RAILROAD WEEK IN REVIEW

April 24, 2020

"I think our effort in response to the COVID pandemic in treating U.S. and Mexico the same and in doing everything across our network, regardless of which side of the border, has served us extremely well, and resulted in some pretty outstanding health statistics." — Pat Ottensmeyer, President, KCS

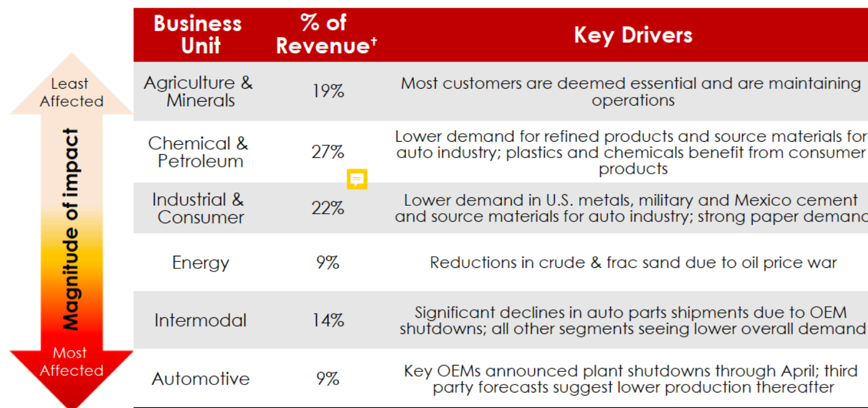
"CP grew RTMs by nine percent, had a sub-60 OR, and grew earnings by 58 percent. Rest assured the same operating model that produced these results is just as resilient heading to the challenging times that we are facing. It's a model and a team that's proven its ability to adapt our resources and our cost in a rapidly changing environment." — Keith Creel, CP President

"Pricing continues to be very good. Same-store sales sequentially year-over-year are very, very good and our negotiated contracts exceeded our same-store sales pricing. So the team is doing an exceptional job in these circumstances to extract good value for the transportation product that we are delivering to our customers." — Mark Wallace, EVP Marketing, CSX

"For the first time we are seeing improvement across all of our metrics, and as a result, we are seeing a better service product for our customers. This is a direct result of our focus on improving network efficiency and service reliability as part of our operating model." — Jim Vena, COO, UnionPacific

First quarter results reports got underway Friday a week ago with KCS. Here the story was, and as I suspect it will be elsewhere, not so much about first quarter results as about the effects of COVID-19 on freight volumes going forward. That said, KCS had made great strides in running a faster, smarter, more cost-effective railroad so was well-positioned for COVID-19.

This mix chart from the presentation slides shows the strengths of a carload-centric franchise.



Business Unit	% of Revenue+	Key Drivers
Agriculture & Minerals	19%	Most customers are deemed essential and are maintaining operations
Chemical & Petroleum	27%	Lower demand for refined products and source materials for auto industry; plastics and chemicals benefit from consumer products
Industrial & Consumer	22%	Lower demand in U.S. metals, military and Mexico cement and source materials for auto industry; strong paper demand
Energy	9%	Reductions in crude & frac sand due to oil price war
Intermodal	14%	Significant declines in auto parts shipments due to OEM shutdowns; all other segments seeing lower overall demand
Automotive	9%	Key OEMs announced plant shutdowns through April; third party forecasts suggest lower production thereafter

The magnitude of the current economic downturn is felt least in the top three groups, which make up 68 percent of the KCS revenue book. And because this is mainly single-car business, minimizing crew-starts ($2 million a year each per Ottensmeyer) is critical. Here the PSR initiative has really paid off. As volumes began to decline in late March, train starts were trimmed by 26 percent by mid-April yet train length was up five percent.

First quarter revenue units increased 3.9 percent to slightly more than half a million loads; RPU increased 3.3 percent and freight revenue grew 7.4 percent to $691 million. Operating expense decreased 14 percent, yielding a whopping 80 percent jump in operating income to $289 million and an un-adjusted 60.5 operating ratio (59.7 before restructuring charges, the best OR ever, says Ottensmeyer). Net income was $152 million, up 48 percent.

