THE RAILROAD WEEK IN REVIEW

July 24, 2015

"Status quo political interests seek to transform hurly-burly capital markets into a stable inflation-generation utility." — Ben Hunt, Chief Risk Officer, Salient Partners

Canadian National led the six rails reporting to date with year-over-year gains in revenue, merchandise carload revenues, revenue per carload, and gross ton-miles, while taking 321 basis points out of operating ratio, to 56.4, an industry low.

On the call, CN attributed its performance to its "swift response to slower growth environment, recalibrating resources to drive efficiency. Core metrics were in-line or better than last year." Reduced train starts, more cars switched per yard-hour, more trailing-tons per available horsepower, more car-miles per day and a hiring freeze all contributed.

Total revenue was C$3.1 billion, essentially flat vs. 2014. Operating income was C$1.4 billion, up eight percent on three percent fewer revenue units — merch loads were off six percent — though system RPU was up three percent. Revenues declined across the merch sector with lower volumes of Canadian grain versus 2014's record crop; reduced shipments of energy-related commodities, including crude oil, frac sand, and drilling pipe; and lower volumes of semi-finished steel products and iron ore.

The CN outlook assumes that full-year North American industrial production will be up about a point, reduced from April's three-percent estimate. U.S. housing starts will be in the range of 1.2 million units, and U.S. motor vehicles sales will be approximately 16.7 million units. As noted above, grain was off on tough comps; the assumption for the 2015/2016 grain crops in both Canada and the United States will be about in-line with historical run rates.

The bloom is off the energy rose at CN. The railroad no longer expects growth in energy-related commodities, particularly crude oil and frac sand, compared with its earlier projection of 40,000 cars of crude oil. As a result of these outlook assumptions, we're looking at no significant year-over-year change in merch carload volumes for the full 2015 year. CN now sees total carloads for all freight categories in 2015 as roughly unchanged from the 2014 numbers, though they still assume pricing gains in the three-four percent range.

Canadian Pacific freight revenue decreased two percent to C$1.6 billion on three percent fewer revenue units; RPU gained one percent. Operating income gained ten percent to $C646 million, thanks to lower fuel, comp, and materials costs. The OR came down a whopping 421 basis points to 60.9. Below the line, EPS was up 12% to C$2.36.

CP continues to post solid operating metrics: train speed, dwell, GTMs per locomotive hour, personal injuries and train accidents all went in the right direction as Creel & Co sought to right-size daily ops to match the vols out there. GTMs dropped 6.1 percent, fuel burn dropped 6.8 percent and CP achieved the Holy Grail of less than one gallon per thousand GTM (0.99, actually).

Merch commodity freight revenues in constant dollars drifted south some three percent. Forest products and industrial chems were the only double-digit revenue gainers; potash and crude oil were the only strong volume gainers. This happy combination propelled the system merch carload RPU upwards by five percent.

Tim Marsh, newly-tapped Chief Marketing Officer, put the quarter's commodity story thus:

> A couple items that I need to bring up — and relevant to our original expectations — are the weakness in the U.S. grains and our energy-related volume. U.S. grain saw lower volumes, as the U.S. farmers elected to sit on their crops, given the strength of the U.S. dollar to global supply and the lower commodity prices. This is largely considered a timing issue.
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> As we look to the second half of the year, we expect these volumes to right-size. The numbers are already starting to move in the right directions, as our sitings of trains have doubled since the lows of May. And our dedicated train services have been ramping up significantly in the recent weeks. Lower commodity prices and tight spreads hindered energy-related commodities such as crude oil, frac sand, and steel. With additional pipeline coming online over the quarter, movements of the heavy crude were particularly challenged.

Then there was the intrigue. Hunter was not on the call - shocking!! Turns out he'd had leg surgery to improve circulation and, as one would expect with Hunter, Keith said his boss

> has many great attributes; patience is not one of them, as we all know. He knows one speed, which in railroad terms is Run Eight — wide open, so he didn't exactly follow the doctor's orders with his recovery time. Finally his doctor has put his foot down and said no work, no travel. He has insisted that he take some time to fully recover to get back to 100 percent.

Ergo no HH on the call. Moreover, it appears there was some dissension among Board Members over disclosures. According to the *Globe & Mail*, "Two of the railway's directors – chairman Gary Colter and director Krystyna Hoeg – resigned Tuesday after what insiders described as a spirited boardroom dispute over their handling of the departure of another director, who resigned for health reasons." Evidently a press release was launched "without the approval of other directors about the timing of the resignation of director Stephen Tobias. The news release stated Mr. Tobias resigned June 30, when in fact he offered to exit July 3." So Andy Reardon, formerly of the Frisco and TTX, becomes Chair. Back to work.

Union Pacific rounded out the week's earnings adventures on Thursday. Total revenue declined ten percent to $5.4 billion on vols down six percent and system RPU down five percent. Operating expense dropped nine percent largely on the 41 percent cut in fuel expense, though, truth be told, ops expense ex-fuel rose two points. Operating income was $1.9 billion, down 11 percent and EPS came down seven percent to $1.2 billion. The OR was 64.1, up 6/10 of a point.

Revs were down in every commodity category but auto, up three percent. Even intermodal was down as vols were up two percent and RPU slipped five percent. Fuel surcharge revenue was down $368 million, though fuel expense was down $382 mm, meaning a net fuel credit of $14 million to the bottom line. Says Chief Commercial Officer Eric Butler,

> We generated solid core pricing gains of four percent, but it was not enough to offset the drop in fuel surcharge and the mix headwinds. Grain volume was down 19 percent partly on feed grains; export wheat also declined, partially offset by moderately better domestic shipments. Ethanol carloads declined six percent because of extended plant maintenance downtime. Partially offsetting the ethanol decline was increased demand for soybean meal exports to China and an increase in bio-diesel shipments. Food and refrigerator shipments were down two percent — fewer potato shipments and frozen meat exports.

Elsewhere, plastics vols gained 11 percent on buyer confidence and strong exports. NGL vols grew ten percent; however, crude oil carloads got hammered for 29 percent due to lower numbers of crude oil shipments, the major contributors being lower crude oil prices and unfavorable price spreads. Construction products revenue was off five percent on fewer housing starts (though Texas is still building); the minerals group was down 24 percent mainly on frac sand. And domestic steel suppliers still suffer from cheap imports.

Train speeds were slightly improved as were train size and yard productivity in cars switched/ day. UP has parked more locos and furloughed more TYE personnel to match lower vols. But what's the customer impact? Frankly, I miss the Customer Satisfaction Index that Jack Koraleski championed. Union Pacific was the only railroad that actually went out and interviewed customers and published satisfaction results based on these numbers. We keep hearing about the market absorbing increased rates, but we hear zip about how higher rates affect satisfaction.

I conclude UP is moving less traffic and shrinking the fungibles needed to move freight. Bigger trains, fewer train-starts, fewer crew-starts. However, total vols are down by greater percentages than the other four Big 6 Class Is reporting to date and Wall Street sure noticed. As of noon Thursday shares were down five percent for the day. Surely UP can do better.

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