved the holy grail of one gallon per thousand GTMs.

Running a faster, more efficient railroad pays off in customer satisfaction. On the call, Chief Commercial Officer JJ Ruest, speaking in terms of as-reported Canadian dollars, said grains and ferts revs rose 24 percent on "solid operating execution," spotting an average 4,500 cars a week, up 22 percent year-over-year.

Crude-by-rail dipped 10 percent sequentially from the 33,000 units run last quarter, but mix remains at 60 percent heavy over light. Low nat-gas feedstock prices boosted vols at CN-served plastics producers. Frac sand was up 70 percent over last year, yet weaker energy-related steel demand offset the upside in semi-finished steel, aluminum and other non-ferrous metals.

For the balance of 2014, CN has new crude oil terminal start-ups in Alberta and Illinois, though the present crude oil price volatility is likely to keep vols down. That said, CN budgets 40,000 cars of combined crude oil and frac sand this year. US housing start increases are likely to boost lumber and panel board moves later in 2015. Of particular note (and you'll read about this in my upcoming *Trains* lumber story),

> We are having good success with our high/low-velocity pool system, which prioritizes order taking. The velocity of our premium boxcars and center beam fleet has increased, and we are achieving a higher customer order fulfillment with a more positive customer sentiment.

Kansas City Southern did not have a stellar quarter. Total revenue slipped seven-tenths of one percent to $603 million on 540,000 revenue units, up one percent. If you take out the effects of the weaker peso and lower fuel surcharges, total revenue would have been up four percent. But it wasn't, and that's why I tend to discount factors the railroad can't control. Not to put too fine a point on it, CEO Dave Starling said on the call that auto revs would have been up 15 percent rather than the reported four percent gain absent these effects.

From a pure freight revenue standpoint, KCS is a 76 percent carload railroad, including auto plus oil and gas exploration and production. Three-quarters of the merchandise carload revenue is in chems (STCC 28, 29), forest products, metals and scrap, and ag products. Frac sand and crude oil are less than five percent combined. So when grain and metals/scrap are off double digits, it hurts. Moreover, RPU was a mixed bag, with mid-single digit ups and downs in all but utility coal, down 13 percent.

Like CSX, KCS saw fuel cost drop double-digits, which, when combined with excellent cost control elsewhere, helped bring the ops expense down five percent, propelling operating income to an 11 percent gain and bringing the OR down 321 basis points to 70.5. Fuel burn was down two percent on GTMs off the same amount. Gallons per thousand GTRMs remained at 1.4.

For the balance of the year, the outlook is promising for 60 percent of the book, particularly in both cross-border and domestic intermodal, new volumes out of Lazaro Cardenas, and automotive, with petroleum products playing a supporting role. Tough grain comps will be a drag in 2Q, though the 2015 second half ought to see some improvement. Coal, metals and frac sand combined comprise perhaps a third of total vols and there are no particularly encouraging words to be heard here.

You could almost hear the jaws dropping on the Canadian Pacific call when Hunter Harrison opened with a 63.2 operating ratio, down nearly nine points, revenues up ten percent, and non-GAAP eps jumping 59 percent (GAAP earnings were up 34 percent, still not too shabby). As I noted above, Hunter's forte is and has always been wringing maximum results from the hand he's dealt, and continuous gains in operating metrics are key: train length, terminal dwell, and fuel use in gallons per thousand GTMs, all improved year-over year, even as total GTMs rose five percent on no change in gallons consumed.

Freight revenue rose ten percent to C$1.7 billion thanks to 642,000 revenue units, up four percent, system RPU up six percent, and revenue per RTM up five percent. Bulk products — potash, sulfurs/ferts — and chems ex-crude oil all posted double-digit volume increases. Double-digit RPU gains were posted in grain, potash, sulfur/ferts, and forest products. As a carload-sector guy, I'm particularly pleased to report that the sector now accounts for 71 percent of RTMs and 72 percent of revs. I've long held that CP wasn't charging enough so it's good to see that changing.

Operating expense, including a 23 percent drop in fuel expense, jumped nine percent (five percent FX-adjusted) on double-digit gains in all line-items. Still, operating income gained 30 percent vs last year and the OR as mentioned above dropped to that 63.2. Operating cash flow increased to 141 percent of net income to C$992 million from C$645 million, 104 percent of last year's net, leaving C$295 million free cash flow after capex and dividends, triple last year's.

CP earned C$8.50 a share in 2014, a 17 percent CAGR from 2010's C$3.87. Add to that CAGR the 1.5 percent dividend, apply the total growth rate to the 2014 year-end closing share price of $192.69, and get a price potential $227.22, a 15 percent potential gain. The Street consensus is in the $244 range and the 2011-2015(e) CAGR of 27 percent says there's still room to wring out more revenue per RTM and higher yields from the CP franchise.

Between the financial reports and the presentation slides, Union Pacific, among all Class Is, sheds the most light on the commodity franchise. Total first quarter revenue was unchanged at $5.6 billion as total revenue units slipped two percent, mostly on coal and intermodal. Merch

carloads, including crude oil and automotive, were up a point at one million. System RPU gained 1.3 percent; merch carload RPU was up 1.1 percent. Fuel surcharge collected was down four percent, offsetting the four percent core-pricing gain. Mix improved, adding one percent to the revenue stream, but it only offset half the two percent volume loss.

Here's where the slides are useful. We see within ag products grain was down, while grain mill products and STCC 20 processed foods gained. Ethanol and beer contributed to the upside. Crude oil carloads were off 38 percent, overwhelming the 8 and 10 percent gains in plastics and ferts respectively, leaving the chems group down a point.

Strong demand for aggregates and other construction products, a third of the IP franchise, wasn't enough to offset the declines of 17 and 8 percent respectively in metals and waste. I'm singling out these groups because they represent the commodities running on the most short lines and it is hoped those carriers can use this data to sharpen their relationships with UP.

Operating expense came down four percent. Fuel (down 39 percent) was the biggest factor, with gains in personnel costs, rents (car hire and equipment leases), and depreciation eating up most of the fuel savings. Operating income rose seven percent and net income was up six percent. Per-share earnings gained nine percent on a three percent drop in the diluted share count.

Our story thus far. With four out of five reporting roads' results in, I come away very much encouraged that the roads are using this lull in volume deltas to fix the operating metrics and get costs out. I'm less concerned with using debt to repurchase shares if you can borrow at prime-plus and reinvest in shares that are earning multiples of that.

The performance metrics (cars-on-line, train speed, hard dwell) have been a little misleading with their minuscule changes, but, bottom-line, we see ops expense gains moderating and yields increasing. And as long as revenues increase faster than expenses, operating ratios will continue to come down. Not a bad quarter thus far, all things considered.

The Railroad Week in Review, a compendium of railroad industry news, analysis and comment, is sent as a PDF via e-mail 50 weeks a year. Individual subscriptions and subs for short lines with less than $12 mm annual revenues $150. Corporate subscriptions $550 per year. To subscribe, click on the Week in Review tab at www.rblanchard.com. © 2015 The Blanchard Company.