RAILROAD WEEK IN REVIEW

October 25, 2019

"Fewer locos and cars online should drive lower maintenance expense and reduce network congestion, which also leads to lower expenses (fewer touches per car, less car idling time, etc.). There is often a lag between when volumes start declining and when fewer resources translate to lower expenses. CN has demonstrated its ability to align resources with demand in the past, which should provide a cushion if the freight backdrop remains weak." — Allison Landry, Credit-Suisse

"We will maintain our focus on margin improvement driven by price, service and productivity, while collaborating with our customers to provide a platform for growth. The six percent decline in volume led to a four percent revenue decline in the quarter, partially offset by increased revenue per unit, which has improved year-over-year for 11 consecutive quarters." — Alan Shaw, Chief Marketing Officer, NS

"We have a strong pipeline of unique opportunities to bring incremental volumes to Canadian Pacific. The sales and marketing team is collaborating closely with our operating team to ensure we are right sized for any business environment and we are selling to the benefits of our available capacity and our service advantages. There can be a tendency to try to commoditize the service we provide. We're not going to fall into that trap. We're not going to grow this railroad for growth's sake." — John Brooks, Chief Commercial Officer, CP

Canadian National finished the third quarter with total revenue of C$3.8 billion, up 3.9 percent, on 1.5 million units, unchanged; RPU gained 4.1 percent to C$2,471. Operating expense was C$2.7 billion, up a point. Operating income gained 8.1 percent to C$1.6 billion and the 57.9 operating ratio was a 166 basis point improvement. Net income was C$1.2 billion, up 5.4 percent.

CN continues to fire on all operational cylinders. As CEO JJ Ruest noted in his introductory remarks, "The CN franchise has a very high barrier to entry, namely, we are the only railroad that reaches the three coasts. That gives CN direct access to 15 ocean container terminals and 23 inland terminals and growing." COO Rob Reilly is making sure that access is unimpeded.

In the present quarter, CN has parked more than 6,000 freight cars and is returning the last of the leased locomotives. The goal is to "right size our fleet to the rail volumes we are experiencing and decrease our expenditures associated with them. As a result of these efforts, our active online inventory has dropped six percent year-over-year leading to a more fluid railroad." Moreover, CN continues to lead the pack in fuel efficiency: 9/10 of a gallon per thousand GTM. Mechanical is realigning resources "to improve our fleet's availability while minimizing the amount of inventory we carry at forward shop locations."

Merchandise ("rail centric supply chain" in CN parlance) carloads include coal but not automotive. Coal revenue units were unchanged as weak thermal coal exports damped the gains from a new mine. Grain dipped 7.1 percent on a late harvest, lumber shed 14 percent on curtailed mill production, petrol/chems gained 9.9 percent on Alberta crude and export plastics transloaded into containers at Port Rupert. The "consumer central supply chain" — intermodal and auto — posted gains in both.

Norfolk Southern checked in Wednesday morning with total revenue down four percent to $2.8 billion on 1.9 million revenue units, down six percent, though system average RPU increased two percent to $1,495. Merchandise carloads came to 622 million units, including automotive, down four percent.

All the commodity groups but auto posted negative year-over-year volume deltas. Twelve of the 18 specific commodities were down for the quarter, with double-digit declines in STCC 24 wood products, metallic ores, metals and metal products, ferrous scrap, and non-metallic minerals such as fertilizer.

Intermodal boxes declined five percent thanks to the triple whammy of excess truck capacity, trade uncertainty, and manufacturing declines. Coal carloads dropped 15 percent as tonnage decreased eight percent due in part to double-digit declines in export, domestic met, and industrial, though utilities still burn 57 percent of the coal NS moves.

COO Mike Wheeler showed on the call how NS is skinnying down operating activities to the bare minimum. Train speeds are up, dwells are down, merch carload trip plan compliance is up, and on schedule intermodal available times are up. Trains are getting bigger as they combine merchandise, auto, coal, and intermodal consists where possible — a far cry from the "boutique" unit trains of yore.

All of which helped trim operating expense by more than four percent, though not enough to offset the revenue decline: operating income dipped two percent to $996 million while the OR improved a mere 45 basis points to 64.9. Net income was down more than six points. Cash from operations improved four percent to $3 billion; free cash flow after capex and dividends but before share repos was down 14 percent to $798 million.

At the end of the call, my concern remains that NS is depending too much on RPU increases to offset revenue unit declines. Merch RPUs were up four percent on four percent fewer carloads, so it's almost beginning to look like higher prices are chasing away low margin businesses. To my way of thinking, that's a mistake. Carloads making RVCs of 1.3 are better than no carloads, and the added volume provides a broader base to cover ROI. Let's see what Q4 looks like.

Canadian Pacific wrapped up the week's festivities Wednesday evening with record Q3 total revenues of C$2 billion, up 4.2 percent, on 711,900 revenue units, up 1.4 percent; system RPU was up 2.8 percent, roughly equal to the other five Class Is reporting to date. The operating ratio was 56.1, an all-time low. Net income was off slightly, down 64 basis points, cash from operations was up 9.9 percent to just shy of C$2 billion, and free cash flow after capex and divs was C$512,000, up 15.8 percent.

The operating metrics improved nicely, showing better numbers for terminal dwell, train speed, car-miles per day, and trip plan compliance. Fuel efficiency slipped slightly in GTMs per gallon and gallons per thousand GTM, even as fuel burn increased 2.8 percent. GTMs increased 1.7 percent and RTMs were off 1.2 percent. The merch carload franchise (all but coal and intermodal) is 68 percent of RTMs and 70 percent of revenue.

Merch carloads were off point yet produced a 4.9 recent revenue gain. On the call, Chief Marketing Officer John Brooks noted that grain carloads are recovering (off 70 bips in the Q) and potash (down 14.2 percent) are recovering, the frac sand sector remains fractious, and shortline carload gains helped offset CP organic losses in steel and related commodities.

CP's "Connect 2019" Short Line and Transload conference convenes in Calgary this Sunday and Monday. This is the only such meeting actually held on railroad property where one can see the very trains being talked about, and the sessions are held in the pavilion housing much of the Royal Canadian equipment (which one can use for one-on-ones, BTW).

There's a reception Sunday, and Monday will be VP-level talks in the AM and commodity break-out sessions after lunch. Like last year, I suspect senior-level remarks will be geared to what the short lines can bring to CP as market extenders. As of this writing, representatives of some 30 CP partners — roughly half of of all CP short lines and regionals — will be there from properties in both Canada and the US. And, given the encouraging words on the earnings call, I'm sure there will be many positive take-aways. On both sides.