RAILROAD WEEK IN REVIEW

April 27, 2018

"Part of our growth strategy is picking the commodities, the movements, and the trains that are going to yield the highest margins to us." — John Brooks, Chief Marketing Officer, CP

Canadian Pacific revenue units came in at 649,100, increasing four percent on intermodal and, to a lesser degree, coal. Merchandise carloads were up just a point, thanks mainly to the eight percent drop in grain loadings. Total freight revenue likewise increased four percent to C$1.6 billion; revenue from merchandise carloads, $C1.1 billion increased two percent, with grain again the chief downside culprit. Revenue/revenue unit was unchanged at C$2,500 while merch RPU was up half point to C$3,407 — more than double the intermodal per-box number.

Total revenue increased four percent to C$1.7 billion. Operating expense gained 12 percent, dragging operating income down 11 percent to $540 million, bumping the OR up five points to 67.5, still not too shabby a number. Though fuel expense gained 27 percent on a 28 percent hike in per-gallon price, GTMs and RTMs were both up six percent, GTMs per gallon improved three percent and CP achieved the Holy Grail of less than a gallon per thousand ton-miles, 0.98.

Below the line (all GAAP numbers, pre-adjustments), net income dipped 19 percent to C$348 million and EPS slid 18 to C$2.41 as the result of a two percent reduction in the diluted-share count. Free cash flow (operating cash less capex) nearly doubled to C$156 million. After divs and repos, FCF went negative to C$224 million, vs. a positive eight million loonies a year ago.

Canadian grain volumes dropped four percent on tough operating conditions and US grain vols dropped by a fifth due to export patterns. Potash revenues gained 18 percent on strong export and domestic demand, and CP expects this trend to continue. Frac sand volumes continued to run at a rate of about 20,000 carloads per quarter, which will increase on a new single line-haul service from Wisconsin to the Bakken; the Marcellus and Alberta drilling regions are next.

I came away from the call with the feeling that CP is taking a very disciplined approach to handling what it's got and where to go after more. Says President and CEO Keith Creel, "We're matching marketplace demand with the discipline to make sure we maintain our growth model, which is fueled by profitable sustainable growth. We'll have a solid second quarter, and, I think, a very encouraging third quarter and fourth quarter."

Kansas City Southern freight revenue increased four percent to $611 million; total revenue increased five percent to $639 million after ancillary fees, demurrage, liquidated damages, etc. Revenue units were up one percent to 547,300; merch carloads including frac sand, crude oil, and automotive grew two percent to 260,900 units. System RPU was $1,117; merch carloads got $1,844 each — five times the intermodal take per box. (Even at an ideal two boxes per platform it hardly seems worth it.)

Operating expense was $420 million (including a $9.2 million fuel credit from Mexico), up five percent, for an OR of 65.8, up 32 basis points, and operating income of $219 million, up four percent. Below the line, net income to common shareholders, after allowances for non-controlling interests and preferred shares, was $145 million, down a point; EPS was $1.40, up two percent after a three percent reduction in diluted shares.

Market cap for the quarter increased 24 percent to $11.3 billion, delivering $37 for every dollar of increased retained earnings. I think this is an important measure of capital conservation because, per Warren Buffett, a dollar of retained earnings should deliver a dollar of market cap gain. KCS passes this test handsomely. Free cash flow per share after capex but before dividends was $30.60, up from a negative $30.50 a year ago.

The Industrial and Consumer commodity group, plus the Chemicals and NGL group, account for nearly half of all revenue, and were the strongest performing commodity groups on the railroad. Energy (frac sand, coal and crude oil) car-counts and revenue were down, though RPU gained 11 percent on commodity mix (Mexico is a big part of the positive news). Ag products lost ground on declines in both grains and food products.

The full-year 2018 outlook is favorable for 80 percent of the KCS book — petroleum, plastics, cross-border intermodal, automotive from Mexico, metals both in the US and from Mexico. Another ten percent has a neutral outlook, mainly ag, and the final ten percent, mainly energy, carries the Unfavorable tag. Bottom line: if 80 percent of one's book is looking up, and if Mexico is a big chunk of that book and it's looking good, then I'd have to say KCS ought to be in for a continued profitable ride.

