RAILROAD WEEK IN REVIEW

October 22, 2021

"We continue to operate in a challenging commercial environment with auto plant shutdowns caused by the global microchip shortage, teacher strikes, and disruption of service between Lazaro Cardenas and Mexico City, and, finally, increased regulation of refined fuel products shipments into Mexico resulting in supply chain disruptions in that area of our business." — Pat Ottensmeyer, CEO, KCS

"Our unique geographic reach and exclusive access to the Port of Prince Rupert will help us be a leader in carload growth over the next several years. Canadian grain recovery in Q4 2022 will be followed by emerging new renewable fuels and refined petroleum products projects that will propel our growth through 2023." — James Cairns, CN SVP, Rail Centric Supply Chain

"The last thing we're going to do is put ourselves in a position where we're going to draw the ire of or irritate the STB. The STB is the regulator, they're going to regulate. And we're not going to put ourselves in a position to give them any reason or justification to take exception to what we're doing." — Keith Creel, CEO, CP

"Over the course of the year we have redesigned our recruiting process to eliminate unnecessary steps and significantly shorten the time from application to job offer. We have also implemented new recruiting tools and referral programs that are better at identifying highly qualified candidates." — Jamie Boychuk, CSX EVP OPs

"We have maintained higher crew and locomotive resources in the short term to assist in reducing excess car inventories to drive increased fluidity. As operating car inventory declines, we will quickly adjust resources to current volume levels." — Eric Gehringer, UP EVP Ops

Kansas City Southern led off the Q3 earnings season Tuesday. Total revenue was $744 million, up 13 percent, on 560,400 revenue units, down three percent. RPU was $1,257, up 16 percent. Merchandise carloads — including frac sand, crude oil, and automotive — increased half a point to 267,800, as merch revenue increased 12 percent to $559,000. The shift in energy consumption resulted in 39 percent more utility coal carloads, frac sand units up by half, and crude oil a triple.

Operating income slipped seven percent to $251,900, partially due to a 14 percent comp and benefits gain, partly the result of increased hiring in the US and overtime in Mexico because of

the various non-railroad service interruptions faced.[1] The GAAP operating ratio was 66.1; back out the $35 million for merger costs and the OR becomes a respectable 61.2. Net income all-in was $156.2 million, down 18 percent.

Key operating metrics were largely improved year-over year — GTMs, train speed, terminal dwell, fuel efficiency — and those that declined YOY looked much better by the sequential quarters — train length, crew starts, craft employees. Contributing factors include increased train speed, streamlining yard operations in Mexico, and making faster crew changes at Laredo.

Adding a little more color to the significant operational strides of the quarter, EVP Ops John Orr added, "On time origination of the network improved to 87 percent versus 77 percent a year ago. And within the overall network, the execution in Mexico really stands out. Right car, right train improvements went from 82 percent versus 77 percent. The first-mile, last-mile performance has improved 86 percent and 83 percent versus 83 percent and 78 percent beginning in 2021."

As for the CP merger, Ottensmeyer expects that they will set a date for the special shareholders meeting following the completion of the STB review, probably next quarter. KCS shareholders will get their money on closing into the Voting Trust, probably in 1Q2022. CP is expected to take full control in late 2022. Until then, I'd say Ottensmeyer & Co. have prepared a superb property to convey to our friends in Calgary.

Canadian National reviewed its Q3 Tuesday afternoon. Total revenue increased five percent to C$3.6 billion on 1.4 million revenue units, off a point. RPU gained six percent to C$2.042. Merch carloads dipped a point to 669,000 with gains in petrol/chems and mets/mins while forest products, grains/ferts, and auto all posted losses. The outlook is more robust, however, with gains projected in intermodal volumes to all three coasts, propane, grains, fertilizers, and lumber.

Operating expense increased 10 percent, pushing ops income down two points to C$1.3 billion and the GAAP operating ratio increased 273 basis points. Net income, including the C$886 below-the-line merger termination fee, was C$1.7 billion. GTMs slipped three points even though fuel burn increased seven percent; RTMs dropped a point with merch carloads representing 64 percent of the total. Fuel efficiency increased nine percent to another industry-leading 0.84 gallons per 1,000 ton-miles.

Perhaps the big news *du jour* was JJ Ruest's announcement that he will be retiring as President and CEO effective Jan 31, 2022. According to the press release, the actual retirement date could be "at such later time as a successor has been appointed to ensure a flawless transition." The Board has appointed a CEO Search Committee of select Board members to conduct the global search and make recommendations to the full Board, though no time line has been set.

