RAILROAD WEEK IN REVIEW

February 28, 2020

"Charlie and I urge you to focus on operating earnings – which were little changed in 2019 – and to ignore both quarterly and annual gains or losses from investments, whether these are realized or unrealized. — 2019 Berkshire Hathaway Chairman's Letter

*"In the paragraphs that follow, we group our wide array of non-insurance businesses by size of earnings, **after interest, depreciation, taxes, non-cash compensation, restructuring charges** – all of those pesky, but very real, costs that CEOs and Wall Street sometimes urge investors to ignore." — 2019 Berkshire Hathaway Chairman's Letter [emphasis added —- rhb]*

"Rail & Leasing manufactures, leases and maintains railcars; leases intermodal tank containers; manufactures mobile railcar movers; provides in-plant rail switching and loading services; performs track construction and maintenance; and manufactures steel tank heads and cylinders." — 2019 Berkshire Hathaway Chairman's Letter

"We rebuilt the engine. We've right-sized resources to optimize our network; upgraded the network to improve performance and increase capacity; are running longer, faster trains with less dwell time; and are leveraging strengths to deliver superior value to our customers."
— Canadian Pacific Investor Presentation, February 20

BNSF wraps the earnings season with full-year revenue of $23.5 billion, a year-over-year decrease of $340 million, or one percent, on 2.2 million revenue units, down four percent. (BNSF does not do quarterlies). RPU increased four percent. According to the 10-K, "The decrease in revenue is partially offset by a favorable outcome of a [JB Hunt] arbitration hearing." Fuel surcharge revenue dropped ten percent.

Consumer Products volumes (automotive, intermodal) slipped five percent on fewer intermodal boxes thanks to the availability of truck capacity as well as lower west coast imports. Industrial Products volumes decreased three percent primarily due to overall softness in the industrial sector and lower sand volumes; the big gainer was crude oil while sand/gravel dove 20 percent on a decline of nearly 73,000 carloads.

Agricultural Products got hammered with a ten percent drop — 67,000 units — in grain carloads and a seven percent shortfall grain mill products. Packaged food and other farm products were essentially unchanged. Coal/coke volumes dropped more than 16 percent — 115,000 carloads thanks in part to lower natural gas prices. Coal is now down to 16 percent of revenues whereas just four years ago it was nearly 18 percent.

Operating income was $8.1 billion, up three percent, thanks to a four percent haircut in ops expenses, led by a 12 percent drop in the fuel bill. The operating ratio came down 163 basis points to 65.7. Net income increased five percent to $5.5 billion; free cash flow after capex was down three points to $4.6 billion; capex was 15 percent of revenues vs. 13 percent a year ago.

The five-year operating income comparison for the six North American Class I railroads is quite revealing. Note I'm using operating income rather than net income or earnings per share. That's because below-the-line items like property sales or changes in tax regulation can cause swings in net that have nothing do with actual railroad performance in its core mission, hauling freight for a fee in a competitive environment.

And don't get me started on the evils of share buy-backs and other non-GAAP "adjustments" that can make end-of-period results look a lot better than they deserve to when operating results aren't up to snuff. I'm also using a straight percentage change over the five years because CAGR can be misleading, especially when one year is an outlier that in turn amplifies the rate of change with its neighbor.

Five years operating earnings ($mm)

