RAILROAD WEEK IN REVIEW

July 21, 2017

"To get there we have to go through this change. There's going to be a little pain and suffering. I don't know frankly how to get there without some bumps in the road." — Hunter Harrison, CEO and President, CSX, Q1 earnings call

CSX led off the second quarter earnings season with total revenue of $2.9 billion, up 6%, on 1.6 million revenue units, up 2%. Merchandise carloads slipped 2% as coal, up 7%, and intermodal, up 3%, masked the merch downtick. Merch carloads slipped to 61% of revenue from 66% a year ago with coal making up for the entire delta as intermodal revs as a percent of total remained essentially unchanged at 18%.

Operating expense increased 6% to $2.0 billion with modest reductions in payroll, materials/supplies/other, and car hire/rents, for $958 million operating income, up a laudable 14%. The Operating Ratio dropped 160 basis points to 67.4. Below the line, net income hit $510 million, up 15%; earnings per share increased 18% to 55 cents thanks to buybacks.

GTMs increased 3% on a 1% decrease in fuel burn, RTMs increased 5%, GTMs/gallon improved 4%, and gallons per KGTM got closer to the 1.0 holy grail, decreasing 4% to 1.04. Free cash flow before divs and buy-backs increased 16%, and CSX has parked 900 locos and 26,000 cars. On the call Hunter Harrison said they've reduced the fleet by 50,000 cars.

Thus it's quite understandable that capex YTD is 17% of revs, down from 20% a year ago. Consider: CSX increased revenue units 2% even against this massive fleet shrinkage, is on a roll to reduce hump yards to 3 from 11, and is doing all this with 3,000 fewer souls by year end. Clearly CSX is positioning itself to handle future freight volume with less of everything.

The conference call lasted two hours: 15 minutes for the *slides and prepared remarks* and the rest for Q&A, giving Hunter ample opportunity to lay out his vision and plans. He calls himself a short timer, which shocked some, but as I recall he had said at the outset his task is to right the ship and move on. Asked if could make Precision Railroading the CSX Model, he cited successes at IC, CN, CP. Responding to a question about how fast it can be done, he said there's nothing new about Precision Railroading and most CSX-ers had heard about it before he got here. Thus making Precision Railroading CSX's own ought to go along smartly.

Other Hunter-isms in no particular order: Benefits accrue over time going forward, the biggest challenge being cultural. There will be bumps in the road in customer relations, but 90% of CSX revs come from 400 or 500 customers and they seem to be OK with what we're doing. As long as we do what we say we'll do, we will be rewarded.

Dwell times in some yards may not come down as fast as one might like, but the nature of the business — blocking for the distant node, skipping some yards — makes that happen: would you rather spend three days in three yards between OD pairs or 25 hours in one yard? Customers shut down for weekends and holidays so unit trains get in the way of the scheduled railroad where irregular load/unload patterns create loco and crew needs you can't predict. And finally, we're not buying any more assets to support coal; we'll take what's there as long as we can, but when it's gone so are we.

Canadian Pacific was next up. Total revenue increased 14% to C$1.6 billion; carload revenue was up 16% to C$1.1 billion, with the percentages differences owing to meager revenues in the "other" column. There were double-digit gains in potash, grain, chems including energy-related (non-coal) commodities, and metals/minerals/consumer.

Total system revenue units were up 8%; merchandise carloads were up 11%, with double-digit increases for grain, potash, chems etc, metals/minerals/consumer. System RPU gained 5%. RTMs were up 12%, half again the revenue unit gain, thanks to longer, heavier trains ; GTMs were up 10%, fuel burn was up 10%, and gallons per 1000 GTM unchanged at 0.97, still best in class. Train-miles increased 10% — average core train length 7,128 feet, - 2%, train weight in tons 8,695, up 2%, thus accounting for RTMs being up more than rev units.

Operating expense increased 7%, leveraging a whopping 23% operating income gain for a 58.7 operating ratio, down 330 basis points. Net income was C$480 milion, up 46%. Cash from operations was C$922 million, up 26%; FCF after capex but not divs or repos was a healthy C$200 million, up from virtually naught a year ago.

