RAILROAD WEEK IN REVIEW

July 31, 2020

"When volumes began to recover late in the quarter we started recalling employees and added train starts to meet demand but we are confident that many of the changes we made during this period are durable and make CSX a stronger company." — Jim Foote, CSX president and CEO

"While the macroeconomics for energy and industrial production are forecast to be negative in the third quarter, we're focused on what we can control. In fact, the team has been able to win new business throughout our premium and manifest networks. Our car velocity improvements allow us to better compete with trucks and opens new markets for us." — Kenny Rocker, EVP, Marketing & Sales, Union Pacific

Norfolk Southern has appointed Cindy Sanborn, formerly CSX Chief Operating Officer, as Chief Operating Officer, effective September 1, succeeding Michael Wheeler who will retire, effective October 1. Sanborn most recently served as vice president of network planning at Union Pacific."— Norfolk Southern Press Release, July 27 (UNP).

CSX second quarter revenue units dropped 20 percent to 1.3 million from 1.6 million a year ago. Freight revenue was off 27 percent year-over-year. Merchandise carloads including automotive dropped 22 percent to 554,000; revenue fell 22 percent as system average RPU was down eight percent. Total revenue was $2.3 billion, down 26 percent from $3.1 billion last year.

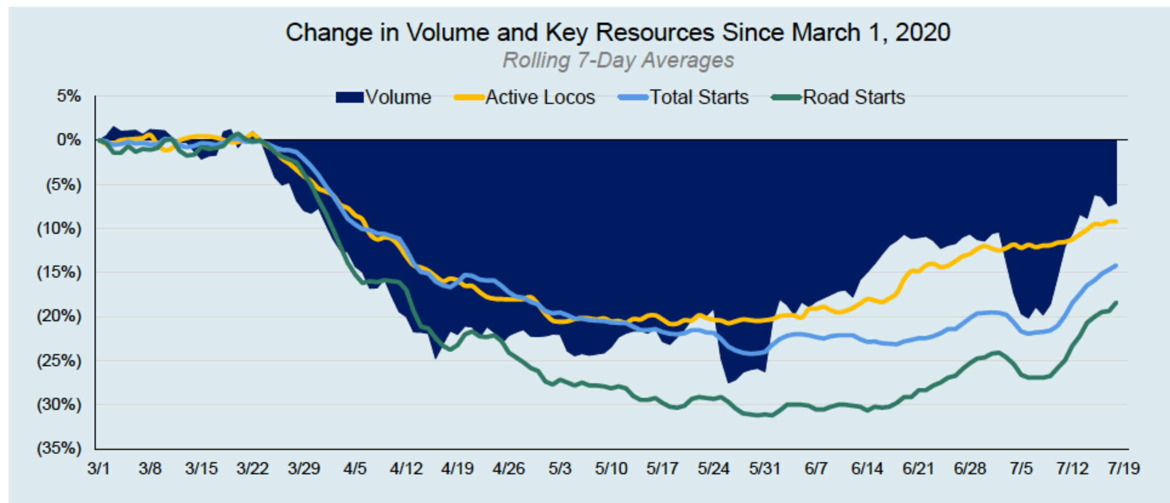
Operating expense declined 19 percent with double-digit declines in labor, fuel, and car hire etc., yet operating income skidded 37 percent to $828 million. The operating ratio added 5.9 points to 63.3. Fuel burn decreased 25 percent against a 23 percent drop in GTMs, a positive, and revenue ton-miles were off 21 percent.

Fuel efficiency improved 230 basis points to 0.96 gallons per thousand GTMs. Below the line, net income was off 43 percent to $499 million vs. 870 million a year ago. Cash from operations came down four percent to $2.2 billion; capex increased four percent to $801 million; and free cash flow after capex and dividends was $983 million, down 11 percent.

The carload commodity story shows some serious hits. Carloads in chemicals were down on fewer loads of industrial chemicals, petroleum, and waste. Minerals were off thanks to declines in limestone and others. Ag and food fell on food, grains, and ethanol; naturally ferts followed. Lower automotive and industrial production hammered the metals group, and both forest products STCCs being off took the group down.

