RAILROAD WEEK IN REVIEW

January 28, 2022

"Tracy Robinson will be joining CN from five years at TC Energy and previously spent almost three decades at Canadian Pacific. She is a well-respected and seasoned public company executive with more than 35 years of operational management, strategy development, and project execution experience. She is highly regarded within the Canadian federal and provincial regulated natural gas industry and beyond." — CN press release, January 25

"We're streamlining the hiring and onboarding process. We've trimmed weeks from the process of first identifying eligible candidates; increasing trainee pay and offering [financial] incentives; lengthening and combining trains; using a variety of techniques to optimize our existing crews, including realigning crew districts and making crew bases more fungible." — Cindy Sanborn, COO, NS

"Railroading is an outdoor sport. We knew the quarter would be challenging, certainly given the grain comps. We stayed close to our customers and our operating team worked hard to find solutions across our marketplace. The pricing environment continues to be very strong." — John Brooks, EVP Marketing, CP

Dave Rosenberg writes in his Jan 10 "Breakfast with Dave," that the slippage we see in the single-family housing sector is becoming a function of affordability as more expensive digs "continue to crowd out the first-time buyer."

Dave continues, "Existing home sales tumbled five percent in December to a four-month low of 6.18 million units (annualized rate). The consensus was at 6.42 million, so a big downside miss. All the major regions posted declines — the Northeast and Midwest were down 1.3 percent apiece; the once-hot South was down 6.3 percent and the West was down 6.8 percent."

On the other hand, Berkshire's Clayton Homes sees unit volumes now two percent higher than they were in early 2020 — one way that entry-level homebuyers are dealing with the most onerous affordability conditions since 2008. However, you gotta know the territory.

The west as a whole may be down 6.8 percent, yet a shortine owner in central California writes that his lumber loadings jumped 23 percent last year and drywall loads increased 11 percent, only to cool off lately as many housing projects were being completed. Yet, "another batch of housing projects have been green lighted for this year so I expect this year to be the same.

"Nothing scientific, but looking at the new houses which are being sold while being built, the demographics are zoomers and multi-generational families moving into our service area from major metro areas. These houses are expensive — zoomers must make a lot and multigenerational families must have multiple resources to purchase a new house." I've known this chap for decades and he does his homework and knows his customers. Invaluable intelligence.

Canadian National's retiring President and CEO JJ Ruest gets high marks for what his railroad delivered in a pretty tough year. Total revenue increased three percent to C$3.8 billion, of which two thirds came from the merchandise carload franchise. Total revenue units came in at 1.4 million loads, down ten percent as intermodal and grain saw double-digit drops. The superior service product (more on this below) allowed a 15 percent jump in RPU.

Operating expense dropped three points — despite higher fuel costs — for a record fourth quarter operating income of C$1.6 billion. The OR dropped more than three points to a Q4 record C$1.6 billion; net income grew 17 percent to C$1.2 billion. Capex stayed right at 20 percent of revenue and — CN is unique among the Class Is — still had nearly a C$billion in cash for after capex, dividends, and share buy-backs.

The superior CN operating product is consistent and attractive to customers. Gains in network velocity, through network train speed, and industry-beating fuel efficiency (less than nine-tenths of a gallon per thousand GTMs) are only the tip of the iceberg. New services include unit trains of undiluted bitumen, three new facilities in Louisiana for renewable fuels, and truck-to-rail cross-border opportunities.

JJ's successor is Tracy Robinson, who assumes the mantle of President and CEO and member of its Board of Directors, effective February 28, 2022. She will be joining CN from TC Energy (EVP, President of Canadian Natural Gas Pipelines, and President of Coastal GasLink). She knows the railroads well, having previously spent almost three decades at Canadian Pacific. JJ will continue in an advisory role until Mar. 31, 2022, to ensure a seamless transition. Thanks, JJ, for a great ride. Tracy, I'm sure you'll keep the momentum going, especially with your track record in the energy industry.

Norfolk Southern turned in a much better Q than I had expected. Total freight revenue increased 11 percent to $2.9 bn even as revenue units dropped four percent to 1.7 mm; carload freight revenue grew eight percent on units up two percent. System RPU increased eight percent and carload RPU was up two percent. Intermodal took the real hit with units down seven percent, though RPU jumped 23 percent (could it be that aggressive pricing is costing boxes?).

Metals/const was the carload winner — RPU up five percent. Marketing EVP Ed Elkins says metals were up due to "sustained high demand from the manufacturing sector," adding that record merch RPU less fuel has increased on 26 of the last 27 Qs. Which makes me ask again: how much of the OR decrease is pricing and how much is from actual lowering of operating expense?

Total revenue based on 4Q2021 revenue units at the 4Q2021 reported system RPU would be $2.5 bn, down four percent Put that against the 4Q2021 operating expense and get a 69.4 OR. Reported 4Q2020 OR was 61.7, so my pro forma 4Q2021 OTR with no rate increases would have been 69.4, a 12 percent increase vs. a reported two percent decrease. Looks like rate hikes are indeed driving the OR lower.

It surely seems like management has taken the position that a mere basis point OR increase is to be avoided. Combine that with the aggressive share buy-back program and you get EPS gains which, at present multiples, generate healthy share price increases. That helps owners but not customers — a shortline owner says, for example, just one customer had to divert 400 carloads to the highway thanks to irregular NS service. He is not alone in saying service is not yet up to par.

This appears to be at odds with the upbeat tone of the call, such that one might conclude the RR is running much better. Yet volume and crew-starts were both down four percent. Train speed and dwell still lag. Recall that local freights are not included in train speed, so dwell has the largest effect on spot and pull experience. The operating goals — accelerating employee pipeline replenishment and pursuing productivity — are very laudable — let's see what it looks like at the end of March.

Canadian Pacific wrapped up the Class I earnings calls. It was a busy quarter. They came through operating challenges of network outages and extreme cold, closed KCS into a voting trust, and celebrated six consecutive years of personal injury ratio reductions. Numbers-wise, they've done better: freight revenues up a point to C$2 bn, revenue units down ten percent to 655,600; merch carloads were down 11 percent to 334,900 but revenues gained a point to C$1.4 bn. Double-digit volume hits in grain and auto were exacerbated by nine percent drops in coal and intermodal.

On the call Chief Commercial Officer John Brooks said they expect 2022 gains in potash, ferts, energy/chemicals/plastics, and metals/minerals/consumer products. The Canadian grain shortage will be alleviated by a 14 percent increase in US corn to Canada. Key to all this is going out to see the customers. Brooks says in the last few months they've sat down with close to 100 customers to "educate them on our new routes and competitive advantages."

Operating expense surged 11 percent in the Q. Reductions in payroll and car hire couldn't offset significantly jumps in fuel and purchased services adjusted for acquisition costs. Operating income fell ten percent to C$832 mm and the OR was up an unadjusted five points to 59.2. Net income slipped 34 percent strictly on below-the-line items related to the KCS transaction.