The relationship between velocity and car miles/day was immediately apparent: foreign car hire dropped 28 percent, even as GTMs increased four percent, fuel burn dropped two percent, and GTMs per gallon of fuel increased six percent. More block-swapping at intermediate points keep cars moving in fewer, bigger trains and reducing transit time between OD pairs.

Canadian Pacific on Tuesday reported revenue units increasing 8.7 percent to 690,600 with particular strength in Energy, Chemicals, Plastics (ECP), Fertilizers/Sulfur, and Grain. CP's commodity mix is 51.9 percent carload ex-coal; grain and ECP account for half of that. Freight revenue increased 15.9 percent to C$2 billion even and system RPU was up 6.6 percent to C$2,896. Operating income jumped 53.6 percent to C$834 million, thanks to the 1.2 percent drop in ops expense against the 15.9 percent total revenue gain.

Gross ton-miles increased 10.0 percent while consuming just 5.5 percent more fuel. Revenue ton-miles increased 8.9 percent, GTMs per gallon of fuel increased 4.3 percent, and gallons per thousand GTMs dropped 4.1 percent to meet the Holy Grail of fuel efficiency — less than one gallon per thousand GTMs. Below the line, net income decreased 5.8 percent to C$409 million due to accounting rules changes and other administrivia.

Chief Marketing Officer John Brooks said on the call that Canadian grain hit an all-time Q1 tonnage record. The 8,500-foot grain train operating model "enabled the movement of an additional 100,000 metric tons of grain in Q1." He is upbeat on potash even though Q1 revs and vols were off a bit. Exports were good, and he foresees volume gains in fertilizers as NA farmers look to replenish soil nutrients lost in wet weather.

ECP is a bright spot with revenue growth of 56 percent on 29 percent more carloads. However, crude-oil vols are slipping "given the steep decline in demand resulting from COVID-19 and the impact of oversupply from the Saudi Arabia-Russia production dispute." Forest products and Mets/Mins/Consumer vols increased six and nine percent respectively due to strong pulp and steel demand.

CSX gave a good account of its first quarter results on Wednesday after the close. CEO Jim Foote's tone on the call was confident and firm — the Street must have been impressed as shares gapped up four percent at the open Thursday. There were a lot of things to like: cutting costs faster; moving more freight with fewer assets; tighter trip plans; signs of more aggressive field sales representation plus better coordination with the operating department.

Revenue units slipped 1.1 percent to 1.5 million, freight revenue declined 3.2 percent to $2.8 billion, and RPU lost 4.2 percent to $1,886. See details in the green box at right. Total revenue was $2.9 billion, with "other revenue" coming down 39.9 percent.

Operating expense dropped 6.5 percent, helped in part by double-digit declines in labor and fuel.The OR took an 80 basis point haircut to 58.7, a record for CSX. Operating income was off 3.4 percent to $1.2 billion. Below the line, net income declined 7.7 percent to $770 million.

Revenue Growth in Merchandise More Than Offset by Coal and Other Revenue Declines

- **Chemicals** increased due to higher shipments of industrial chemicals, energy, and plastics
- **Agricultural & Food Products** growth driven by gains in ethanol, sweeteners and oils, and grain
- **Automotive** declined due to lower North American vehicle production, including impact of plant closures in March due to COVID-19
- **Minerals** increased on highway and paving project activity growth
- **Forest Products** increased with growth in pulpboard and woodpulp
- **Metals and Equipment** increased due to growth in equipment, scrap metal, and aluminum
- **Fertilizers** increased as long-haul fertilizer growth offset short-haul phosphate declines
- **Coal** decreased as domestic utility coal demand was negatively impacted by low natural gas prices and export coal was impacted by lower global benchmark prices
- **Intermodal** decreased as growth in domestic intermodal was more than offset by declines in international due to COVID-19-related impacts

Two things stand out for me, in spite of the slight slippage in revenue operating income and in net income. First, the way CSX is getting closer to customers in order to grow revenues from current customers and win back those who stepped away for whatever reason. Second, positive signs of better coordination of revenue development schemes and operating department objectives. Often they have been at odds; I think the culture changes at CSX will benefit both.