Canadian National reported Monday after the bell, with performance and results much diminished from what we have come to expect from CN. Freight revenue was C$3.1 billion, unchanged from a year ago, on three percent more revenue units (merch was down three percent, IM and coal both up 10 percent). System RPU slipped three percent, but same-store RPU increased three percent; contract renewals are running at plus four percent, reflecting a tighter freight market. Total revenue, including ancillary fees from Other Revenue derived from non-rail logistics services that support the Company's rail business, were flat at C$3.2 billion.

Operating expense increased nine percent, pushing operating income down 15 percent to C$1 billion, bumping the OR back up six points to 67.8, a number not seen since 2013. On the call, however, COO Mike Corey showed how the railroad is clearly on the mend, with March-April 2018 metrics (GTMs/mile and HP, cars switched per hour, terminal dwell, etc.) virtually back to where they were first quarter last year and far superior to the January-February performance. Fuel use held at the one gallon per KGTM sweet spot.

Net income dropped 16 percent to C$741 million, and EPS shed 14 percent to one looney even, after a three percent reduction in diluted share count. Cash from operations tumbled 40 percent to just C$755 million, just shy of the C$771 million shelled out for capex (13 percent of revenues) and dividends. The C$615 million share repo was entirely on borrowed money.

On the call, COO Mike Corey went into operational detail in a way unique to these calls. If you want a lesson on running trains where capacity is constrained, read the transcript. An excerpt:

> From an operational perspective, results were combination of two things. We had lower resiliency in some high volume areas going into winter. This made maintaining fluidity very challenging. Fluidity is the most important thing. This lower resiliency, coupled with the harsh winter conditions in those same areas, resulted in a decline in the service levels and an increase in operating cost, as evidenced in our operating metrics.

The service wobbles surely affected volumes. Every merch commodity was down (metals/minerals the exception, thanks to frac sand) in car count and revenue. Grain/fertilizer, petroleum/chemicals, and forest products were the biggest percentage losses. As to grain, Interim President and Chief Commercial officer JJ Ruest says there is still a backlog, but they're gaining on it. Lumber to the US is looking up as well. JJ notes that it's a long-term business and they're adding equipment to support it — 250 center-beams, e.g.

I think CN got blind-sided by the combination of extreme winter weather and heightened customer demand. They're aggressively adding capacity, mostly west of Winnipeg, and are fixing the service shortcomings. Said JJ in his closing remarks, "The capacity that we have is more valuable than in the past, and I think most of our customers understand that." So do I.

Norfolk Southern stepped up to the plate Wednesday. From Squires' opening remarks to the end of the Q&A, I heard a very positive tone of voice with no wavering or ums or ahs. Both COO Wheeler and Chief Marketing Officer Shaw came across as very much in control, more so than on past earnings calls. And CFO Cynthia Earhart gave her remarks in a robust presentation, very much in the style of the dean of all CFOs for earnings calls, Rob Knight of UP.

The presenters had a right to be upbeat. The results generally surpassed analyst expectations and bode well for the rest of the year. Freight revenue increased six percent to $2.7 billion on three percent more revenue units. The two percent negative delta in merch carloads comes from a point or two in ag and paper/clay forest and seven points in auto. RPU gains held revenue declines to a point in both PCF and auto; ag was up a point. Absent FSC, system RPU would have been $1,358, even with last year; total revs would have been $2.6 billion, up four percent.

Operating expense increased by a paltry four percent, creating ops income of $835 million, up ten percent, and an OR of 69.3, down 130 basis points. (Absent FSC, the OR would have been 72.8, unchanged, so you can see how FSC distorts the way results look. I disapprove.) Net income increased 28 percent, largely helped by the 30 percent income tax reduction. EPS, after a two percent reduction in the diluted share count, increased three percent to $1.93. Cash from operations slipped four percent to $816 million, though free cash flow after capex was up six percent, helped largely by the $100 million capex reduction from last year.