Even though the quarterly numbers are grim, traffic is on the mend. CSX moved 111,141 revenue units in Week 13, down 9.6 percent, hit a low of 91,167 units in Week 19, down 23.9 percent, and by week 26 had recovered to 106,504 units, down 12.8 percent. This presentation slide tells the story most eloquently.

ADJUSTED RESOURCES IN RESPONSE TO LOWER VOLUMES



Foote certainly tried to put his best foot forward on the call. He concludes, "While these trends are encouraging the ultimate path of the recovery remains too wide to accurately predict at this point." Yet since better service begets more business, the fact that trip plan compliance is getting better -- second quarter on-time arrivals were 84 percent vs 73 percent a year ago — is a plus. And with the carload sector comprising two thirds of the revenue stream on 41 percent of total revenue units, I'd say the outlook for CSX and its feeder lines is encouraging.

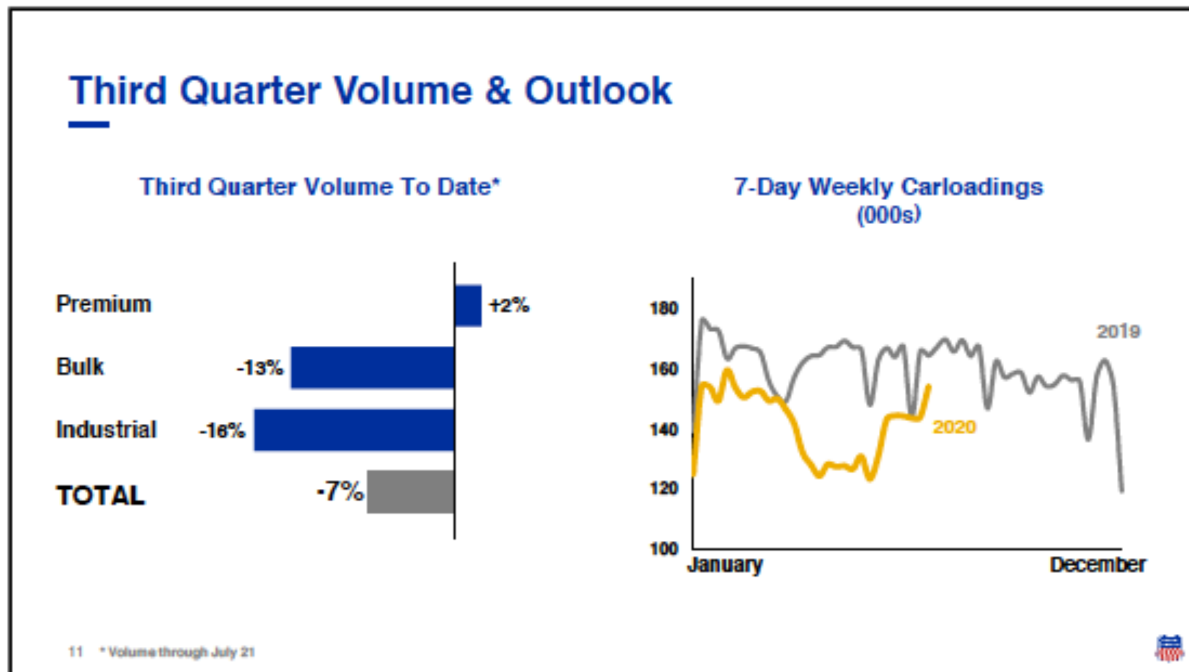
Union Pacific second quarter revenue decreased 24 percent to $4.2 billion as 1.7 million revenue units was a decrease of 20 percent; system RPU was off six percent. Carloads were off double-digits in every group but grains/grain products and ferts. Ditto for revenue by commodity. Operating expense decreased 22 percent, operating income decreased 27 percent to $1.7 billion, and the OR increased 141 basis points to 61.0. Net income decreased 28 percent to $1.1 billion.