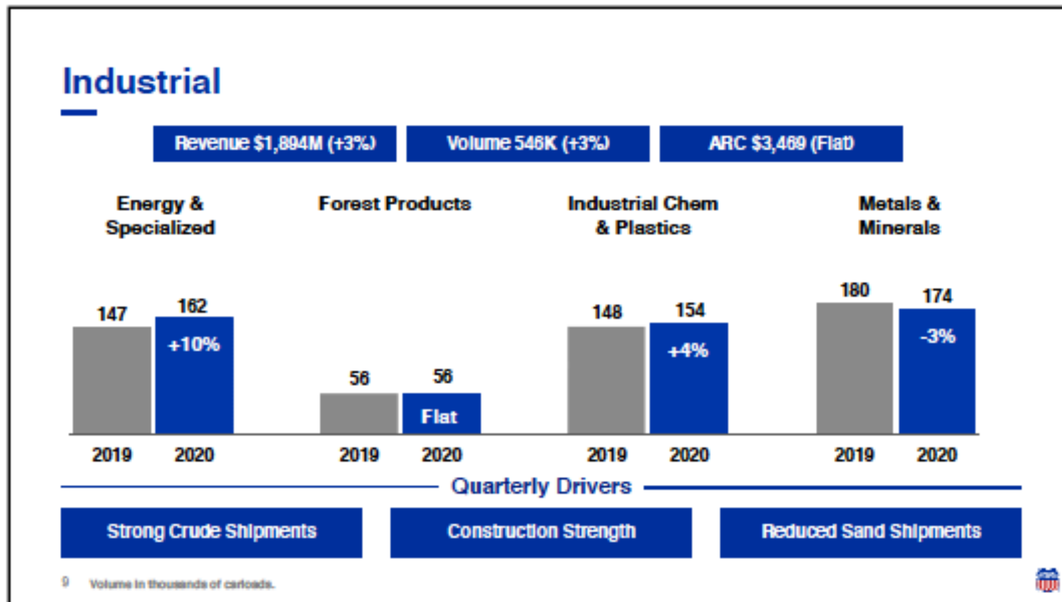
Union Pacific closed out the week, posting quarterly operating income of $2.1 billion — up nine percent, even with total revenue down three percent and revenue units down seven percent. The magic was taking taking operating expense down ten percent year-over-year on double-digit decreases in payroll, car hire/leases, fuel, and purchased services/materials. In fact, every expense line showed a decrease.

Gross ton-miles slipped four percent to 202 billion, yet fuel burn dropped nine percent. GTMs per gallon increased five percent and gallons per thousand GTMs dropped five percent. The OR dropped an astounding 460 basis points to 59 even, an all-time best quarterly OR. Freight car velocity improved eight percent due to better asset utilization and fewer car classifications. As a result, terminal dwell decreased 11 percent, helped by transportation plan changes to eliminate car touches.

Marketing and Sales EVP Kenny Rocker has unwrapped a new carload commodity reporting protocol, showing the individual lines within the broader Bulk, Industrial, and Premium categories. Merch carloads including everything ag and the usual industrial suspects were up

three percent and revenues increased four percent as RPU was up five percent points even though merch RPU was unchanged. Coal/renewables took a 19 percent volume hit as a result of softer market conditions from historically low natural gas prices and a mild winter. Auto slipped a point, and intermodal sank 15 percent due to domestic market slippage and international intermodal volume was down 24 percent during the quarter.

Drilling down into the merch carload area, here are Kenny's slide and commentary:



Forest products volume was flat. Reduced paper shipments were offset by increased lumber carloads due to a strong housing start and a mild winter during the quarter. Industrial chemicals and plastic shipments grew by four percent on strength in domestic and export plastic shipments along with strong demand of detergents and chemicals.

Metals and minerals volume decreased by three percent as reduced sand shipments from the impact of local sand and drilling decline were partially offset by continued strength in rock shipments in the south coupled with increased metal shipments. We expect to see continued challenges in sand with oil prices remaining at lower level.

Color me impressed with ALL the results this week, stressing as they do the benefits of getting PSR right, increasing operating efficiency, and creating greater customer value.

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