I find sticking around for the Q&A always yields a few nuggets. A sampling, in no particular order...

-- Truck-competitive pricing works where customers see a competitive advantage for NS.
-- Incremental margins north of 80 were helped by productivity enhancements; incremental merchandise sector revenues go fastest to the bottom line.
-- Growth in intermodal boxes is partly as a result of the ELD requirement, providing an improved pricing base and better train revenue density, and creating new intermodal moves in shorter lanes.
-- Network velocity getting better with smarter use of the asset base: crew allocation, dispatching, loco fleet management, etc.
--As yards are flattened (Chattanooga, e.g.), expect to see more manifest train block-swapping.

This was a particularly helpful and encouraging call, full of clues as to where new carload customers are to be found.

Union Pacific wrapped up the week's events on Thursday. Freight revenue increased seven percent to to $5.1 billion on 2.1 million revenue units, up two percent. System RPU gained five percent. Total revenue increased seven percent to $5.5 billion on $353 million of Other Revenue, mainly revenues earned by UP subsidiaries, fees from commuter rail operations that UP manages, and charges for demurrage, switch fees, etc.

Operating income was $1.9 billion, up eight percent, as the expense increase was held to six percent. The OR was 64.6, down 60 basis points. Below the line, net income increased 22 percent to $1.3 billion; EPS increased 27 percent to $1.68 as diluted shares came down four percent. Cash from operations increased a point to $1.9 billion and capex was up 12 percent to $910 million. Free cash flow after capex but before dividends slipped eight percent to $991 million; FCF after divs and share repos was a negative $743 million vs. a negative $179 million a year ago.

UP now reports commodity results in four groups: agricultural products, energy, industrial, and premium. Agricultural includes all the usual suspects — grains, grain mill products, STCC 20 packaged foods, ethanol, and fertilizer. Energy includes coal and coke; crude oil; NGLs and STCC 29 petrol chemicals; and frac sand and barite (a mud used in oil wells for drilling). Industrial comprises mainly single-car commodities from metals to construction products, industrial chems including plastics, both forest products STCCs, and auto parts moving by the carload, not intermodal. Premium is finished vehicles and intermodal.

As a result, commodities I usually call merchandise or manifest carloads are spread across three groups — ag, industrial, and energy — so comps with other roads will be very complicated. Let's just say I'll report UP for what it is, leaving it to the reader to break out frac sand from energy or automotive from premium. That said, of all four commodity groups, only ag vols decreased, down four percent (revs were flat owing to a four percent RPU increase), and the other three posted gains in both revs and vols.

Chief Marketing Officer Beth Whited says the 2018 volume outlook calls for gains pretty much across the board, except for grain (exports held back by cheaper grain for global markets from non-US sources) and coal — no surprise there. Incremental margins are in the 50 percent range and UP is looking to move that up a few points, so shortlines able to add commodity carloads at little variable cost increase ought to be looked on kindly.

COO Cameron Scott says the increase of carloads beyond the level UP usually handles comfortably has pressured yard thoughput, added train starts (requiring more locos and crews), increased cars-on-line, and decreased velocity between OD pairs. And even though the OR is the most frequently mentioned metric in the analyst calls, Scott stresses the fact that there's more to life than the OR: car contribution per day, GTMs per available horsepower, trip plan compliance, to name three. From the above, I'd say UP has its arms around the increased carload business and is looking forward to adding more. Short lines please note.

Kansas City Southern will re-start its weekly intermodal service between the Port of New Orleans (served by the NOPB) and east Texas beginning next month. (Intermodal service in this lane had been discontinued following Hurricane Katrina in 2005.) The new terminal is northeast of Dallas at Wylie, having opened for operations in 2015.

Wylie Intermodal Terminal has an automated gate system with high definition imagers, optical character recognition and biometric driver identification. It also has 1,500 parking spaces, 400 container stack spots, enhanced traffic signals, specific turn lanes, two 5,000-foot intermodal tracks, and by the end of 2018, will have an annual lift capacity of over 342,000 units. Ought to work well for all concerned.