RAILROAD WEEK IN REVIEW

November 3, 2017

"We have a unique opportunity to divert shipments away from the highway to rail boxcars." — Alan Shaw, Chief Marketing Officer, Norfolk Southern

Canadian National opened the second week of earnings with total sales up 7% to C$3.2 billion. Operating income gained less than 4% to C$1.5 billion as operating expense jumped nearly 10%, wiping out the revenue gain and then some. The operating ratio added 139 basis points to 54.7 — hardly shabby, but a function of vols growing faster than expected. COO Mike Cory showed on the call how three of their six key operating metrics — terminal dwell, car miles per day, and AAR train speed —deteriorated, however slightly.

Revenue units increased 11% (well ahead of its Class I peers) with metals/minerals the best performer led by the 130% frac sand gain. Petroleum/chemicals carloads were up a few points, while forest products (paper and wood), grains, and auto slipped a few points each. Same store prices inched up 2.4%, yet system RPU dipped 4%.

Looking ahead, CN sees moderate volume gains in export coal, grain and pet coke as nicely positive for Canadian producers, while U.S. coal and grain will be down from last year. On crude oil, CN is by choice taking "a bit of a growth pause, waiting for a more attractive entry point." Frac sand continues its speedy upward trajectory; other merch carloads will be slightly up.

Net income was off 1.4% to C$958 million, though the three percent reduction in share count managed to increase earnings per share by a point-plus to C$1.31. Free cash flow per share before divs and repos increased 35%. Fuel burn missed its usual high marks, increasing 14% to support 12% more GTMs. But CN is still the top performer in achieving fuel Holy Grail-hood: 0.91 gallons per thousand GTMs.

Norfolk Southern batted second last week. Revenue increased 6% to $2.7 billion on a 4% revenue unit gain. System RPU increased 2% to $1,364. Looking strictly at merch carloads (which include auto at NS), revenue gained 3% even as rev units slipped 0.5% with RPU up 4%. Metals/construction was the strongest commodity group, helped immensely by frac sand; ferts helped, too. Even coal helped, with loads up a point on the export surge. During the Q&A on the call, CMO Alan Shaw said, "We have a unique opportunity to divert shipments away from the highway to rail boxcars." That's a first and I hope to hear more on this theme.

Operating expense held to a 3% gain, leveraging an 11% ops income gain to $911 million and pulling the OR down 183 basis points to 65.9. Fuel expense jumped 8% on a 12% price hike, but fuel burn dropped 2% while generating 3% more RTMs, increasing GTMs per gallon by 5% and reducing gallons/KGTM by a like amount. Net income increased to $506 million, a healthy 10%, and free cash flow before divs and repos increased 14% to $1.2 billion.

In his formal remarks on the call, CMO Alan Shaw said the NS goal is to “deliver a customer-centric service product that adapts to the needs of our customers, while providing an environment in which, it is easy to do business. Our customer-centric service product first focuses on tailoring the right service to our customers.” And yet, in my channel checks, I find many reports that performance in the field fall short of this claim.This is a great opportunity for short lines to gather the data and make the case for matching words to actions.

But here’s an encouraging word: during the Q&A, Shaw observed, “We have a unique opportunity to divert shipments away from the highway to rail boxcars.” That’s a first and I hope to hear more on this thread. When asked about winning jump-balls with CSX given the execution changes there, Shaw adds, “Our primary focus is making sure that any volume we bring on is accretive to the bottom line and does not disrupt the responsibilities that we have to our existing customer base.” In other words, if it fits we’ll take it. Dual-served short lines take note.

Union Pacific wrapped up the Class I earnings calls for the third quarter on Thursday. Total revenue increased 5% to $5.4 billion. Revenue units slipped a point to 2.2 million, though manifest carload units increased 15%. Operating expenses increased 6%, for a 3% gain in operating income, $2 billion. The operating ratio gained 68 basis points to 62.8. Below the line, net income was $1.2 billion up 6%. On fuel, UP burned 1.2% more gallons to generate 2.3% more GTMs. Gallons per thousand GTMs slipped 1% to 1.1. Free cash flow after capex but before divs and repos was $3.74/share, up 10%.

