THE RAILROAD WEEK IN REVIEW

July 31, 2015

"We feel that the fundamentals are there long term for increased demand for highway-to-rail conversions." — Alan Shaw, Chief Commercial Officer, NS

Norfolk Southern brought up the markers for the Class I Earnings Season Monday. It was hardly their brightest hour, though if you drill down through the smoke, there are positive nuggets to be discovered. To begin, NS reported 2Q total sales of $2.7 billion, down 11 percent vs. last year. Revenue units declined two percent and RPU slid nine percent.

Operating income was $814 million, down 20 percent. Operating expense came down six percent after a 38 percent cut in fuel expense, but it wasn't enough to keep the OR from gaining back 349 basis points to 70-even. Below the line, net income fell 23 percent to $433 million. Free cash flow after capex was $587 million, down seven percent. After dividends and share buy-backs, free cash flow was a negative $538 million vs. a positive $193 million a year ago.

On the other hand, if you drill down past the GAAP numbers to see how the railroad is really running, you get a different picture as the big hits were in the coal numbers and fuel surcharge collections. Coal carloads dropped 21 percent; RPU sank 14 percent, and revenue came down 33 percent — about $100 million. Putting that in perspective…

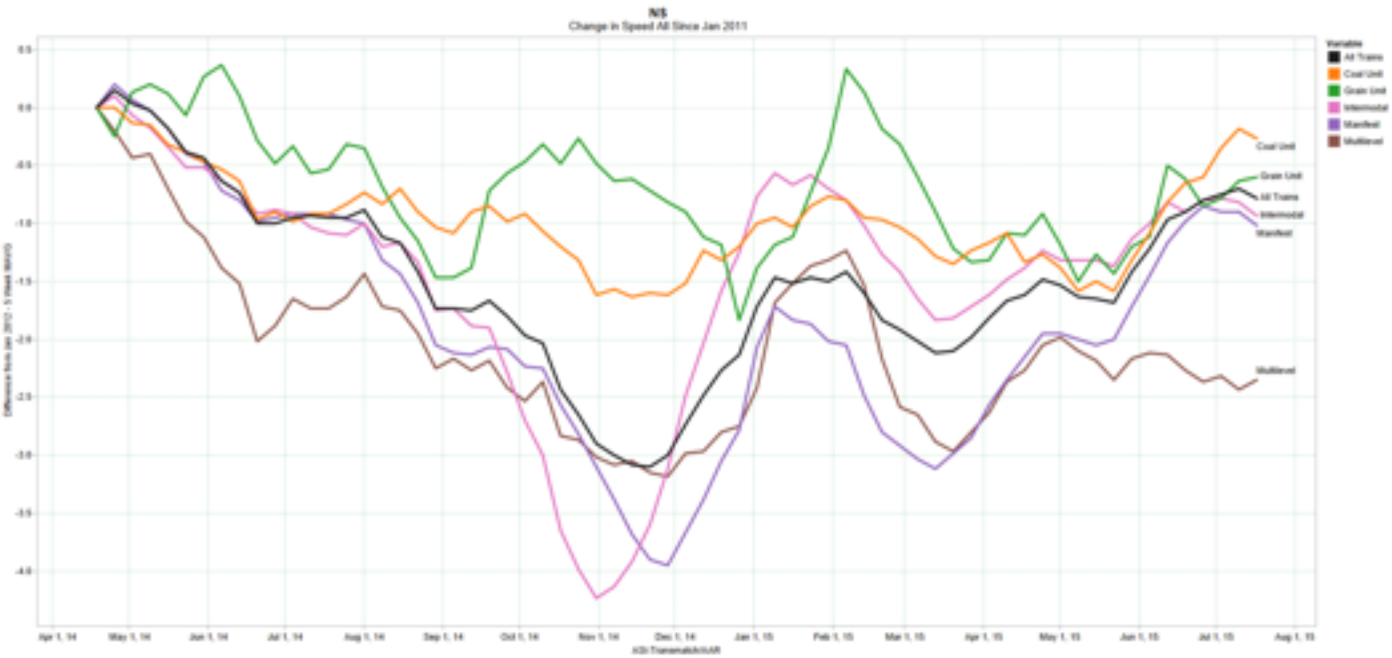
For the six months ending June, 2013, NS did 76,000 tons of coal — 63 percent utility, 21 percent export. The 2015 period saw 60,000 total tons, down 20 percent — 66 percent utility, 15 percent export. On the call, Alan Shaw maintained that domestic utility coal going forward will run about 20 million tons per quarter and export coal run rate to about 3 million tons. That's about where we are now, so it may be the worst of the coal decline is over.