Whereas the *presentation slides* were scanty, the 10-K provides additional color on the operating metrics. GTM gains were mainly due to increased volumes of Canadian grain, frac sand, Canadian coal, export potash, and crude oil. Train weight averages came on heavier bulk and frac sand trains. But average train length came down a point on more short-haul bulk moves.
All in all, a worthy collection to the roster of strong earnings reports.

Union Pacific reported $5.3 billion total revenue, up 10%. Freight revenue was $4.9 billion, up 11%. The Industrial Products group was strongest merchandise group gainer, up 24%, propelling the IP group to an 11% revenue increase. Total units were up 5% mainly on coal, itself up a respectable 17%. Merchandise units grew 4% with IP the strong performer, up 15%, against slight declines in auto and chems.

Within the manifest carload sector, Ag Products vols increased 3% on wheat exports and poultry corn in the mid-South, while combined food/beverage and grain mill prods were unchanged. Automotive was down a point with finished vehicles down and parts up. The Chemicals group, which includes both STCC 29 petro chems and STCC 13 crude oil, was off 2% — petroleum/LPG dropped 20% — offset by nice gains in plastics/ferts. The Industrial Products group was the hero, up 15%, with particular strength in minerals (frac sand, though brown sand from west Texas could hamper the upside) and construction/remediation waste.

Average UP revenue per unit gained 6% to $2,287 with IP the overall leader, up 8% to $3,270. The revenue mix: merchandise carloads 64%, intermodal 18%, coal 12%, the rest "other." Revenue unit break: merch 48%, coal 14%, intermodal 52%. (One has to wonder where the margins are: intermodal RPU $1,149, merch carload $3,232. UP uses a carload equivalent of 1.7 boxes per platform, so the carload equivalent revenue is $1,938, 60% of carload RPU.)

Operating expense increased 4% for a handsome 21% ops income increase to an even $2 billion; the OR dropped a highly respectable 4 points to 61.8. Fuel burn increased 6% against the 10% gain in GTMs. Fuel efficiency (gallons/KGTM) improved 3% to 1.10 from 1.14. (At $1.69/ gallon, that's worth a fair piece of change.) Below the line, net income increased 19% to $1.2 billion, eps jumped 24% to $1.45 thanks in part to the 4% drop in diluted share count YOY. Cash from operations came in at $3.5 billion, -2%. Capex was unchanged at $1.6 billion, dropping to 15.3% of revs from 16.6%.

Like CSX and CP, UP continues the trend of doing more with less. On the call, COO Cameron Scott reported new T&E hires, generating the best-ever train size and cars switched per hour. They're "deconstructing train size by lane and commingling service products" (which I take to mean more unit train carloads in mixed carload manifest trains); have seen eight consecutive quarters of train-size expansion; and have room to add new mixed-carload volumes with the assets at hand. Moreover, UP's lowest-cost switching is in the hump yards, so is in no hurry to start flattening them. The more-with-less theme continues.

Kansas City Southern brought up the markers for the week, posting record second quarter revenues of $656 million on revenue units up 6%; RTMs gained 19% against GTMs up 15%. Merchandise revenues grew 15% on 8% more revenue units. The BNSF intermodal offering is ahead of plan with the potential to double. Refined products carloads to Mexico are ramping up as quickly as storage capacity is built out; right now vols are limited by transload capacity. KCS is targeting incremental margins of 50%. That's the good news.

The bad news is operating expense jumped 20% on double-digit gains in payroll, fuel, car hire, and materials. The Mexican fuel credit more than halved from last year on a timing issue, helping to make the OR 63.5, worse by 222 basis points. Not as much of the 15% revenue spike fell to the bottom line as I would have liked: up just 9% to $239 million, still an all-time record for quarterly operating income.

Net income to the railroad was$135 million, up 12%, before preferred divs, contribution to non-controlling interests. Cash from operations was $417 million essentially unchanged. Capex was up a meager point; free cash flow before dividends and share repurchases was $132 million, tumbling 18%.

The commodity outlook is favorable for chems (refined petroleum and LPG to Mexico, industrial chems, plastics); automotive in finished vehicles out of Mexico, both cross-border and overseas export; frac sand and crude oil are looking strong. More muted are prospects for ag products and minerals; industrial products from steel to lumber to aggregates and consumer products may slip.