Kenny Rocker's commodity comments on the call were particularly helpful in that he paired the current situation with the outlook so you had both in context. Too often you get current commentary up front and the outlook toward the end. Paraphrasing his remarks, carloads of grain and grain products were down six percent as the pandemic reduced demand for ethanol and related products. This was partially offset by increased shipments of export feed grain. Fertilizer and sulfur carloads were slightly down two percent, partly because of a one-time 2019 event related to tight barge capacity.

As for what's coming in ag, Rocker sees a more positive outlook on grain exports due to purchases by China. In addition, ethanol production is expected to continue its recovery from historical lows in the second quarter. There will be continued challenges in sand with oil prices, combined with the recent financial risk that frac sand producers are facing coupled with continued in-basin supply.

The food & beverage sector was down 21 percent, primarily driven by COVID-related production challenges for import beer and supply chain shifts in other food products.
Forest products volume decreased by 11 percent. Fewer lumber shipments were driven by mill curtailments due to a reduction in housing starts. Industrial chemicals and plastic shipments declined by ten percent due to pandemic-related impacts on demand.

Metals and minerals volumes decreased by 19 percent due primarily to reduced sand shipments from drilling budget reductions associated with the decline in oil prices and a surplus of local sand. UP expects to see continued declines in sand with low oil prices and the new financial risks that distant frac sand producers are facing due to continued in-basin supply.



The carload sector is not off to a good third quarter start though, like the other Class Is reporting to date, the trend is generally up and to the right. I think Rocker's put the right revenue-producing tools in place to capitalize on UP's PSR successes to date.

Norfolk Southern brought up the earnings call markers on Wednesday, and it's not a pretty sight. Net income was cut nearly in half (-46 percent) to $392 million from $722 million last year. Revenue units tumbled 26 percent to 1.4 million, and revenue per unit took a four percent haircut. In fact, NS had the worst declines of all Class Is in total revenue, revenue units, RTMs, and merchandise carloads.

The merchandise carload sector was hammered to the tune of down 26 percent in revenues to $1.3 billion and carloads down 29 percent to 451 million. For the gory details, go to the AAR Week 26 carload report and see how 17 of 18 commodity lines decreased (farm products ex-grain was the exception, but it's only six-tenths of a percent of merch carloads). Paper and waste were the only categories not down double-digits; eleven lines were down 20 percent or more.

Operating expense was down 21 percent for an operating income of $610 million, down 43 percent; the operating ratio was up 715 basis points to 70.7. As noted above, Q2 net income was way down but net income for the half was off 45 percent, yet six-months cash from operations was down just 9 percent to $1.8 million, 227 percent of the net vs. 140 percent of net a year ago. Capex was down 25 percent vs 2019, and free cash flow -- cash from ops less capex -- actually gained five percent.

NS burned 32 percent fewer gallons of diesel fuel to handle 26 percent fewer GTMs. Fuel efficiency in gallons per KGTM improved 7 percent to 1.14, though it still has a way to go to reach the new industry standard of 1.0 (CSX hit 0.96 in Q2). All the service and productivity metrics are heading in the right direction, though the "Service Delivery Index" remains a mystery. Mike Wheeler said on the call, "Our service delivery index measures shipment on-time performance, indexed to 2018." It's showing 18 percent — does that mean only 18 percent of carloads arrive on time? I'd rather we had a trip plan compliance number like CSX and others.

It's a concern to me there is so little mention of customers either in the slides or the earnings call remarks. All the metrics seem very inward-looking with no mention of customer benefit or how NS intends to create more customers. I've read the earnings call transcript and I only found the word "customer" mentioned three times in the prepared remarks — all by Shaw in terms of what NS sees as customer value. No "Customers tell us…" and the carload numbers do not help.

Still, there are signs of savings in ops and stricter financial controls. Wheeler said on the call they intend to apply what they've learned in this downturn to running a faster, smarter railroad as volumes return. NS had always been a financial powerhouse until recently, and the FCF story suggests the company may be regaining some of its former vigor. Welcome, Cindy Sanborn.

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