THE RAILROAD WEEK IN REVIEW

July 17, 2015

"For the full year we estimate in excess of 40,000 new intermodal loads from truckload conversions." — Clarence Gooden, CSX Chief Commercial Officer

CSX opened the Q2 earnings season with record quarterly operating income, operating ratio and earnings per share. Quite an accomplishment, considering revs were off six percent and revenue units were off a point. Moreover, coal was off ten percent, showing CSX is making good on its promise to replace lost coal with gains elsewhere, particularly intermodal and auto. Both of these are largely consumer-driven, which is in itself encouraging.

Total second quarter revenue came in at $3.1 billion, of which 61 percent is from merch carloads and automotive. Among merch carloads, ag products, phosphates/fertilizers, food & consumer, metals, and forest products all posted declines, pulling merch carloads including auto down two percent. System RPU slipped four percent, though on the call it was said that pricing from here out is expected to support market rates and equipment replacement costs — good news for short lines paid on a percentage of RPU. Fuel surcharge revenue dropped 58 percent, pulling RPU ex-FSC down a point.

Ag was down thanks to an oversupply of ethanol in eastern markets, though feed grains offset. Phosphates and ferts were down on lower export vols and weak demand at home. Processed and fresh food also posted lower vols. In chems, it's all about energy with LPG and crude holding up better than frac sand. Printing paper and lumber were both down; metals declined double-digits on more imports and fewer pipe moves. Aggregates were the only bright spot, up five percent.

Operating expense dropped nine percent on the 38 percent cut in fuel expense as price per gallon declined by a third. Expense control elsewhere was excellent as the ten percent savings in materials and supplies more than offset the two percent payroll increase. Car hire and rents came down 11 percent even as GTMs were down three percent, suggesting the focus on cycle time is working. All of which paid off in generating a two percent ops income gain, even as pure freight revs were off seven percent, and taking the OR to 6.8, down 2.5 points.

The third quarter commodity outlook is a mixed bag. Food & consumer, intermodal and aggregates vols look promising; grains, auto and chems less so; the rest, comprising 30 percent of total vols, are "unfavorable." Partly as a result, investors still see CSX shares more apt to trend down than up. The Recognia tech-watcher service cites an unbroken series of bearish indicators going back a month with a ten percent slide in share price to $32 from $35 in the period. I think the middling commodity shipment trends fore and aft may have something to do with it.

GWR's June carloads in North American disappointed, but that was to be expected. All year long we've been watching shortline cars languish and GWR, with 113 individual names in North America, is a good a proxy for the whole non-Class I railroad community as we're going to get. Total carloads slipped 7.3 percent to 137,386; back out 3,370 cars from the added-within-one-year Pinsly roads plus RCP&E, and they're down 9.5 percent. Year-to-date carloads are down four percent all-in.

Six out of ten commodity groups were down and three of these — coal, aggregates, and ag products — are among the commodities that make up some 80 percent of all GWR carloads, and are concentrated in just three of GWR's nine NA operating regions: the Ohio Valley, Midwest and Canada. "Other" carloads, mostly overhead for Class Is, are about four percent of all carloads and were off a tad more than four percent for the quarter.

KCS clocked in Friday with revenues down ten percent to $1 billion on six percent fewer revenue units (537,200); RPU shrank four percent. Operating income declined nine percent to $187 million even as ops expense was down ten percent and the OR dipped to 68.1, down 21 basis points. Below the line, net income and earnings-per-share to common shareholders dropped 14 percent. Year-to-date free cash flow after capex, dividends and share repurchases went to a negative to $51 million vs. plus $74 million a year ago.

In their defense, it must be noted eight points of the ten percent revenue drop can be attributed to foreign exchange rates and lower fuel surcharge recovery; add back the four points lost on utility coal and revs would actually have increased two percent. Below the line, the after-tax hit to earnings was two cents a share and adjusted eps is still down 14 percent.

Seems to me that foreign expense exposure goes with the territory as do penalties for lease termination and sudden drops in any commodity, not just coal. Trying to add back these items falls in the *if-only-but* category, only wasting one's times and clouding the real issue: are we making any money?

Not this quarter. The cash and equivalents balance dropped to $51 million from $190 million a year ago and free cash flow per share before dividends and buybacks sank to 34 cents from a buck-sixteen a year ago. Market cap dropped 15 percent on the share price decline to $91.20 from $107.51. Revenues declined in eight of 14 commodity groups and vols were lower in 11. This is a 75-percent carload revenue outfit — 80 percent if you include coal — so losses of this magnitude really hit home.

On the call, KCS President Pat Ottensmeyer said several times that commodity losses were more a function of service than lack of demand, so vols should recover in line with service performance. I have to give him credit for that. Cross-border revenues before fuel surcharge and FX offsets were 30 percent of total revenue, a record. Adjusted auto revs were up seven percent, Lazaro intermodal jumped 20 percent and crude oil, though a mere two percent of total revenue, gained 42 percent, chiefly on Canadian crude oil heading for the gulf refineries via KC.

The second-half outlook for three-fifths of the KSC commodity franchise is "favorable," and includes such key manifest carload groups as grain, crude oil, metals, forest products, and STCC 29 petroleum products. Pat's neutral on nearly everything else: industrial chemicals (include plastics here), STCC 20 foods, and aggregates. Frac and and ores/minerals are the only negatives and they are but two percent of vols. Not bad.

As an aside, KCS will not hold its usual Shortline, Transload and Ports Conference as previously scheduled for late September. The company cites "the current business environment, saying, "We do not believe now is the time to divert our attention from the matters at hand." Given the above, we have to give them a pass.

Earnings continue next week with CN Monday after the close, CP Tuesday and UP Thurs. NS completes the Listed Class I calls the 27th and GWR rounds out the season August 3. BNSF (ahem - Berkshire) seems to report the first Friday of the second month of the quarter, so look for that August 8, unless they surprise and do it Saturday Aug 1.

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.