RAILROAD WEEK IN REVIEW

February 2, 2024

"The average of new orders, production, and employment through December has been negative for 16 months in a row. We have never seen a string of poor prints like this for this series (data back to 2004). While equity markets continue to scale new record heights, it is important to remember that the economic fundamentals remain poor with little signs of an improvement on the horizon." — Breakfast with Dave, Jan 30

"The freight environment in 2023 was soft, with weak demand for goods, lower levels of manufacturing activity, and generally less freight coming in from overseas. These conditions amplified our excess capacity in transportation, pressuring margins and growth opportunities." — Ed Elkins, NS Chief Marketing Officer, Jan 26

"We will continue to benefit from the new business wins that started up in Q3 and Q4 of 2023 even as some of this growth was muted by a facility outage and slower gains. With solid demand fundamentals, the ongoing ramp-up of business wins and continued synergy gains, we are setting up for a strong 2024 in energy, chemicals, and plastics."
— John Brooks, CPKC Chief Marketing Officer, Jan 30

NS results for the quarter and year disappoint. For the quarter, freight revenue dropped five percent, mainly on fuel surcharge (FSC) reductions. Revenue units fell two percent, largely due to intermodal's 13 percent free fall. Happily, merch carloads including automotive gained six percent, though RPU dropped seven percent. The oversized role that fuel surcharge (FSC) has had in boosting RPU was evident. In the quarter, FSC added but one point to the merch RPU, six percent to intermodal, and not a cent for coal.

Operating expense rose ten percent on wages and purchased services, the latter largely linked to the 2023 East Palestine event. Operating income sank 32 percent and the GAAP operating ratio increased ten points to an unwholesome 73.7 Net income was off 33 percent to $527 million.

NS burned 1.5 percent more fuel to move 2.3 percent more GTMs, suggesting NS is improving on train handling. Fuel efficiency was flat — 1.12 gallons/1000 GTMs. Free cash flow after capex and dividends fell 136 percent; free cash flow after share repurchases sank 49.2 percent. At least they cut back share repurchases by 80 percent — last year repos were about a third more dollars than capex.

I actually feel you get a better sense of how the railroad is doing when you look at a year's worth of data. The week 52 year-to-date NS carload report to the AAR is ideally suited. I am excluding automotive revenue units from the carload category because it's 90 percent auto racks. Likewise coal because it's mostly unit trains. That leaves us with 17 carload commodity categories — nine posted negative year-over-year changes.

Not negative doesn't necessarily mean positive. In most not-negative cases, the year-over-year changes range from zero to one percent. In other words, they may not have been negative deltas, but they weren't all that positive either.

This is very revealing because volume changes reflect customer demand and we look for growing demand in growing companies. Flat to down year-over-year changes in results say demand is slowing for the products or services of any company. Clearly, NS isn't seeing much change of demand for its services. And that has consequences.

On last Friday morning's earnings call, almost as an aside, CEO Alan Shaw tossed off this tidbit in his opening remarks: "We are streamlining our cost structure and eliminating inefficiencies… We'll take actions this year to reduce costs in [several] areas. This includes a program to reduce management headcount by roughly seven percent to help offset increases in critical operating areas." My understanding is this is tantamount to some 300 layoffs.

Twenty years ago NS was a financial powerhouse, the envy of the industry. But that took a long-term view and a management team that knew how to railroad. The cultures of both the Southern and the N&W were well in hand. They are sorely missed today.

Shortline support from NS has become increasingly uneven. Railroad A has blocks of cars placed and pulled from the interchange yard fairly consistently. Railroad B can't get into the yard because there's no room. Consequently crews outlaw and customers lose supply chain days. Railroad C can't even get an interchange agreement signed. A Class I friend who knows his railroad history calls NS "broken" — a sobering thought.

Canadian Pacific Kansas City brought up the earnings call markers on Tuesday. In sharp contrast to the NS earnings call, Creel and company brought a lot of energy and encouraging words to the proceedings.

You will see two sets of numbers in their filings. I'll be using the reported GAAP numbers here, showing the year-over-year comps for the CP year plus KCS for three quarters. Elsewhere — in the presentation slides, e.g. — you'll see comps for what CPKC would have delivered had the combo been in effect a year ago. See, for example Keith

Creel's slide 4 "CPKC Combined" numbers or John Brooks' Q4 revenue highlights. Carload comps were up 64 percent per GAAP and up four percent "CPKC combined."

The GAAP reported results show what the combined properties can deliver in terms of absolute numbers. For example, CPKC expects to roll out its 8,5-foot grain train model into Mexico. Metals and wood products as single-line service between Canadian origins and Mexican destinations becomes a reality. And we can't overlook automotive, where there is "solid continued production from our OEMs and steady equipment supply driven by improved operations and cycle times, particularly in Mexico."

That's what can be. Here's what Q4 looks like in GAAP terms. Total revenue increased 53 percent to C$3.7 million on 1.2 million revenue units despite system RPU slipping six percent to C$3,776. Operating expense was up 58 percent and operating income rose 46 percent to C$1.4 million and the OR increased a mere 198 basis points to a highly respectable 61.8.

Below the line, net income fell 20 percent to C$1.0 billion, largely on the loss of the KCS income tax credit taken a year ago. Cash from operations year-to-date was C$4.1 billion, even with last year. Free cash flow after capex dropped a third as capex jumped 59 percent. Earnings as a percent of sales was 31 percent.

The 2024 combined railroad forecast calls for lower grain due to weaker harvests in Canada for the current crop year, partially offset by growth in U.S. grain and strong export potash volumes. Industrial products ought to see gains in refined fuel products, lumber and related items, and particularly strong growth in metals driven by industrial customer growth and near-shoring, partially offset by weaker frac sand.

In sum, a very encouraging report. Wall Street evidently liked it it, too, pushing shares up four percent after the close. Compare that with Norfolk's four-point share price drop on the heels of their earnings call a week ago. See what strong railroading leadership and looking ahead years rather than months can do?

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