In the ag group, grain and grain mill products were down; food in reefer boxcars were up. Grain was off 19%, primarily driven by a delay in harvest and lower U.S. exports, partially offset by domestic strength in the Mid-South poultry and Idaho dairy markets. Grain products carloads were down 10%, predominantly due a decline in export vols off the Gulf Coast. Food and refrigerated volumes were at 5%, driven by continued strength in import beer with strong summer demand.

As for chemicals, revenue was up 2% for the quarter, on a 5% decrease in volume, and 8% increase in average revenue per car. But caution is warranted. The 5% down carload number includes STCC 29 petrol products and STCC 131 crude oil.The AAR chems/petrol break out shows Q3 chems (STCC 28 incl ferts) at 221K units, up 2%. Petrol products -- everything from LPG to asphalt plus crude oil -- represent about 41K units, down 17%. Since chems carloads outnumber petroleum carloads about 5:1, the big drop in petrol has less effect on the combined chems-plus-petroleum, thus the negative 5%.

Chemicals volume, excluding crude oil, was down 2% in the quarter. Plastics carloads were down 6%, with seven plastics plants impacted by Hurricane Harvey. Fertilizer was up 6%, driven by continued strength in potash exports. T^he drop in petroleum products is largely due to a decline in crude oil shipments, which were down 82% to about 2,000 carloads, result of lower crude oil prices and available pipeline capacity.

Automotive finished vehicles loads were down; auto parts, 49% of total auto vols (most of which moves in containers; short line participation is nil), showed no change. Intermodal revenue was up 3% on a flat volume and a 2% increase in average revenue per quarter. Domestic volume was down 1%, due to a challenging competitive environment; international volume was up a point; however, excluding the Hanjin impact in 2016, international volume would have been up 5%. Coal from the PRB was down whereas export coal from other sources increased. The volume outlook calls for more processed food in reefers and boxcars, more plastics and ferts in chems, and continued strength in frac sand.

Genesee & Wyoming third quarter total consolidated revenues increased 15% to $577 million; operating income grew just 21% to $111 million as operating expense gained 14%. Below the line, net income fell 6% to $53.4 million, thanks in part to an oversized Other Income credit of $1.5 million a year ago — clearly an example of how accounting rules can cloud the underlying earnings. Absent these one-time 3Q2016 puts and takes for restructuring, acquisitions and the retroactive 45G credit, net income was essentially unchanged year-over-year.

North American properties brought in total revenues of $319 million, up 3%, with freight sales of $243 million plus $60 million in “freight-related” fees (terminal and switching operations, mostly), and $16 million in ancillary and other fees. Revenue units were up a point to 408,000 — ag products, 13% of volume, were off 12% (South Dakota drought) and utility coal (GWR export coal is negligible), 14% of vols, dipped 3%. Same-store carloads were down 2% (excludes HOG and P&W additions) but same-store sales were flat at -0.3%.

GWR says North American revenue in 4Q2017 ought to be in the $310-315 million range with operating income about $75 million and an OR around 75 based on something approaching 400,000 units. That lags 4Q2016 slightly, with revenues of $322 million 403,000 carloads. It also says that the NA portion of the GWR pie is slipping: what used to be revenue split 80% NA/20% everywhere else, in 3Q2017 the split became 55% NA/45% other, down from 62/38 a year ago. The 4Q2017 guidance sustains the 55/45 split.

RailTrends in NY (Nov 30- Dec 1) will feature a Canadian I Chief Commercial Officer face-off. There is a return engagement for CN’s J.J. Ruest and a debut appearance for CP’s John Brooks. I’m hoping to hear these gentlemen cover such topics as the political impacts on rail markets, cross border and domestic, as well as their views on the various stages of what might be called the “post-Precision Railroading revolution” processes. Never a dull moment.

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