Rio Grande Pacific, a shortline holding company in Fort Worth, has re-branded its dispatching services from Nebraska Central Dispatch to Rio Grande Pacific Dispatch (RGPD), to strengthen its connection with the parent company and to depict more accurately its operations. While RGP's dispatching services originated as part of the Nebraska Central Railroad more than 10 years ago; the dispatching center's move to Fort Worth in 2016 made the rebranding essential.

RGPC owns four railroads operating some 700 main-track miles and serving 140 customers in six states: the Idaho Northern & Pacific Railroad; the Nebraska Central Railroad; the New Orleans and Gulf Coast Railway; and the Wichita, Tillman and Jackson Railway. Rio Grande Pacific Dispatch provides around-the-clock primary and backup rail dispatching for its own short lines, the Denton County Transportation Authority, and seven other regional freight carriers predominantly in the midwest and mid south.

Tres Meyer, VP Operations, also reported, "The rebranding of RGP Dispatch, through its logo and name, was motivated by a desire to unify and simplify our organization in a cohesive way. The new logo is based on a stylized modern railroad trackside signal said Meyer. "Rio Grande Pacific is widely respected throughout the industry for its commitment to customer service. We're proud to be part of the RGP family, and we wanted the new logo and the name to reflect that."

RGP Dispatch is, of course, fully FRA compliant, offering a full range of dispatching services, meaning it fulfills the the Railroad Safety Improvement Act's 24-hour crossing requirement (ENS), has streamlined record retention (including electronic record keeping), and creates customized reports and metrics tailored to each customers' needs. Well done, say I.

Genesee & Wyoming same-store rail volumes increased 3.3% in June with particularly strong showings in aggregates, coal, and waste. Coal and industrial commodities from ag products to construction aggregates to forest products (both STCCs) make up 80% of the franchise revenue-unit volume. This keeps life simple: all this tonnage is in fungible bulk commodities, where one grain of sand or kernel of corn is like every other.

P&W and HOG are the new kids on the block, and without them carloads are essentially flat, proving once again shortline growth in this economy comes more from acquisitions than from same-store (same commodity, same car type, same OD pairs -- thank you, Clarence Gooden) sales. The proof of that particular pudding is that GWR's Q2 was up 5% -- not too shabby.

The latest Wolfe Research shipper survey from Scott Group is both revealing and encouraging. Rail service is perceived as at least getting a little better and school is still out on EHH and his changes at CSX, though the percentage of shippers planning to shift biz to NS from CSX has declined slightly. The comment about more use of dedicated (read shipper-owned) trucks is in line with Matt Elkott's preference for tracking private fleet numbers because they can be a proxy for beneficial owners' outlook for their business and thus the economy. I've sprinkled highlights throughout so you can speed-read.

Dennis Gartman is always both instructive and entertaining. I see some positive remarks about grains and housing starts (construction materials in general seem to be doing better than lumber and panel). As a trader, he is well qualified to say that "leveraging into a losing position is a mug's game." That shoe also fits for carloads where the RPU is less than the RVC ratio, and this is something more short lines have to watch more closely. I'm looking right now at a C&D move where the cost of track damage to the excepted track, loco and crew overtime, and opportunity cost of both exceed the RPU. This is not sustainable.

I've updated my Rule of 100 to $7,800 per mile per year from $5,000. I bumped up the per-tie installed price to $70 from $50 to include tie disposal cost. but it only works for a railroad of 50 route-miles or more. I'm only talking about track; no bridges, weed-spray, outside contractors, etc. The reason is you still need a base load of employees — 2 T&E, 2 MOW, 2 shop, one admin, one manager — and that's pretty much fixed regardless of route-miles. And even at that, 5,000 cars on a 50-mile railroad only gets you to break-even.

By way of review, the Rule of 100 says you need at least 100 cars per year per mile of main track to break even, assuming a per-car allowance of $250 and paying staff $20 an hour — $30 fully-loaded. On the other hand, if you put 200 cars/mile on a 50-mile railroad you could conceivably get to an 83 operating ratio, seven points better than the shortline average I computed for an FRA project some years ago.

The Rule of 100 is a rule of thumb, and thumbs are easily broken. For example, if just minimal intermediate switching is required, and you run long distances in flat,dry rural areas -- the cars per mile threshold for rule of thumb can drop towards 70 to 80.