The fuel surcharge spread is an even bigger hit: $239 million. A year ago, Norfolk collected $358 million; this year that number crashed to $119 million, making freight revenue before FSC $2.6 million; back out last year's higher FSC and see $2.7 million net freight revs, a decline of a mere three percent. Another way, eight points of the 11 pct freight revenue shortfall was FSC. Operating expenses ex-fuel were up two percent, mostly comp and car hire. Million GTMs/ gallon and gallons per thousand GTMs were unchanged and lag others of the Big Six.

The reported revenue numbers show declines in every commodity line. Carloads are a little better: merch carloads are up a point and intermodal up two points. But go to the AAR commodity volume numbers at nscorp.com and see declines in nearly half the commodity groups, and even then some further drill-down is necessary. NS reported chems including petroleum products and crude oil up 13 percent, but AAR chems are up only three points and petroleum up 28 percent.

The AAR's "petroleum products" group includes all the STCC 29 nat gas liquids etc as well as STCC 13 crude oil. To break them apart, go to the STB's Quarterly Commodity Statistics (QCS) and see that each quarter NS runs a consistent 3,000-3,500 cars of LPG (the largest STCC 29 group) while crude oil jumped by 8,000 units year-over-year to more than 30,000 in 1Q2015 (QCS lags a quarter, but you can see the trends).

On the call, Chief Operating Officer Mark Manion pointed to improving dwell and train speed performance. Says he, "Picking up the velocity of the railroad obviously helps the crew starts. We really, in a big way, reduced our re-crews these last couple of months." As you can see in this



graph from Drew Robertson, train speed for all but multi-levels has indeed improved since mid-March, and, based on Manion's remarks on the call, I have every reason to believe the trend is bankable. Manion again: "With this momentum continuing through the second half of the year, our focus will be on further improving our service levels and maintaining the right resource balance with our business volume."

The reported revenue by commodity line was down, no doubt about that; however, Shaw noted several times that without the FSC hit, many lines would've been up. He cites continuing crude-oil moves to the Northeast refinery complex as well as moves supporting gas-drilling in central Pennsylvania and eastern Ohio. Housing starts are up more than ten percent this year (AAR lumber is up 10 percent for NS) and continued growth is projected for next year. Shaw:

> Merchandise volume grew one percent in the second quarter. Excluding fuel, revenue per unit also increased as solid pricing partially offset the negative effect of fuel surcharges. Metals and construction volume was down six percent for the quarter driven by global oversupply in the steel market and the impact of low natural gas prices on drilling inputs.
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> Aggregates were up due to construction growth in the Southeast. Our agriculture volume decreased one percent primarily due to reduced volumes of fertilizers and wheat, while ethanol volumes grew from greater gasoline consumption. A 13 percent gain in chemicals volume was due to crude by rail as well as year-over-year growth in natural gas liquids from Marcellus-Utica shale plays. [*See my comments above - rhb*]
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> The outlook is for more corn and ethanol shipments due to rising levels of gasoline consumption as well as project-related growth. And our natural gas liquids market will see continued strength from fractionators [plants that separate out liquids in the gas] in the Marcellus-Utica region. With North American light vehicle production projected to be up three percent year-over-year, we expect continued growth in automotive volumes. Lumber, plastics, basic chemicals, aggregates and consumer goods will all benefit from increased housing starts and construction activity.

I got the sense that Jim Squires really took control of the call, fielding every question and calling on others by name to provide added color. The individual reports seemed much less scripted than before, both in the prepared parts and the Q&A. There was even some discussion of how and where Squire's approach to capex might differ from Wick's. Listening between the lines, I got the sense there may be room for adjustments.

My take: NS is very much A Work in Progress, well on the way to recovery from some performance lapses not worthy of NS. Squires is stepping up to make it His Own Railroad and is empowering his C-Team to do their parts. I still need to see evidence of better cost control in the field and matching train starts to the vols available.

For NS shortline connections, there was much discussion during the call on service performance and how it links to pricing. That tells me now's the time to watch ISA performance like a hawk. I'd look for interchange times trending out of the permissible window on successive days and keep a log. NS works well with facts and I'm convinced they can fix what's broken once given quantified data as opposed to mere anecdotes.