RAILROAD WEEK IN REVIEW

May 1, 2020

"We expect moving into Q2 that the majority of crude we continue to move is going to be the heavy undiluted barrel. It just simply does not make sense to move the dilbit barrel in today's climate, particularly given that the dilbit barrel is a pipeline spec barrel and the pipelines have ample capacity to handle that barrel." — James Cairns, CN SVP, Rail Centric Supply Chain

"We project year-over-year volume declines across all business groups with large impacts in the second quarter. Future volumes are dependent upon the depth of the downturn and the timing of the reopening of the economy, as well as energy prices." — Alan Shaw, Chief Marketing Officer, Norfolk Southern

Canadian National reported first quarter freight revenue of C$3.4 billion, up 30 basis points on 1.3 million revenue units, down six percent, with system RPU increasing seven percent. Revenue ton-miles decreased one percent, telling me they're getting more RTMs per load and increased price per revenue unit is key. They didn't say on the call how much of the revenue unit decrease was a function of higher prices, but rates up at twice the rate we're hearing from truckers has to raise an eyebrow.

Total revenue was C$3.5 billion, essentially flat, but the five percent cut in operating expense propelled operating income up 13 percent (!) to C$1.2 billion. The operating ratio came in at 65.7, down 380 bips. Fuel expense dropped ten percent year-over-year on a seven percent fuel burn decrease against GTMs down less than two percent. GTMs per gallon increased six percent and fuel efficiency achieved the Holy Grail of one gallon per thousand GTMs: 0.96 gallon.

Below the line, net income increased 29 percent to an even C$1 billion thanks largely to a 36 percent income tax cut. Cash from operations increased 18 percent to C$1.2 billion, capex decreased 14 percent to C$603 million, and free cash flow after dividends but before share buy-backs was C$168 million vs. negative C$95 million a year ago.

Chief Operating Officer Rob Reilly said on the call that car velocity had increased five percent to 200 miles per day, train velocity improved by seven percent, and yard dwell fell four percent. Train velocity increased ten percent and dwell dropped seven percent after the blockades had been lifted, proving once again that increasing car and train velocity while reducing dwell allows one to use fewer locomotives and cars to move the same amount of GTMs.

Merchandise highlights include record March grain tonnage, replenishing potash inventories; more coking coal to Teck; and increasing propane to Ridley with the opening of new terminals. Less encouraging are the outlooks for frac sand (no surprises there), and for economically-sensitive commodities such as forest products, metals/minerals, and raw material inputs for the automotive industry.

Overall, this is the very sort of bullish report one would expect from CN, even in the worst of times. And it drives home the need for short lines to put more emphasis on RTMs rather than carloads per customer.

Norfolk Southern checked in on Wednesday with first quarter freight revenue down eight percent to $2.6 billion, with large hits in coal and automotive. Revenue units sank 11 percent to 1.7 million; every merch category declined and that group was off five percent. There was some salvation in the four percent RPU gain. Making it a little tougher to see what's where, NS has redesigned its commodity groups, combining ag and forest products and making some other small tweaks.

Happily, the AAR weekly commodity carload reports yield some color. Through March 28 ag was down six percent and forest products was off eight percent. Fifteen of 18 AAR commodity lines showed lower numbers than were posted a year ago. Alan Shaw noted on the call that merchandise revenue was down less than a point.

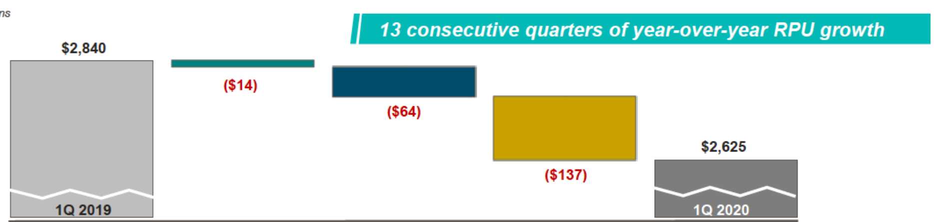
Steel volumes continued to be impacted by weak demand and frac sand faced pressure from low energy prices, while favorable spreads allowed increases in crude oil volumes. NS has combined its ag and forest products commodity groups, showing a five percent decline in volumes.

The Week 13 (March 28) year-to-date AAR car counts have ag down six percent on ten percent declines in both grain and grain mill products such as corn sweeteners and soybean meal. In forest products, Week 13 YTD lumber is down ten percent and pulp/paper fell five percent. Together, ag and forest products make up eight percent of total merchandise carloads.

RAILWAY OPERATING REVENUE CHANGE

Q1 2020 vs. 2019

Revenue change $ millions



	Merchandise		Intermodal		Coal		Total	
Revenue	$1,672M	(1%)	$655M	(9%)	$298M	(31%)	$2,625M	(8%)
Volume	569,100	(5%)	955,100	(11%)	163,500	(31%)	1,687,700	(11%)
RPU	$2,939 RECORD RPU	4%	$685	2%	$1,826	(1%)	$1,556	4%
RPU (less fuel)(1)	$2,875 RECORD RPU LF	5%	$589 RECORD RPU LF	2%	$1,811	1%	$1,478 RECORD RPU LF	5%

Operating expense is where it gets interesting. They took a "non-cash" loss of $385 million on the "ongoing disposal of 703 locomotives." They're showing this as a non-GAAP number and it makes the earnings story a lot better. I will have none of it. Shrinking the locomotive fleet is part of doing business and the expense must be accounted for. Thus the numbers I show here in WIR are strictly GAAP and reflect the true performance of NS for the Q.

Operating expense including the loco disposal charge was up ten percent and operating income plummeted a whopping 41 percent to $568 million vs. nearly a $billion a year ago. The operating ratio jumped 12.4 points to 78.4 and net income dropped 44 percent to $381 million. GAAP EPS (what investors invest on) dropped 41 percent.

Key performance indicators are improving, though it's hard to tell by how much. The Service Delivery Index measures the improvement in the percent of loads being delivered when NS said they would be. There is no mention of trip plan compliance. And even if you go the non-GAAP route, operating income is still down one percent to $953 million from $966 million a year ago and the "adjusted" OR is 63.7, down 230 bps from 66.0 a year ago

It must be said that the loco dispo charge did have a positive effect on cash flow. Cash from operations increased eight percent to $955 million; free cash flow after capex and dividends was $347 million, a near double, but $466 million to buy back shares ruined it all: free cash flow after repos was minus $119 million.

I think the main take-away from all this is that the nimble non-Class I feeder line will focus on those commodity groups with the biggest losses -- aggregates, grain, lumber, metals. I also think New England railroads may benefit as CN expands its northeastern footprint. In response to a question about nearshoring, CN President JJ Ruest said

> I think this so-called nearshoring has been happening partly before the pandemic. It was related to the high labor costs in China and some of that manufacturing moving to other countries like Vietnam and that's one reason why, for example, we're working so hard on the East Coast strategy because over time Vietnam, Singapore and the countries around through to India will become a more important trade factor for us.

And on that note, here ends the first quarter earnings presentations. Berkshire reports Saturday and the BNSF numbers will be there. You'll see my comments next week, though I can say from the AAR carcounts that Week 13 YTD revenue units declined six percent vs. a year ago.