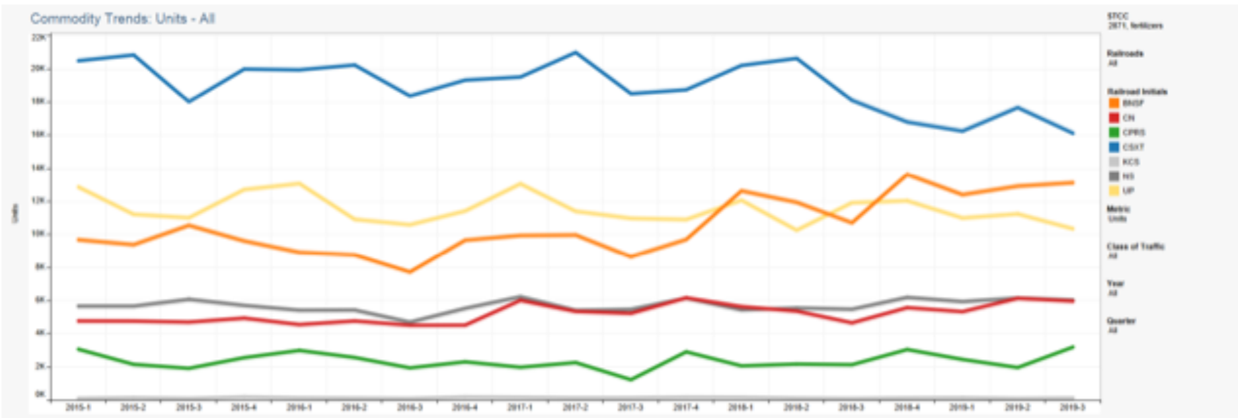
Railroad	2015	2016	2017	2018	2019	100.2%
BNSF	$7,767	$6,637	$7,293	$7,800	$8,071	3.9%
CN	$5,266	$5,312	$5,243	$5,493	$5,593	6.2%
CP	$2,688	$2,578	$2,519	$2,831	$3,124	16.2%
CSX	$3,584	$3,389	$3,720	$4,869	$4,965	38.5%
KCS	$ 804	$ 819	$ 922	$ 986	$ 886	10.2%
NS	$2,884	$3,074	$3,371	$3,959	$3,989	38.3%
UP	$8,052	$7,272	$8,106	$8,517	$8,554	6.2%

The percentage change spreads between NS/CSX and BNSF/UP are within a few points of each because each serves about the same markets and neither railroad has that much of a competitive edge over its regional partner.

On the other hand, the wide spread between CN and CP stems from the fact that CP lagged CN for a number of years until they embraced the Precision Railroad mantra under Hunter Harrison and then Keith Creel. KCS is in a world of its own and the gains come from sharpening operating practices and successfully melding US-Mexico operations.

Yes, we're seeing some disappointing results of late, but here again it's the economy. You can't manufacture revenue units when customers slow down their rates of buying and selling stuff that must be moved from here to there. Consider the rule of 72: divide that by ten for the percentage rate needed to double the starting number; divide 72 by the interest rate for the number of years it'll take the starting number to double. Thus BNSF operating income will double in 18 years; KCS will double in seven.

From UBS comes a note saying John Deere ag sales are down. That's not surprising due to the fall-off in harvests and export markets diminishing farmers' free cash flow. Usrailimpact.com shows ferts demand had remained fairly constant through 3Q2019. CSX takes the only significant hit. From this one concludes planting and harvesting continues, only with older equipment doing the work.



The shortline intermodal terminal concept may be taking root. Kenny Rocker, UP's Chief Commercial Officer, said during the Q&A following his Q4 prepared remarks, "We have a product for our international intermodal business that's with the Iowa Northern Railroad… The expectation is that the truck capacity should tighten up by mid-2020," so a move to shorten drays makes sense.

He's referring to the new IANR partnership with supply-chain manager Valor Victoria and the Watco intermodal terminal team for the newly-developed Butler Intermodal Terminal in Shell Rock, Iowa. The location is just north of Waterloo and convenient to the MSP market. It's a logical move for UP to drop the east-bound MSP blocks for the IANR, saving UP and the customer the time and expense of off-loading boxes in Chicago and draying them back to MSP.

IANR is the last-mile rail service provider, Watco runs the ramp, and Valor Victoria brings the customers. And the Butler facility fits with UP's goal of establishing terminals on regional carriers to free up mainline capacity. Everybody wins.