RAILROAD WEEK IN REVIEW

April 28, 2017

"We focus on yield, we focus on operating ratio. We look at a specific OD pair, we look at the revenue to cost ratio of that OD pair. If it's a move where I supply the railcars — like moving steel or moving pulp — I'm looking for contribution per car day." — JJ Ruest, CN

Canadian National led off Week Two of the Q1 earnings after the close Monday. It was positive and upbeat all the way through. CN presented a solid quarter with no hemming or hawing, and Chief Commercial Officer JJ Ruest seemed to open up more than usual on the Q&A: We watch contribution per car day on our moves in railroad-owned equipment; CP says it wants to get biz back from us but we'll let the market decide. CEO Luc Jobin was clearly in charge and passed the Q&A ball around as appropriate.

Freight revenues increased 8% to C$3.8 billion on 9% more rev units, 1.4 million. Merchandise carload revenue gained 7% on 11% more units as RPU dropped 4%. JJ says part of it is more frac sand and other stuff moving in leased equip at lower RPU. Revenue from grains and fertilizers gained 16% on 12% more loads and 4% more RPU as CN moved 55% of the Canadian quarterly grain crop vs 51% a year ago. Coal revenue gained 39% on a 50% RPU gain, even though vols dipped 8%, thanks in part to a new coal mine in the west. RTMs were up 14% on 8% more units.

Asked about the "competitive landscape" and CP's drive to win back "natural" traffic, JJ said, "The question of natural market share is getting to be an old story and eventually the proof has to be in the pudding," where CN increases its competitive advantage and customers reward CN accordingly. To which Jobin adds, "We're not cocky here, but we earn our business the old fashioned way — we earn it every day by giving our customers the best service we can."

Operating expense rose 9% on higher fuel prices and higher volume-related operating expense. The comp & benefits line item actually shed two points — COO Mike Cory showed improvement in six key operating metrics covering velocity, yard productivity, and loco use.

> There's no doubt inclement weather affects terminal and road performance. It creates network stoppages, traffic bunching in and out of terminals, increases dwell on equipment, and it reduces velocity of cars and trains. We improve winter to winter with pinpointed investment in, among other things, AC power, strategic capacity improvements and wayside health monitoring detectors,
>
> Improved service reliability provides top line growth. We set a record for grain car order delivery and spotting performance in Q1. Our merchandise car order fulfillment percentage

was higher than 2015, even though we saw some delayed equipment returns from our rail partners.

The unadjusted OR was 59.4, down 42 basis points, burning 9% more diesel fuel to move 12% more GTMs. Fuel consumption broke the holy grail of 1 gallon per KGTM — down to 0.97. I came away with a great sense that CN continues to do all the right things commercially (everybody talked in terms of supply chains), operationally (metrics moving in the right direction), and financially (positive free cash flow after capex, divs and share repos).

Norfolk Southern was next up. Total revenue increased 6% to $2.6 billion on 1.9 million revenue units, up 5% to 1.8 million. System RPU was up a point as a surge in short-haul utility coal (revs up 20.3% on 20.9% more units) took the edge off. Merch carload revenue as a percent of the total slipped to 61.5% from 64.0% with coal accounting for 80% of the difference. Operating income increased 7% to $773 mm and the OR shed a mere 14 basis points to 70 even.

In volumes other than coal, the merch carload category was up less than a point, and intermodal gained 4%. The Metals/Construction group was the best performer, up 9% mainly on raw steel and drilling-related commodities such as pipe and frac sand. Chems dropped 2% as shipments of crude oil fell 30% thanks to pipeline substitution. (But since short lines don't really do much crude, and they are involved in drilling supplies, the key metric for them is rig counts and production trends as mirrored in the mets/const group.)

NS is doing a number of things to increase the visibility and profitability of the merch carload group. In his opening remarks, CEO Jim Squires specifically mentioned "resource utilization" and "strong partnerships." Both CMO Alan Shaw and COO Mike Wheeler talked about the importance of reducing the number of car types in the fleet (now 40 from 60) and going to a standardized boxcar that costs less to maintain, can accept a wider variety of commodities, and can turn faster. This is the right approach. The merch segment generates 62% of revs on only 59% of RTMs and 5% more dollars per RTM than the system average.

Separately, Mike McClellan, VP Industrial Products for NS, says in the current *Short Line Connector* magazine from the ASLRRA, "Most of the business we do with short lines is non-unit train business that offers the most opportunity for growth outside the commodity cycles." This is the bread and butter segment for general-service boxcars.

Having more cars in the fleet with the widest-possibility commodity applications— see my *Trains* boxcar story a year ago — will offer the best returns. I'm sure we'll hear more about this at the NS shortline meeting in a few weeks. Bring your questions and specific examples of commodity OD pairs where better service can yield more carloads.

Getting back to the call, productivity themes had to do with locomotive utilization (more DPUs per train-start), train size (see Wheeler's slide 15), and fuel efficiency (RTMs per gallon up 8%; gallons per KGTM down 5%). Asked about NS productivity and operating practices given the

changes at CSX, Squires rose to the occasion, saying NS is tasking a “measured approach” and at the end of the day the key driver is supply chain value for the customer. And where have we heard that before? (Clue: the railroad with the lowest OR in captivity.)

Union Pacific rounds out the Class I first quarter analyst call series with total revenue increasing 6% to $4.8 billion on roughy equal parts volume, fuel surcharge, and mix/core price. Revenue units increased 2% to 2.1 million, led by a 16% increase in coal (RPU gained 8% on length of haul and exports out of California), and 6% more ag products carloads (grains up 19%) with RPU essentially unchanged. Grain product carloads were flat; stronger DDG exports to Mexico and soybean meal shipments in the U.S. were offset by a drop in canola meal and oils volume.

In automotive, finished vehicles (52% of the category total carloads) were off 8% but carloads of parts gained 5%. Increased West Coast imports and new production in Mexico helped offset some domestic losses. Chems vols slipped 4% mainly on crude oil (down a whopping 87% to about 2,000 units), with plastics and industrial chems (together 55% of chems vols) gaining; chems group carloads were up a point overall excluding crude oil.

Industrial Products gained a point-plus with frac sand (16% of IP vols) pushing the minerals group up 32% due to increased drilling activity and per-well profitability — a pattern expected to continue through 2017, especially in the Permian (brown sand entering the mix) and Eagle Ford. The construction segment (32% of IP vols) slid 9% on rock shipments in Texas. Intermodal volumes was unchanged, with domestic boxes edging out international 52 to 48%. The carload volume outlook for the balance of 2017 sees growth in STCC 20 processed foods, auto parts, frac sand, and plastics.

Operating expense gained 6%, neatly offsetting the 6% revenue gain, and generating operating income of $1.8 billion, also up 6%, and a 65 OR, unchanged from a year ago. The PI ratio remains safely below 1.0, though reportable incidents per million train miles increased 11%. Fuel use patterns continue to impress, with GTMs up 6.5% on 2.4% more gallons burned. Gallons per thousand GTM improved 4%. Below the line, net income grew 9% to $815 mm.

All told, UP’s Q1 performance shows three positive trends: (1) strengths in frac sand volume growth being driven by improved fundamentals; (2) a possible pricing bottom with openings for increases in the second half; (3) solid volume growth and productivity gains continuing to increase operating margins. I recommend short lines compare their carload patterns with UP’s and identify strengths and weaknesses. Do it again when 2Q2017 results come out in late July and bring your fact-based questions to the UP short line meeting the following week.

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