RAILROAD WEEK IN REVIEW

July 26, 2024

"We are building a portfolio of business that works for us, fits our network, and enables us to efficiently provide strong customer service. The recent strength in our petroleum and fuels business, the growth of our sand franchise, the rebuild of our international portfolio are all part of this." — Tracy Robinson, CN President and CEO

"Freight car velocity was flat in the second quarter compared to 2023 as improvements in terminal dwell were offset by weather impacted train speeds. The opportunity here is to drive even stronger terminal dwell performance by removing unnecessary car touches across the network." — Eric Gehringer, EVP & COO, Union Pacific [my emphasis]

"We have delivered a six percent improvement in car velocity by reducing handlings, extending train schedules and improving connection performance. Car velocity is something I monitor closely. It captures improvements in our operating plan, terminal execution and over-the-road performance." — John Orr, EVP & COO, Norfolk Southern

Canadian National opened the 2Q2024 earnings calls with net income of $C1.1 million, down five percent. Earnings per share dipped half a point to $C1.75 and the share count came down four percent. (The $C2 million of share repos caused a $C900 million drop in retained earnings, not a good sign for CN's owners, and that includes shareholders.) Operating income came down three percent to $C1.6 million on revenues of $C4.3 million, largely due to a 13 percent increase in labor, for a 64.0 operating ratio, up 3.5 points since 2Q2023.

CN handled 1.4 million revenue units, up 3.7 percent, and freight revenue was up 6.7 percent, helped by a 2.9 percent increase in RPU. Merchandise carloads including automotive increased three percent and revenue for the sector increased nearly nine percent. Petroleum/chems was the hero of the quarter: revenue up 14 percent on 7.3 percent more carloads (RPU plus six percent). Grains and fertilizers including potash saw revenue up seven percent on units up the same. Forest products carloads were unchanged, though RPU was up a point, pushing the revenue line up four points.

According to the CN *Quarterly Review*, the Q2 revenue gain "was mainly due to higher volumes thanks to higher Canadian grain exports and higher shipments of international intermodal, frac sand and refined petroleum products." RPU decreased due to lower fuel surcharges and an increased average length of haul.

Elsewhere, in February CN applied to the STB to acquire the Iowa Northern Railway (IANR). The decision is due today with an effective date of 30 days thereafter. And in May CN announced its intention to transfer ownership of *Quebec Bridg*e to the Government of Canada for a nominal amount. CN will retain the requisite rights to occupy and operate the railroad portion of the bridge and will pay an annual occupancy fee over a term that also includes a non-cancellable period.

Union Pacific delivered very strong Q2024 results. I think the numbers reinforce the theme that their multi-year strategy is driving success. The solid financial performance is driven by core pricing gains and improved operational efficiency. Freight revenues increased a point to $5.6 billion even though year-over-year revenue units of two million was unchanged; fuel surcharges — down 25 percent — had minimal effect. Freight revenue and RPU without it increased both increased two percent.

Recall that UP divides its commodity book into three parts: bulk (ag-related and coal), industrial (all other merch carloads) and premium (auto and intermodal). In bulk, gains in fertilizers and STCC 20 items offset flat STCC 01 grain and the 21 percent drop in coal; industrial slipped slightly on metals/minerals and lumber-related items. Intermodal provided most of the premium upside.

Operating expense came down four percent, operating income grew nine percent to $2.4 billion, and the OR shed three points to 60 dot zero. UP gets a gold star in the fuel column: a one percent decrease in gallons consumed on the same GTMs. Revenue ton-miles came down a point. GTMs/gallon was up a point and gallons per thousand GTM was 1.078, closing in on the Holy Grail of one gallon per thousand GTMs. Net income before taxes grew an enviable 12 percent; after tax net was $1.7 billion, up seven percent.

There was virtually no share buyback program yet earnings-per-share increased six percent to $2.74. Operating cash flow for the first six months was $4.0 billion, up five percent. Free cash flow after capex and dividends was up 13 percent and the drastically reduced share buyback program let free cash flow after dividends and share repos turn positive for a change. YTD retained earnings doubled to $1.6 billion.

Given the above commentary, you can see why I'm calling this a "strong" quarter for Union Pacific. The outlook for the balance of the year calls for regained strength in STCC 01 grains and STCC 20 grain products. The industrial side looks good for petroleum and plastics in particular, and international intermodal plus automotive will support the premium side of the house. All of which shows how a management that knows how to run a railroad and pull the right levers can produce superior results.

Norfolk Southern wrapped up Week One of the Class I railroad 2Q2024 earnings calls. It's beginning to look like a serious turnaround story with all the metrics heading in the right direction. Freight revenue was $3 billion, up two percent, on 1.7 million revenue units, up five percent, though system RPU fell three percent. Coal revenue was off three percent on two percent fewer units; intermodal revenue dropped 40 basis points with revenue units increasing nine percent. (Buying loads with rate cuts??)

Merchandise carload revs increased four percent on a two percent revenue unit gain. The YTD volume mix story tells all. Merchandise slipped a point to 33 percent of total volumes from 34 percent. Coal has dropped 70 basis points to under 10 percent. And intermodal has increased to 58 percent of total volume from 55 percent a year ago.

As noted above, only merchandise carload revenue increased, posting 36 out of 37 consecutive quarters of RPU-less-fuel increases. EVP-Marketing Ed Ellis said on the call that metals and chemicals rang up revenue-less-FSC records. Be mindful that scrap metal and coke volumes are part of the metals story, and both were up. Chemicals includes non-met minerals, refinery products, and crude — all of which posted gains and account for a quarter of all merch carloads.

NS uses a lot of non-GAAP numbers to minimize the effects of the East Palestine event among other things. I do not. As far as I am concerned, accidents happen and their costs reverberate through the organization. So what follows comes from Norfolk's raw numbers rather than the reported "adjusted" numbers. Operating expense dropped 20 percent and operating income nearly doubled to $1.1 billion.

The OR shed 17.8 points to a more reasonable 62.8. Below the line, net income and diluted EPS nearly doubled to $737 million and $3.25 respectively. Free cash flow after capex and the Cincinnati Southern acquisition was negative $1.6 billion but positive without CS. Retained earnings increased six percent to $10.9 billion — a healthy sign given all the puts and takes over the last few years.

Said Alan Shaw in his closing remarks Thursday, "Our focus is on the significant productivity opportunities in front of us, which gives us the confidence in reaffirming our full year OR guidance, despite the lower revenue outlook. The momentum demonstrated in the second quarter is a testament to the strength of our strategy." Agreed.

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