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[1] *One of which is AMLO's "desire to put the state in control of the energy industry." — Mary Anastasia O'Grady, WSJ, Oct 20. At the top of the list is electricity, where the aim is to help Pemex unload its hi-sulfur fuel, which now goes to the US for de-sulfurization and returned for the power generating plants. O'Grady adds, "The bill violates the former NAFTA agreement by abrogating contracts" and more.*

It seems odd JJ would retire before the Special Shareholders Meeting scheduled for next March and makes one wonder whether it has anything to do with the recent TCI board intrigue. Tony Hatch writes, "My initial thought is: how do you go into battle without your general? I remain confused….is this a white flag? Is Jim Vena the anointed one? CN announced a search for a 'World Class Leader' to replace JJ (interestingly language similar to the TCI deck from yesterday). Can the CN's new WCL be ready to battle with TCI's picked WCL?"

Hard to tell. However, JJ said on the call "We intend to use a balanced approach, achieving operational excellence rationalizing our cost structure, adjusting capex, and capitalizing on our technology investments." Could this mean an end to the Cult of the Operating Ratio? Regardless of how it all sorts out, JJ and his predecessors have made Canadian National a prime example of How to Run a Railroad and build a sticky customer base.

Canadian Pacific started its call at 0800 Wednesday, with CEO Keith Creel setting the tone citing the CP focus on "the elements we can control." CP total revenue increased four percent to C$1.9 billion as 665,000 revenue units represented a mere one percent increase. Operating income slipped 60 basis points to C$774 million and the GAAP operating ratio added two points to a still-respectable 60.1. Net income dropped 21 percent to C$472 million thanks to an increase of nearly C$100,000 in Other Expense.

The quarter was not without its challenges, starting with a 29 percent decrease in grain because of a 40 percent decrease in crop size this year; the 18 percent drop in potash will likely correct itself on strong prospects ahead. Ferts did OK as a better crop year will demand more nutrients. The energy/chems/plastics group ("ECP" in CP parlance) was up 23 percent and Metals/minerals/consumer (MMC) increased 19 percent. Short lines are clearly winners here.

Fuel expenditure increased 42 percent, mainly on the 57 percent in the per-gallon price. Fuel burn actually came down four percent on two percent lower GTMs. Fuel efficiency improved two percent to 0.908 gallons per 1,000 GTMs. The cash flow picture is quite encouraging. Cash from ops increased by two thirds to C$3.1 billion, free cash flow after Capex jumped by a factor of four to C$2.0 billion. There were no share repos so FCF at the end of the day was C$1.6 billion vs (C$808) million a year ago. I'd say CP is on a roll.

CSX closed out Wednesday with 3Q freight revenue of $2.9 billion, up 12 percent, on 1.6 million revenue units, up three percent. RPU increased nine percent to $1,823. Operating income rose 26 percent to $1.4 billion, net income rose 32 percent to $968 million. Total revenue now includes the Quality Carriers acquisition, $200 million. Carload results are not affected.

This was the first time I've heard COO Jamie Boychuk on the call and his remarks surrounding slide 7 were enlightening. Intermodal trip plan compliance was 88 percent; carload TPC was 68 percent — obviously needs work. (Note: carload TPC is to/from shortline interchange; it does not include shortline dwell time interchange on/off.)

T&E hiring is on the increase, run-arounds are being extended, and yard throughput is being accelerated. The presentation slides carry more useful information than they have in a while. The slide 5 commodity commentary is good to see here, rather than buried in the Quarterly Financial Report.

In the merchandise sector, chemicals were up on plastics, frac sand, waste but lost a bit on crude. Ag/food took hits in export grain and ethanol. Minerals — largely construction commodities — increased as a result of higher shipments of aggregates, cement, lime and limestone. Forest products posted higher shipments of pulpboard, woodpulp and building products.

Metals increased across the board, and ferts rose even though long-haul moves were flat due to phosphate declines. Overall, the tone of the call was the most positive I've heard from Foote & Co. We now have some specific targets to measure against.

Union Pacific brought up the markers Thursday morning. My first impression from the UP call was one of a company making serious strides in productivity and financial results. Five of the eight industrial and bulk commodity groups posted double-digit volume increases. Revenue increased 12 percent to $5.6 billion on flat volumes; RPU also increased five percent or more everywhere but grain.

Operating income was $2.4 billion, up 20 percent, as ops expense was held to a nine percent gain — comp/benefits up three percent, equipment rents (mainly car hire) flat on faster turn times, purchased services and materials flat. Fuel jumped 81 percent on a 74 percent per-gallon price increase yet burn increased just four percent on a five percent GTM increase. Gallons/KGTM decreased one percent. Net income and free cash flow after Capex both increased 23 percent.

Kenny Rocker's marketing slides get the Best in Class award among all the Class I commercial slides shown. Each merchandise category slide shows, across the top, revenue, volume and RPU; the middle shows volume change bar charts for each; the bottom shows what caused the changes. Second prize goes to the operating department for their portrayal of Key Performance Metrics. I especially like the sequential changes.

I think UP's strong story was a fitting close for a week of aggressive results presented with a minimum of hype and maximum clarity. I'm sure NS will follow through next Wednesday.